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TERAFORCE TECHNOLOGY CORP

Form 10-Q

November 14, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10 - Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2002

Commission File Number 0-11630

TERAFORCE TECHNOLOGY CORPORATION
(exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

76-0471342
(I.R.S. employer
Identification No.)

1240 EAST CAMPBELL ROAD, RICHARDSON, TEXAS
(Address of principal executive offices)

75081
(Zip code)

469-330-4960
(Registrant's telephone number, including area code)

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

There were 95,338,850 shares of Common Stock outstanding as of October 31, 2002.

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TERAFORCE TECHNOLOGY CORPORATION AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

TERAFORCE TECHNOLOGY CORPORATION AND SUBSIDIARIES Consolidated Condensed Balance Sheets (Thousands of dollars, except share data)

	SEPTEMBER 30, 2002	DECEMBER 31, 2001
	-----	-----
	(UNAUDITED)	
Assets		

Current assets:		
Cash and cash equivalents	\$ 5	\$ 1

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Temporary cash investments	662	53
Accounts receivable net of allowances of \$1,658 in 2002 and \$1,691 in 2001	578	869
Receivables from affiliate	779	816
Inventories	2,693	3,262
Prepaid services	321	-
Net current assets of discontinued operations	-	2,880
Prepaid expenses and other current assets	764	224
	-----	-----
Total current assets	5,802	8,105
Property and equipment, net	623	638
Investment in affiliate	884	1,284
Other assets	281	169
	-----	-----
	\$ 7,590	\$ 10,196
	=====	=====
Liabilities and Stockholders' Equity (Deficit)		

Current liabilities:		
Notes payable	\$ 3,800	\$ 7,554
Accounts payable	1,114	1,864
Accrued liabilities	1,435	2,389
	-----	-----
Total current liabilities	6,349	11,807
	-----	-----
Long-term notes payable	2,900	-
Other long-term liabilities	1,200	-
Stockholders' (deficit) equity:		
Common stock, \$.01 par value. Authorized 200,000,000 shares; 89,922,184 and 87,088,850 shares issued in 2002 and 2001, respectively	899	871
Additional paid-in capital	181,979	181,898
Accumulated deficit	(184,150)	(182,793)
	-----	-----
	(1,272)	(24)
Less 400,474 shares of common stock in treasury - at cost	(1,587)	(1,587)
	-----	-----
Total stockholders' equity (deficit)	(2,859)	(1,611)
	-----	-----
	\$ 7,590	\$ 10,196
	=====	=====

See accompanying notes to consolidated condensed financial statements.

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	THREE MONTHS ENDED SEPTEMBER 30,		NINE SE
	2002	2001	2002
	(UNAUDITED)		
Net revenues	\$ 718	\$ 925	\$ 4,007
Cost of revenue	625	1,510	2,344
	-----	-----	-----
Gross profit (loss)	93	(585)	1,663
	-----	-----	-----
Expenses:			
Engineering and development	546	1,276	2,486
Selling and administrative	1,743	2,099	4,614
Costs related to sale of assets	-	1,570	-
	-----	-----	-----
	2,289	4,945	7,100
	-----	-----	-----
Operating loss	(2,196)	(5,530)	(5,437)
	-----	-----	-----
Other income (expense):			
Litigation settlement	-	-	6,300
Share of loss of unconsolidated affiliate	(295)	-	(401)
Interest expense	(125)	(69)	(315)
Interest income and other	62	(31)	16
	-----	-----	-----
	(358)	(100)	5,600
	-----	-----	-----
Income (loss) from continuing operations	(2,554)	(5,630)	163
Loss from discontinued operations	(1,520)	(1,117)	(1,520)
	-----	-----	-----
Net loss	\$ (4,074)	\$ (6,747)	\$ (1,357)
	=====	=====	=====
Basic and diluted loss per share:			
Continuing operations	\$ (.03)	\$ (.06)	\$ -
Discontinued operations	(.02)	(.02)	(.02)
	-----	-----	-----
Net loss per share	\$ (.05)	\$ (.08)	\$ (.02)
	=====	=====	=====
Weighted average number of common shares outstanding (thousands) basic and diluted	88,725	86,689	87,968
	=====	=====	=====

See accompanying notes to consolidated condensed financial statements.

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(Thousands of dollars)

	NINE MONTHS SEPTEMBER ----- 2002 ----- (UNAUDITED)
Cash flows from operating activities:	
Net loss	\$ (1,357)
Adjustments to reconcile net loss to net cash used in operating activities:	
Litigation settlement	(6,300)
Utilization of prepaid services	679
Depreciation and amortization	177
Share of loss of unconsolidated affiliate	401
Other	927
Changes in operating assets and liabilities:	
Accounts receivable	29
Inventories	569
Assets held for sale	-
Accounts payable and accrued liabilities	(1,241)

Net cash used in operating activities	(6,116)

Cash flows from investing activities:	
Proceeds from litigation settlement	6,300
Capital expenditures	(154)
Investment in temporary cash investments	(609)
Net proceeds from disposal of discontinued operation	1,337
Proceeds from sale of assets	-
Investment in joint venture	-
Other	-

Net cash provided by investing activities	6,874

Cash flows from financing activities:	
Proceeds from issuance of notes payable	500
Principal payments on notes payable	(1,354)
Proceeds from issuance of common stock	100

Net cash provided by (used in) financing activities	(754)

Net increase (decrease) in cash and cash equivalents	4
Cash and cash equivalents, beginning of period	1

Cash and cash equivalents, end of period	\$ 5
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See accompanying notes to consolidated condensed financial statements.

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TERAFORCE TECHNOLOGY CORPORATION Notes to Consolidated Condensed Financial Statements (Unaudited) September 30, 2002

BASIS OF PRESENTATION

The accompanying consolidated financial statements have been prepared by the Company without audit in accordance with accounting principles generally accepted in the United States of America for interim financial statements and with instructions to Form 10-Q and Rule 10-01 of Regulation S-X. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included.

The accompanying consolidated financial statements do not include certain footnotes and financial presentations normally required under accounting principles generally accepted in the United States of America and, therefore, should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K as of December 31, 2001.

The Company incurred an operating loss in the first nine months of 2002 and has incurred significant operating losses in 2001, 2000 and 1999. These losses were funded by proceeds from the issuance of equity securities and notes payable and the proceeds from the settlement of litigation. As of September 30, 2002, notes payable due within one year amounted to \$3,800,000. In 2001 and through January 2002, the Company disposed of certain operations and assets and has reduced operating expenses. In addition, for the first nine months of 2002 revenues from the Company's defense electronics business exceeded those recorded for the first nine months of 2001, have increased in each of the last three years, and are expected to continue to increase. Accordingly, management expects the Company to generate positive cash flow from operations in the near future. However, there is no assurance that revenues will increase such that the Company will generate positive cash flow from operations. Until that point, the Company expects to generate losses and negative cash flow from operations. Furthermore, should the Company not generate positive cash flow from operations within the expected time frame, additional capital may be required to fund operating losses.

In January 2002, the Company received cash proceeds of \$1,660,000 from the sale of its engineering design services business and in March 2002, received cash proceeds of \$6,300,000 from the settlement of litigation. In September, October and November of 2002 the Company reduced and restructured its outstanding debt and raised additional working capital from the sale of common stock in a series of private placements.

In October 2002, the Company reduced amounts outstanding under its bank facilities by \$2,000,000 with proceeds from the sale of common stock. After this reduction the Company's outstanding debt obligations amounted to approximately \$4,700,000. In October 2002, \$2,500,000 of these remaining obligations was amended such that \$2,500,000 matures on March 26, 2004, with quarterly reductions of \$450,000 beginning December 31, 2002. The Company believes it has reached an agreement in principle, subject to definitive documentation, to extend the maturity of approximately \$2,200,000 of remaining debt to September 2003.

Subsequent to September 30, 2002 and through October 31, 2002 the Company has raised approximately \$750,000 from the sale of common stock and expects to sell additional common stock.

TERAFORCE TECHNOLOGY CORPORATION
Notes to Consolidated Condensed Financial Statements
(Unaudited)
September 30, 2002 (continued)

The Company believes that these amounts and other potential sales of common stock will be sufficient to fund its expected operating losses. The Company further believes that its restructured debt obligations can be satisfied with cash flow generated from operations or from the issuance of other debt or equity securities. However, there can be no assurance the Company can accomplish this or that it can do so under acceptable terms. These financial statements have been prepared assuming the Company will continue as a going concern and do not include any adjustments that might result from the outcome of this uncertainty.

INVENTORIES

The components of inventories are as follows:

	SEPTEMBER 30, 2002	DECEMBER 31, 2001
	-----	-----
	(\$ THOUSANDS)	
Raw materials	\$2,076	\$2,615
Work in progress	330	493
Finished goods	287	154
	-----	-----
	\$2,693	\$3,262
	=====	=====

SEGMENTS OF BUSINESS

Net revenues by business segment:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	-----	-----	-----	-----
	2002	2001	2002	2001
	-----	-----	-----	-----
	(\$ THOUSANDS)			
Defense electronics	\$718	\$814	\$4,007	\$3,243
Optical networking equipment	-	86	-	2,368
Other	-	25	-	260
	----	----	-----	-----
	\$718	\$925	\$4,007	\$5,871
	=====	=====	=====	=====

Segment-specific margins (gross profit less total engineering and

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development costs for the segment):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2002	2001	2002	2001
	(\$ THOUSANDS)			
Defense electronics	\$ (557)	\$ (1,205)	\$ (557)	\$ (1,698)
Optical networking equipment	107	(386)	(88)	(1,079)
Other	(3)	(270)	(178)	(2,022)
Subtotal segment specific	(453)	(1,861)	(823)	(4,799)
Selling and administrative expenses	(1,743)	(3,669)	(4,614)	(8,940)
Operating loss	\$ (2,196)	\$ (5,530)	\$ (5,437)	\$ (13,739)

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TERAFORCE TECHNOLOGY CORPORATION Notes to Consolidated Condensed Financial Statements (Unaudited) September 30, 2002 (continued)

Assets are identifiable only by combined segments as follows:

	AT SEPTEMBER 30, 2002	AT DECEMBER 31, 2001
	(\$ THOUSANDS)	
Defense electronics	\$3,728	\$ 4,052
Optical networking equipment and other	1,896	2,625
Not allocable to a segment	1,966	3,519
Total	\$7,590	\$10,196

INCOME TAXES

For the nine months ended September 30, 2002 and 2001 the Company's effective income tax rate differed from the federal statutory rate due to taxable losses incurred for which no benefit was provided.

EARNINGS PER SHARE

Basic and diluted earnings per share are the same for the nine months ended September 30, 2002 and 2001 because all potential common shares were anti-dilutive for those periods.

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NOTES PAYABLE

In October 2002, the Company amended its \$4,500,000 Business Loan Agreement with Bank One, NA ("Bank One") dated June 1, 2001, as amended. Amounts outstanding under the facility were reduced by \$2,000,000 with the proceeds from the sale of common stock (See Stockholders' Equity) and the facility was amended. Under the loan agreement, the Company may borrow up to \$2,700,000 on a revolving basis. The amount available for borrowing is reduced by \$450,000 per quarter beginning December 31, 2002. All amounts outstanding under the facility are due on March 26, 2004. The amended facility is secured by a non-revocable letter of credit provided by a private investor.

The Company believes it has reached an agreement in principle regarding its \$1,500,000 Loan Agreement with Bank One dated October 12, 2001, as amended. Under the agreement the facility will be amended to provide for a maturity of September 15, 2003, secured by the unconditional guarantee of the private investor that provides the security for the Company's amended \$2,700,000 credit facility with Bank One. The Company also has outstanding \$600,000 in notes payable in favor of this same private investor and believes it has reached an agreement in principle, subject to definitive documentation, to replace these notes with a note payable with a maturity of September 15, 2003. The Company expects to issue the private investor certain warrants as compensation for the credit support provided (See Stockholders' Equity).

COMMITMENTS AND CONTINGENCIES

The Company is contingently liable for certain potential liabilities related to discontinued operations. Specifically, under a stock purchase agreement dated October 3, 1995, the Company

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TERAFORCE TECHNOLOGY CORPORATION
Notes to Consolidated Condensed Financial Statements
(Unaudited)
September 30, 2002 (continued)

agreed to indemnify Savage Sports Corporation ("Savage Sports"), the purchaser of Savage Arms, Inc. (a manufacturer of firearms), for certain product liability, environmental clean-up costs and other contractual obligations, including certain successor liability claims. One of the liabilities assumed involves a firearms product liability lawsuit filed in Alaska Superior Court (the "Taylor Litigation"). A defendant in the Taylor Litigation, Western Auto Supply Co. ("Western Auto") settled the suit for \$5,000,000. Western Auto assigned its indemnification claims against Savage Arms, Inc. to its insurance carriers who in turn asserted claims against Savage Arms, Inc. for the amount of the settlement plus attorney's fees, interest and related costs. In August 2002 Savage Arms, Inc. entered into a Confidential Settlement Agreement and Release with the insurance carriers related to these claims.

In October 2002 the Company and Savage Sports reached agreement in principle regarding the Company's indemnification regarding this and any other related matters. Pursuant to this agreement the Company will pay to Savage Sports a total of \$1,575,000 over a four year period, with \$375,000 payable through October 31, 2003. Under the settlement arrangement, Savage Sports will fund the cost of insurance programs that are expected to respond to any other such claims that may arise. The Company is aware of no such claims and Savage

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Sports has advised the Company that they are aware of no additional claims. As a result of the agreement in principle with Savage Sports the Company has recorded a charge of \$1,520,000 related to this matter in the three months ended September 30, 2002.

The Company has entered into an agreement for the design and manufacture of a "ruggedized" version of its PowerPC products. Ruggedized products are designed to be utilized in harsh environments such as extreme temperature, shock and vibration. Under this agreement, a third party will provide certain design services, testing equipment and will produce initial production quantities of the product. The Company expects that payments by the Company under this agreement will approximate \$700,000 over the next six to nine months. The majority of this amount relates to production quantities of the product that the Company expects to sell to its customers as the product is available from the manufacturer. The Company has provided a \$185,000 standby letter of credit to collateralize its obligations under this agreement.

STOCKHOLDERS' EQUITY

In April 2002, the Company issued 2,000,000 shares of common stock in exchange for the return and cancellation of warrants to purchase a total of 26,017,308 shares of common stock. The warrants had an exercise price of \$0.75 per share. Since the common stock was issued in exchange for other equity securities, the transaction was recorded by crediting common stock for the par value of the shares issued with offsetting debit to additional paid-in capital.

In October 2002, the Company issued 16,666,668 shares of common stock to two private investors for an aggregate of \$2,000,000 in cash. These two private investors had previously provided letters of credit that secured a portion of the Company's \$4,500,000 Business Loan Agreement with Bank One. The proceeds from the sale of this common stock were used to repay amounts outstanding under this loan agreement. In addition, the Company issued to these investors warrants for the purchase of 400,000 shares of common stock at \$0.12 per share, exercisable until September 30, 2005. Other warrants, previously issued to these investors, for the purchase of 780,000 shares of common stock were amended to provide for an exercise price of \$0.12 per share.

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TERAFORCE TECHNOLOGY CORPORATION
Notes to Consolidated Condensed Financial Statements
(Unaudited)
September 30, 2002 (concluded)

In September 2002, the Company issued 833,334 shares of common stock to a private investor for \$100,000 in cash. Subsequent to September 30, 2002, the Company has issued a total of 5,416,666 shares of common stock for \$650,000 in cash in a series of transactions with private investors. Proceeds from the sale of this common stock have been used for working capital.

In connection with the completed and expected restructuring of its debt obligations and in consideration for the debt support provided by the private investor (See Notes Payable), the Company expects to issue warrants for the purchase of 960,000 shares of common stock at a price of \$0.12 per share to the private investor. These warrants are exercisable until October 31, 2004. In addition, the Company expects to amend warrants for the purchase of 1,830,000 shares of common stock, previously issued to this investor, to provide for an

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exercise price of \$0.12 per share.

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ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD LOOKING STATEMENT

This Quarterly Report on Form 10-Q contains certain forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. In this report, as well as in oral statements made by the Company or Management, statements that are prefaced with the words "may," "will," "expect," "anticipate," "believe," "continue," "estimate," "project," "intend," "designed" and similar expressions are intended to identify forward-looking statements regarding events, conditions and financial trends that may affect the Company's future plans, business strategy, results of operations, financing activities and financial position. These statements are based on the Company's current expectations and estimates as to prospective events and circumstances about which the Company can give no firm assurance. Further, any forward-looking statement speaks only as of the date the statement was made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date the statement was made. Because it is not possible to predict every new factor that may emerge, forward-looking statements should not be relied upon as a prediction of actual future financial condition or results. Examples of types of forward-looking statements include statements on future levels of net revenue, costs and cash flow, new product development, strategic plans and financing. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those projected or anticipated. Factors that might cause such a difference include, but are not limited to: general economic conditions in the markets the Company operates in; success in the development and market acceptance of new and existing products; dependence on suppliers, third party manufacturers and channels of distribution; customer and product concentration; fluctuations in customer demand; governmental regulations and controls; the ability to obtain and maintain access to external sources of capital; the ability to control costs; overall management of the Company's expansion; and other risk factors detailed from time to time in the Company's filings with the Securities and Exchange Commission. The terms "we," "our" and "us" and similar terms refer to the Company and its consolidated subsidiaries, not to any individual or group of individuals.

RESULTS OF OPERATIONS

Our engineering design services business was sold in January 2002. As of December 31, 2001 this business is accounted for as a discontinued operation in our financial statements. Accordingly, net revenues, cost of revenues and expenses in the accompanying financial statements do not include any amounts related to these operations. The net operating results of this business are reflected as a loss from discontinued operations in the accompanying statements of operations.

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COMPARISON OF THIRD QUARTER AND NINE MONTHS 2002 TO 2001

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2002	2001	2002	2001
	-----	-----	-----	-----
	(\$ THOUSANDS)			
Net revenues:				
Defense electronics	\$718	\$ 814	\$4,007	\$3,243
Optical networking equipment	-	86	-	2,368
Other	-	25	-	260
	----	-----	-----	-----
	\$718	\$ 925	\$4,007	\$5,871
	=====	=====	=====	=====
Gross profit (loss):				
Defense electronics	\$ 93	\$ (547)	\$1,663	\$ (36)
Optical networking equipment	-	-	-	-
Other	-	(38)	-	(730)
	----	-----	-----	-----
	\$ 93	\$ (585)	\$1,663	\$ (766)
	=====	=====	=====	=====

Net revenues from optical networking products during 2001 represent sales related to our OmniLynx product line. In August 2001, we sold the OmniLynx product line to Intelect Technologies, Inc.

Gross profit from defense electronics increased in the third quarter of

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2002 as compared to the third quarter of 2001, despite the lower net revenues. For the first nine months of 2002, gross profit from defense electronics also increased as compared to the same period in 2001. The increase in gross profit is a result of higher utilization of fixed production costs and the sale of products with lower material costs than in prior periods. Gross profit in the three and nine months ended September 30,

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2002 was reduced by approximately \$87,000 and \$117,000, respectively, due to the revaluation of component inventories to the lower of cost or net realizable value.

As of December 31, 2000, all assets related to the OmniLynx product line were adjusted to the lower of cost and net realizable value. Accordingly, sales of OmniLynx products during 2001 produced no gross profit.

ENGINEERING AND DEVELOPMENT (E&D) EXPENSE

Engineering and development expense decreased 57% to \$546,000 in the third quarter of 2002 from \$1,276,000 in the same period in 2001. For the first nine months of 2002, these expenses decreased 38% from the comparable period in 2001. Costs by product line are as follows:

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2002	2001	2002	2001
	(\$ THOUSANDS)			
Defense electronics	\$ 650	\$ 658	\$2,220	\$1,662
Optical networking equipment	(107)	385	88	1,078
Other	3	233	178	1,293
E & D expense	\$ 546	\$1,276	\$2,486	\$4,033

Engineering and development expenses related to defense electronics in the third quarter of 2002 and first nine months of 2002 reflect on-going enhancements of our PowerPC based products, including "ruggedized" versions of these products, our WingSpan(TM) software environment and other product initiatives. The reduced expenses related to optical networking products reflect the recoupment of certain third party costs related to our Aegean project. As of July 31, 2002 we suspended essentially all activity related to this project. Other engineering and development expenses were primarily incurred in the first quarter of 2002 related to our Centauri project. We suspended essentially all activity related to the Centauri project in March 2002. Engineering and development expenses during the third quarter and first nine months of 2002 include approximately \$119,000 and \$679,000, respectively, of non-cash costs related to design services provided by Flextronics International, Ltd. ("Flextronics"). These services are provided under the engineering design services agreements we entered into when we sold our engineering design services business in January 2002. Other engineering and development expenses in the first nine months of 2001 include approximately \$657,000 related to the engineering organization involved with the Omnilynx product line.

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SELLING AND ADMINISTRATIVE EXPENSE

Selling and administrative expenses decreased \$356,000, or 17%, in the third quarter of 2002 as compared to the third quarter of 2001. For the nine months ended September 30, 2002, selling and administrative expenses decreased \$2,756,000, or 37%, from the same period last year. Approximately \$2,490,000 of this decrease for the first nine months of 2002 relates to costs associated with the OmniLynx product line. The balance of the reduction relates primarily to reduced headcount.

LITIGATION SETTLEMENT

In March 2002, we settled our litigation against Cadence Design Systems, Inc. We received \$6,300,000, net of attorney fees, from this settlement.

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SHARE OF LOSS OF UNCONSOLIDATED AFFILIATE

These amounts represent our proportionate share of the losses of Intelect Technologies, Inc. ("ITI") for the third quarter and first nine months of 2002. ITI was formed in August 2001, and acquired our OmniLynx product line and related assets at that time. We own 33% of the common stock of ITI.

INTEREST EXPENSE

Due to increased borrowings in 2002, interest expense increased by \$56,000 and \$227,000 in the third quarter and first nine months of 2002, respectively, as compared to the comparable periods last year.

LOSS FROM DISCONTINUED OPERATIONS

In the third quarter of 2002 we recorded a charge of \$1,520,000 resulting from the settlement of our indemnity obligations to Savage Sports Corporation. (See Part II - Other Information - Item 1- Legal Proceedings) Our operations that were the subject of this matter have previously been accounted for as discontinued operations.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2002 the Company had cash and temporary investments of \$667,000 and a working capital deficit of \$547,000. Subsequent to September 30, 2002 we reduced and restructured our funded debt as follows:

- o Our \$4,500,000 credit facility with Bank One was reduced by \$2,000,000 with the proceeds from the sale of common stock.
- o The \$4,500,000 credit facility with Bank One was amended to provide for total borrowings of \$2,700,000, a final maturity of March 26, 2004 and provide for quarterly reductions of \$450,000 in the amount available for borrowing, beginning December 31, 2002. This facility is secured by an irrevocable letter of credit provided by a private investor.
- o We expect to amend our \$1,500,000 credit facility with Bank One

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to provide for a maturity of September 15, 2003. This facility is secured by the unconditional guarantee of the private investor mentioned above.

- o We expect to amend notes payable totaling \$600,000 in favor of the above private investor to provide for a maturity of September 15, 2003.
- o The amendments to the credit facilities will not provide us significant new borrowing capacity.

The amendments of the \$1,500,000 Bank One facility and the \$600,000 in notes payable are subject to the completion of definitive documentation. In September and October, 2002 we have issued a total of 6,250,000 shares of common stock in a series of private placements. Net proceeds to us from these transactions total \$750,000. We also are engaged in other discussions regarding the possible sale of additional shares of common stock. We expect that any proceeds from these transactions will be used for working capital, to meet the scheduled reductions in our debt obligations or to reduce the debt obligations prior to their maturity.

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OPERATING ACTIVITIES

Net cash used in operating activities amounted to \$6,116,000 for the nine months ended September 30, 2002. Significant items contributing to the \$6,116,000 include the operating loss of \$5,437,000 and a net increase in working capital of \$643,000, offset by utilization of prepaid services from Flextronics amounting to \$679,000. The net increase in working capital arose primarily from a decrease in accounts payable and accrued liabilities of \$1,241,000, offset by the utilization of \$569,000 in inventory.

INVESTING ACTIVITIES

For the nine months ended September 30, 2002, investing activities provided \$6,874,000 in cash flow. This amount consists primarily of \$6,300,000 from the settlement of litigation and \$1,337,000 from the disposal of discontinued operations, which amount is net of \$462,000 of costs related to the operations. The above amounts were offset by \$154,000 of capital expenditures, primarily for test equipment, and \$609,000 used to acquire temporary cash investments. The temporary cash investments are used to collateralize letters of credit supporting insurance programs and vendor obligations.

FINANCING ACTIVITIES

In the first quarter of 2002, we borrowed \$500,000 for general working capital under a demand note. We repaid a total of \$1,354,000 in demand notes from the proceeds of the litigation settlement and the disposal of discontinued operations.

LIQUIDITY OUTLOOK

As discussed above we have recently reduced our debt obligations and have restructured, or expect to restructure, the remaining obligations to extend their maturity. We also have completed a series of private placements of common stock and expect to complete additional private placements. We expect the proceeds from these transactions, and potentially other similar transactions,

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will be sufficient to provide the working capital we expect to need until such time as we produce cash flow from operations. We also expect the proceeds from these transactions and cash flow generated by our operations in the future to meet the scheduled reduction in our debt obligations. We cannot be sure that the pending debt restructuring transactions will be completed as expected or as to the amounts of the proceeds from the future sales of common stock, if any, or the price per share at which we will sell the stock. The issuance of common stock could result in significant dilution to existing common shareholders.

We may also consider the sale of additional debt or equity securities to financial or strategic investors. Possible use of proceeds from such transactions might include general working capital, expanded or accelerated product development and marketing and reduction of our debt obligations.

If we are unable to meet the scheduled reductions and maturities of our debt obligations, we may be forced to further restructure these obligations. Such restructuring could involve the issuance of additional equity securities which could result in further dilution to existing shareholders. If we do not meet the scheduled reductions or maturities of our debt obligations, we will default on those obligations and the party that has guaranteed them will be obligated to repay those borrowings. In that case, we will have demand obligations to that party equal to the debt repaid. In that event, the

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party will have collateral rights in most of our accounts receivable and inventory. In addition, that party will be our largest creditor and could demand payment at any time. Accordingly, this party could be in a position to obtain a judgment against the Company and exert influence over our actions.

Our consolidated financial statements have been prepared on the basis of a going concern and do not include any adjustments that might be necessary if we were not a going concern. These adjustments include changes in the possible future recoverability and classification of assets or the amount and classification of liabilities.

Our estimates of capital and liquidity needs are subject to a number of risks and uncertainties that could result in additional capital needs that have not been anticipated. An important aspect of our estimated capital and liquidity requirements is our ability to generate positive cash flow from operations. We believe the primary factor in generating positive cash flow from operations is increased net revenue from our defense electronics business. We have increased revenues from these operations over the past year; however, there is no assurance that we will be able to continue to do so. Other factors contributing to our ability to generate positive operating cash flow include generating adequate gross profit on net revenues and controlling other costs and expenses. Our capital needs could increase materially if any of our contingent liabilities are resolved adversely to us. In addition, we could require more working capital if our defense electronics business increases more rapidly than we currently anticipate.

As discussed above, in the accompanying financial statements and in our Annual Report on Form 10-K for 2001, we are obligated under various contracts and commercial commitments. The following table summarizes these obligations:

PERIOD IN WHICH PAYMENTS DUE (IN THOUSANDS)

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12 MONTHS ENDED SEPTEMBER 30:

NATURE OF OBLIGATION	2003	2004	2005	2006
Notes payable	\$3,800	\$2,900	\$ -	\$ -
Operating leases	491	354	156	-
Purchase commitments	700	-	-	-
Settlement payments	590	475	575	150
Total	\$5,581	\$3,729	\$731	\$150

CONTINGENT LIABILITIES

As discussed in "ITEM 3 - Legal Proceedings" in the Company's Annual Report on Form 10-K for 2001 and in the accompanying financial statements, the Company is exposed to certain contingent liabilities which, if resolved adversely to the Company, would adversely affect its liquidity, its results of operations, and/or its financial position.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have outstanding debt that bears interest at a variable interest rate amounting to \$4,000,000 as of September 30, 2002. This interest is based on a widely used reference interest rate known as LIBOR. For example, an increase of 50 basis points in LIBOR would result in an increase in our annual interest expense of \$20,000.

As of September 30, 2002, we have cash and temporary investments of \$660,000. The majority of this amount is invested in money market funds that pay interest at rates that fluctuate with market

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conditions. For example, a decrease of 50 basis points in the interest rate which these investments pay would result in a decrease in our annual interest income of approximately \$3,000.

ITEM 4 - CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

The term "disclosure controls and procedures" is defined in Rule 13a-14(c) of the Securities Exchange Act of 1934, or the Exchange Act. This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. Our Chief Executive Officer and our Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures as of a date within 90 days before the filing of this quarterly report, and they have concluded that as of that date, our disclosure controls and procedures were effective at ensuring that required information will be disclosed on a timely basis in our reports filed under the Exchange Act.

CHANGES IN INTERNAL CONTROLS

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We maintain a system of internal controls that are designed to provide reasonable assurance that our books and records accurately reflect our transactions and that our established policies and procedures are followed. There were no significant changes to our internal controls or in other factors that could significantly affect our internal controls subsequent to the date of their evaluation by our Chief Executive Officer and our Chief Financial Officer, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

SAVAGE SPORTS SETTLEMENT

The Company is contingently liable for certain potential liabilities related to discontinued operations. Specifically, under a stock purchase agreement dated October 3, 1995, the Company agreed to indemnify Savage Sports Corporation ("Savage Sports"), the purchaser of Savage Arms, Inc. (a manufacturer of firearms), for certain product liability, environmental clean-up costs and other contractual obligations, including certain successor liability claims. One of the liabilities assumed involves a firearms product liability lawsuit filed in Alaska Superior Court (the "Taylor Litigation"). A defendant in the Taylor Litigation, Western Auto Supply Co. ("Western Auto") settled the suit for \$5,000,000. Western Auto assigned its indemnification claims against Savage Arms, Inc. to its insurance carriers who in turn asserted claims against Savage Arms, Inc. for the amount of the settlement plus attorney's fees, interest and related costs. In August 2002 Savage Arms, Inc. entered into a Confidential Settlement Agreement and Release with the insurance carriers related to these claims.

In October 2002 the Company and Savage Sports reached agreement in principle regarding the Company's indemnification regarding this and any other related matters. Pursuant to this agreement the Company will pay to Savage Sports a total of \$1,575,000 over a four year period, with \$375,000 payable through October 31, 2003. Under the settlement arrangement, Savage Sports has agreed to

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fund the cost of insurance programs that are expected to respond to any other such claims that may arise in the future. The Company is aware of no such claims, and Savage Sports has advised the Company that they are aware of no additional claims. As a result of the agreement in principle with Savage Sports, the Company has recorded a charge of \$1,520,000 related to this matter in the third quarter of 2002.

SCI ACTION

In July 2002, the Company's wholly-owned subsidiary, DNA Enterprises, Inc. ("DNA") filed suit against SCI Technology, Inc. and SCI Systems, Inc. (collectively "SCI") for breach of contract and fraudulent inducement. The suit alleges that SCI has failed to pay DNA royalties related to a Licensing Agreement involving the joint development of certain circuit card assembly ("CCA") boards. The suit is currently pending in United States District Court for the Northern District of Texas. In August 2002, SCI filed a counter claim against DNA alleging breach of contract, fraudulent inducement and negligent misrepresentation. The Company believes that the counter claims by SCI are

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without basis and intends to vigorously pursue this matter. Discovery has commenced and a trial date has been preliminarily set for June 16, 2003.

SHAREHOLDER CLASS ACTION

A shareholder class action lawsuit was filed in the U. S. District Court for the Northern District of Texas in November 1999 on behalf of all persons and entities who purchased the Company's common stock during the period between February 24, 1998 and November 17, 1998. The named defendants include the Company and certain former and present officers and directors of the Company. The complaint alleges that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by making false and misleading statements concerning the Company's reported financial results during the period, primarily relating to revenue recognition, asset impairment and capitalization issues. The plaintiffs seek monetary damages, interest, costs and expenses. In March 2001, our motion to dismiss the case was denied. Since that date discovery has been proceeding and is essentially completed. The plaintiffs' motion for class certification and our opposition to that motion are currently pending before the court. The court has set a preliminary trial date of April 7, 2003. We believe the case is without merit and intend to defend the case vigorously in all respects.

United Pacific Insurance Company, an affiliate of Reliance Insurance Company ("Reliance"), the insurance carrier which provides the primary \$2 million of insurance coverage for this matter, has been ordered liquidated by the insurance commissioner of the State of Pennsylvania. At this time we are unable to determine what amounts, if any, may be available under this insurance coverage. We expect that it will be a matter of two years or more before it can be determined if any amounts can be recovered from Reliance. We have insurance coverage for up to \$8 million in claims in excess of the initial \$2 million. Through September 30, 2002 we have incurred approximately \$1.2 million in costs related to this matter, of which we have been reimbursed \$300,000 by the Texas Property and Casualty Insurance Guarantee Association.

ITEM 2 - CHANGES IN SECURITIES AND USE OF PROCEEDS

See Current Report on Form 8-K dated October 3, 2002, as amended.

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ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

A. Listed below are all Exhibits filed as part of this report.

None

B. The Company has not filed any report on Form 8-K during the period covered by this Report, except as follows:

Current report on Form 8-K dated August 12, 2002 reporting the filing of a certification of certain officers pursuant to "Item 9 - Regulation FD Disclosure" and the filing of an exhibit pursuant to "Item 7 - Financial Statements and Exhibits"

Current report on Form 8-K dated October 3, 2002, as amended on Form 8-K/A filed November 12, 2002

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TERAFORCE TECHNOLOGY CORPORATION (Registrant)

Date: November 14, 2002

By: /s/ ROBERT P. CAPPS

Robert P. Capps
Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: November 14, 2002

By: /s/ HERMAN M. FRIETSCH

Herman M. Frietsch
Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)

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CERTIFICATIONS

I, Herman M. Frietsch certify that:

1. I have reviewed this quarterly report on Form 10-Q of TeraForce Technology Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

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b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ HERMAN M. FRIETSCH

Herman M. Frietsch
Chief Executive Officer

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I, Robert P. Capps certify that:

1. I have reviewed this quarterly report on Form 10-Q of TeraForce Technology Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

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b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ ROBERT P. CAPPS

Robert P. Capps
Chief Financial Officer

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LIGN="bottom" ALIGN="right">55,000 3,291,986 437,800

J.R. Vipond

0 0 100,000 531,000

E.M. Kopczick

0 0 125,573 55,000 1,431,464 437,800

T.M. Noonan

29,222 326,236 121,432 35,000 1,030,209 265,100

M.H. Mitchell

0 0 10,000 40,000 18,600 267,900

(1) No SARs were held at December 31, 2005.

(2) Computed based upon the difference between aggregate fair market value at December 30, 2005, the last trading day for the year, and aggregate exercise price.

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Performance Graph

The following performance graph compares the total return to shareholders of a hypothetical investment of \$100 in each of Crane Co. Common Stock, the S&P 500 Index, the S&P Midcap 400 Industrial Machinery Index and the S&P Industrial Machinery Index. Total Return means the increase in value of the investment assuming reinvestment of all dividends during the period. Crane Co. was included in the S&P Industrial Machinery Index at all times between December 31, 2002 and December 17, 2004, and in past proxy statements we have used that index for purposes of comparison. As of December 18, 2004 Crane Co. is no longer included in the S&P Industrial Machinery Index but is included in the S&P MidCap 400 Industrial Machinery Index, and management believes that the latter index provides a more meaningful comparison. In accordance with the rules of the Securities and Exchange Commission, this year both the indexes we have used in previous years and the indexes we plan to use going forward are shown on the same graph for purposes of comparison.

Companies included in the S&P MidCap 400 Industrial Machinery Index are: Crane Co.; Donaldson Co.; Flowserve Corporation; Graco Inc.; Harsco Corp.; Kennametal Inc.; Nordson Corporation; Pentair Inc.; SPX Corp.; Tecumseh Products Co.; and Timken Co. Companies included in the S&P Industrial Machinery Index are: Danaher Corporation, Dover Corporation, Eaton Corporation, Illinois Tool Works, Ingersoll-Rand Co., ITT Industries, Inc., Pall Corp. and Parker-Hannafin Corporation.

REPORT ON EXECUTIVE COMPENSATION

BY THE MANAGEMENT ORGANIZATION AND COMPENSATION

COMMITTEE OF THE COMPANY

In 2005 the Management Organization and Compensation Committee of the Board of Directors of the Company (the Committee) maintained its previously established three-pronged approach to executive officer and key employee compensation: competitive base salaries; short and medium-term cash incentive compensation linked to measurable increases in shareholder value; and long-term incentive compensation utilizing stock options the value of which is keyed to increases in shareholder returns (through increases in the price of the Company's Common Stock) and awards of restricted Common Stock for retention purposes.

The Committee has established targets for ownership of Company Common Stock to encourage executive officers and key employees to hold a significant portion of their net worth in the Company's Common Stock, so that the future price of the Company's Common Stock will constitute a key element in their financial planning and ultimately in their net worth. The policy permits executives to sell up to 50 percent of the net shares realized upon an option exercise or vesting of restricted stock, while retaining at least 50 percent of such net shares in order to meet the stock ownership guidelines. Once such guidelines are met the policy permits executives to sell any shares held above the required ownership guidelines. The ownership guidelines for executive officers are expressed as a multiple of base salary, ranging from a multiple of one, for salaries up to \$125,000, to a multiple of five, for salaries above \$500,000.

A. Base Salaries. In 2005 the base salaries of the Company's executive officers and other key managers were reviewed and adjusted where appropriate to reflect promotions and other changes in duties as well as competitive market conditions. The Committee believes the Company's base salaries are sufficiently competitive to attract and retain qualified executive officers and key managers. Base salaries of executive officers were increased an average of 3.4% in 2005.

B. Short and Medium-Term Incentive Compensation Focused on Economic Value Added. The Company's annual incentive compensation program utilizes the principles of economic value added (EVA). EVA is defined as the difference between the return on total capital invested in the business (net operating profit after tax, or NOPAT, divided by total capital employed) and the cost of capital, multiplied by total capital employed.

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The Committee believes that, compared to such common performance measures as return on capital, return on equity, growth in earnings per share and growth in cash flow, EVA has the highest correlation with the creation of value for shareholders over the long term. The program does not involve the meeting of pre-established goals, as such. Rather, the EVA during the year, in aggregate as well as the increase or decrease compared to the prior year, is the sole basis for any incentive compensation award, thereby motivating executives to focus on continuous value improvement. Awards are generally uncapped (subject to a maximum annual award of \$3,000,000 to any one individual) to provide maximum incentive to create value and, because awards may be positive or negative, executives can incur penalties when value is reduced.

The key elements of the EVA formula are the cost of capital, the return on capital, the amount of capital employed in the Company, the net operating profit of the Company after tax and the prior year's EVA. Thus, the EVA formula requires the executive to focus on improvement in the Company's balance sheet as well as the income statement. Awards are calculated on the basis of year end results, and award formulas utilize both a percentage of the change in EVA from the prior year, whether positive or negative, and a percentage of the positive EVA, if any, in the current year. EVA awards for corporate executives are calculated for the Company as a whole.

EVA awards are calculated using total capital employed and NOPAT based on amounts as reported in the Company's published financial statements, except that provisions relating to the Company's asbestos liabilities are excluded. In addition, the Committee has the authority to exclude significant non-budgeted or non-controllable gains or losses from actual financial results in order to properly measure EVA. The component cost of equity is fixed by the Committee at the beginning of each year, while the cost of debt is determined on the basis of the Company's actual interest cost during the year and the blended cost of capital is reviewed and approved by the Committee following the end of the year.

If the EVA award for a particular year is positive, it is paid out to the participating executive up to the predetermined target (percentage of salary), and any excess is credited to the executive's bank account. If the EVA award is negative, an executive may still receive a cash payment from his or her bank account up to the target bonus, before the negative EVA award is applied to the bank account. If the executive's bank account is a positive number, one-third of the account balance is also paid to the executive in cash, and the remainder of the account balance represents that individual's equity in the account for future years. If the account balance is negative, the executive will receive no incentive compensation payment the following year unless the EVA award is positive. Each year, the Company adds interest to a positive balance at six percent. The account is subject to forfeiture in the event an executive leaves the Company by reason of termination or resignation, but is paid in full if the executive dies, becomes disabled or retires at age 65 (or earlier at the discretion of the Committee) or upon a change-in-control of the Company. Although the program is formula driven, the Committee retains discretion to review and adjust the EVA calculation and its impact on individuals for reasonableness and to preserve its incentivizing objectives, provided that the EVA award percentages of the individuals named in the Summary Compensation Table are capped by the Committee at the beginning of the year.

C. Long-Term Incentive Compensation Focused on Shareholder Return. The Company has used its stock option and restricted stock plans as the foundation for a long-term stock-based incentive compensation program focused on shareholder return. The Committee believes that executive officers approach their responsibilities more like owners of the Company as their holdings of and potential to own Company Common Stock increase. This philosophy starts with the Board of Directors, whose non-employee members receive 50% of their annual retainer in Company Common Stock. As of February 28, 2006, 6.61% of the Company's Common Stock is beneficially owned by directors and executive officers. (See Beneficial Ownership of Common Stock by Directors and Management, page 10 of the Company's Proxy Statement dated March 10, 2006.)

(i) *Stock Options.* The Stock Incentive Plan is administered by the Committee, which is authorized to grant options to key employees of the Company or any majority-owned subsidiary of the Company. Options granted become exercisable 50% one year after the grant date, 75% two years after the grant date and 100% three years after the grant date and the option price must not be less than 100% of the average fair market value on the date of grant. Options expire, unless exercised, six years (ten years for options granted prior to 2004) after grant. Because the Company's Stock Incentive Plan requires that options be granted at no less than fair market value, a gain can result only if the Company's share price increases from the date of grant. This incentive program is, therefore, directly tied to increases in shareholder value. In 2005, the Committee granted 1,210,250 stock options, with an expiration date six years after the date of grant, to the officers and key employees of the Company.

(ii) *Restricted Stock.* Under the Stock Incentive Plan, the Committee may also award restricted shares of the Company's Common Stock to selected officers and key employees. The Committee has the authority to select participants and to determine the amount and timing of awards, restriction periods, market value thresholds and any terms and conditions applicable to grants. Since 1998, the Committee has awarded restricted stock only with time-vesting criteria to

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selected employees for long-term retention purposes. A total of 263,000 shares of restricted stock were awarded to officers and other key employees of the Company on this basis in 2005, which generally vest as to one-third of the award on the first, second and third anniversaries of the date of grant, or upon the participant's earlier death, permanent disability, normal retirement at age 65 or upon a change-in-control of the Company.

Since 1995, the Committee has also administered a program using grants of restricted stock to make up the shortfall in executive officer and key employee pension benefits imposed by certain federal tax policies which limit the amount of compensation that can be considered for determining benefits under tax-qualified plans. Under this program, the Committee will grant from time to time to certain executive officers and key employees who have been impacted by such tax limitations amounts of restricted stock to make up that portion of the Company's retirement benefit at normal retirement (age 65) lost by reason of the tax limitations. The Committee is of the view that the grants provide the potential to offset the tax limitations on the executive's future pension benefits, but require the recipient to look to future increases in shareholder value through stock appreciation if that objective is to be actually achieved. A total of 96,400 shares of restricted stock were granted under this program in 2005.

D. Compensation for the Chief Executive Officer. E. C. Fast has an employment agreement, entered into in 2001 when he succeeded R. S. Evans as Chief Executive Officer. The employment agreement with Mr. Fast, the principal terms of which are described below under the caption

Other Agreements and Information, is in keeping with the Committee's view that Chief Executive Officer compensation should include a competitive base salary while emphasizing incentives closely linked to shareholder return, such as the Company's EVA Plan and significant grants of stock options, with substantial awards of time-based restricted stock for retention purposes. After considering competitive salary data for comparable industrial companies, the Committee recommended that Mr. Fast's annual base salary for 2005 be increased to \$850,000, which increase was approved by the Board of Directors. Mr. Fast's 2005 incentive compensation award of \$1,176,600 under the EVA Incentive Compensation Plan was calculated on the basis of a pre-established 30% participation percentage of the aggregate EVA for the Company. Of that award, \$910,881 was paid to Mr. Fast, and the balance was added to his EVA bank account, which stood at \$291,805 at December 31, 2005. In addition, the Committee granted to Mr. Fast options to purchase 130,000 shares of Common Stock at an exercise price of \$26.86 per share, 90,000 shares of time-based restricted stock, and 22,600 shares of retirement-based restricted stock under the program described above. The Committee also approved an amendment of the vesting provisions for retirement-based restricted stock issued to Mr. Fast such that the shares vest upon early retirement (before age 65) provided he has at least 10 years of service. If Mr. Fast takes early retirement before he has 10 years of service, a pro-rated portion of such shares would vest on the tenth anniversary of his date of hire (i.e. September 27, 2009).

E. Internal Revenue Code Section 162(m). Section 162(m) of the Internal Revenue Code limits to \$1 million per employee the deductibility of compensation paid to the executive officers required to be listed in the Company's proxy statement unless the compensation meets certain specific requirements. The EVA Incentive Compensation Plan is intended to constitute a performance-based plan meeting the criteria for continued deductibility set out in the applicable regulations. In addition, the Company believes that all stock options granted under the Company's stock incentive plans will meet the requirements of Section 162(m) for deductibility. The shares of time-based restricted stock granted to offset the impact of the tax limitations on pension benefits, as well as the other time-based restricted stock awarded in 2005 as described in paragraph C above, would not satisfy the performance-based criteria of Section 162(m), and accordingly compensation expense in respect of income recognized by the executive officer upon lapse of the restrictions would not be deductible to the extent that such income, together with all other compensation in such year that did not satisfy the criteria of Section 162(m), exceeded \$1 million. As a matter of policy, the Committee intends to develop and administer compensation programs which will maintain deductibility under Section 162(m) for all executive compensation, except in the limited circumstance when the materiality of the deduction is in the judgment of the Committee significantly outweighed by the incentive value of the compensation.

Submitted by:
The Management Organization and Compensation Committee of the
Board of Directors of Crane Co.

E.T. Bigelow, Jr.

D.G. Cook

D.R. Gardner

W.E. Lipner

D.C. Minton

J.L.L. Tullis

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RETIREMENT BENEFITS

All officers of the Company, including the individuals in the Summary Compensation Table, are participants in the Company's pension plan for all eligible employees. Directors who are not employees do not participate in the plan. Eligibility for retirement benefits is subject to certain vesting requirements, which include completion of five years of service where employment is terminated prior to normal or other retirement or death, as determined by applicable law and the plan. Benefit accruals continue for years of service after age 65.

The annual pension benefits payable under the pension plan are equal to 1 2/3% per year of service of the participant's average annual compensation during the five highest compensated consecutive years of the 10 years of service immediately preceding retirement less 1 2/3% per year of service of the participant's Social Security benefit, up to a maximum deduction of 50% of the Social Security benefit. Compensation for purposes of the pension plan is defined as total W-2 compensation plus employee contributions made under salary reduction plans less (i) reimbursements or other expense allowances; (ii) cash and noncash fringe benefits (including automobile allowances); (iii) moving expenses (including home allowances); (iv) deferred compensation; (v) welfare benefits; (vi) severance pay; (vii) amounts realized from the exercise of a non-qualified stock option or the sale, exchange or other disposition of stock acquired under a qualified stock option; and (viii) amounts realized when restricted stock (or property) held by the employee is recognized in the employee's taxable income under Section 83 of the Internal Revenue Code. In general, such covered compensation for any year would be equivalent to the sum of the salary set forth in the Summary Compensation Table for such years plus the bonus shown in the Table for the immediately preceding year.

The table below sets forth the estimated annual benefit payable on retirement at normal retirement age (age 65) under the Company's pension plan. Benefits are based on accruals through December 31, 2005 for specified salary and years of service classifications, and assume benefits to be paid in the form of a single life annuity. The amounts have not been reduced by the Social Security offset referred to above.

Table of Contents**Pension Plan Table****Average****Annual****Compensation(1)****Years of Service(2)**

	10	15	20	25	30	35
\$150,000	\$ 25,005	\$ 37,508	\$ 50,010	\$ 62,513	\$ 75,015	\$ 87,518
\$175,000	29,173	43,759	58,345	72,931	87,518	102,104
\$200,000	33,340	50,010	66,680	83,350	100,020	116,690
\$225,000	37,508	56,261	75,015	93,769	112,523	131,276
\$235,000	39,175	58,762	78,349	97,936	117,524	137,111
\$250,000	41,675	62,513	83,350	104,188	125,025	145,863

- (1) Commencing January 1, 1994, for the purpose of determining benefit accruals and benefit limitations under the pension plan, a participant's compensation is deemed to be limited to \$150,000 indexed for inflation in future years (the "OBRA '93 Limitation"). As a result of the OBRA '93 Limitation, the covered compensation under the Company's pension plan for the foregoing individuals for the years 1994 through 1996 was limited to \$150,000, then increased to \$160,000 for 1997, 1998 and 1999, to \$170,000 for 2000 and 2001, to \$200,000 for 2002 and 2003, to \$205,000 for 2004, to \$210,000 for 2005 and to \$220,000 for 2006.
- (2) Mr. Fast joined the Company in 1999 and has six years of service credit under the Company's pension plan. Mr. duPont joined the Company in 1996 and has ten years of service credit under the Company's pension plan. Mr. Vipond joined the Company in 2005 and has one year of service credit under the Company's pension plan. Ms. Kopczick has 26 years of service credit under the Company's pension plan, including service with a predecessor company. Mr. Noonan joined the Company in 1996 and has ten years of service credit under the Company's pension plan. Mr. Mitchell joined the Company in 2004 and has two years of service credit under the Company's pension plan.
- The actual retirement benefit at normal retirement date payable pursuant to Section 235(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (and subsequent to 1986 at the age at which unreduced Social Security benefits may commence pursuant to the Tax Reform Act of 1986) may not exceed the lesser of \$175,000 or 100% of the officer's average compensation during his highest three consecutive calendar years of earnings (the "Tax Act Limitation"). The Tax Act Limitation may be adjusted annually for changes in the cost of living. The dollar limit is subject to further reduction to the extent that a participant has fewer than 10 years of service with the Company or 10 years of participation in the defined benefit plan.

OTHER AGREEMENTS AND INFORMATION

The Company has entered into indemnification agreements with E. C. Fast, each other director of the Company, Messrs. duPont, Vipond, Noonan and Mitchell, Ms. Kopczick, and the five other executive officers of the Company, the form of which was approved by the shareholders of the Company at the 1987 Annual Meeting. The indemnification agreements require the Company to indemnify the officers or directors to the full extent permitted by law against any and all expenses (including advances thereof), judgments, fines, penalties and amounts paid in settlement incurred in connection with any claim against such person arising out of services as a director, officer, employee, trustee, agent or fiduciary of the Company or for another entity at the request of the Company, and to maintain directors and officers liability insurance coverage or to the full extent permitted by law to indemnify such person for the lack thereof.

Each of the individuals named in the Summary Compensation Table (and certain other executive officers) has an agreement which, in the event of a change in control of the Company, provides for the continuation of the employee's then current base salary, bonus plan and benefits for the three-year period following the change in control. Upon termination within three years after a change in control, by the Company without cause or by the employee with "Good Reason" (as defined in the agreement), the employee is immediately entitled to a proportionate amount of the greater of the last year's bonus or the average bonus paid in the three prior years, plus three times the sum of his or her annual salary and the greater of the last year's bonus or the average of the last three years' bonuses, and all accrued deferred

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compensation and vacation pay; employee benefits, medical coverage and other benefits also continue for three years after termination. Good Reason under the agreements includes, among other things, any action by the Company which results in a diminution in the position, authority, duties or responsibilities of the employee. The agreements also provide that the employee may terminate his or her employment for any reason during the 30 day period immediately following the first year after the change of control, which shall be deemed Good Reason under the agreement. If it is determined that any economic benefit or payment or distribution by the Company to the individual, pursuant to the agreement or otherwise (including, but not limited to, any economic benefit received by the employee by reason of the acceleration of rights under the various options and restricted stock plans of the Company) (Payment), is subject to the excise tax imposed by Section 4999 of the Internal Revenue Code, the agreements provide that the Company shall make additional cash payments to the employee such that after payment of all taxes including any excise tax imposed on such payments, the employee will retain an amount equal to the excise tax on all the Payments. The agreements are for a three-year period, but are automatically extended annually by an additional year unless the Company gives notice that the period shall not be extended.

On January 22, 2001 the Company entered into an employment agreement with Mr. Fast pursuant to which Mr. Fast agreed to serve as President and Chief Executive Officer of the Company commencing on the date of the 2001 Annual Meeting, April 23, 2001. The employment agreement is renewable each year for one additional year unless either party gives written notice to the other, and provides for the following compensation: (i) an annual salary of no less than \$650,000; (ii) participation in the EVA Incentive Compensation Plan; (iii) the grant of certain stock options in 2001 and 2002; and (iv) the grant of certain shares of restricted stock in 2001. The employment agreement also contains certain covenants of Mr. Fast concerning confidentiality, non-competition and non-solicitation of employees after termination of employment. If the Company terminates Mr. Fast's employment other than for cause, Mr. Fast would be entitled to receive a lump sum cash payment equal to two times his annual base salary plus the higher of his current EVA bank account or two times his highest EVA bonus payment in the preceding five years, all stock options would become fully vested and exercisable and all restricted stock would become fully vested and nonforfeitable.

Mr. R.S. Evans serves as non-executive Chairman of the Board pursuant to an agreement entered into in 2001 upon his retirement as Chief Executive Officer of the Company. Under this agreement as amended in April 2004, Mr. Evans receives an annual retainer of \$100,000. In addition, the Company provides Mr. Evans with an office at the Company's headquarters and the use of the Company's airplane for business and personal use subject to the approval of the Company's Chief Executive Officer. The agreement has a term of three years, renewable each year for an additional year, and if the Company terminates Mr. Evans' employment other than for cause, or if Mr. Evans terminates his employment for Good Reason (as defined in the agreement) or for any reason after a change in control, Mr. Evans would be entitled to receive a lump sum cash payment equal to the full amount of his retainer through the end of the term of the agreement.

The Company has entered into time share agreements with Mr. Evans and Mr. Fast regarding personal use of the Company's aircraft, including aircraft leased by the Company from a third party operator. Under these agreements, which became effective on January 1, 2004, the Company agrees to lease the aircraft to the executive pursuant to federal aviation regulations and to provide a qualified flight crew, and the executive agrees to pay the Company for each flight an amount equal to the lesser of (i) the amount calculated for personal use of aircraft under Department of Treasury regulations or (ii) the sum of specified expenses actually incurred for such flight. During 2005, the aggregate incremental cost to the Company for personal use of such aircraft by Messrs. Evans and Fast, less amounts paid by them under the time share agreements, was \$347,580 and \$29,392, respectively.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

No member of the Management Organization and Compensation Committee is or has ever been an officer or employee of the Company, and no executive officer of the Company has served as a director or member of a compensation committee of another company of which any member of the Committee is an executive officer.

Compensation of Directors. The Company's standard retainer payable to each non-employee director is \$50,000 per annum (as of the 2006 Annual Meeting, \$65,000). Pursuant to the Non-Employee Director Stock Compensation Plan, non-employee directors receive, in lieu of cash, shares of Common Stock of the Company (rounded to the nearest ten shares) with a market value equal to 50% of the standard annual retainer. The other 50% of the annual retainer is paid in cash. All directors who are not employees of the Company, of whom there are currently 11, participate in the plan. The shares are issued each year as of the date of the Company's annual meeting, are forfeitable if the director ceases to remain a director until the Company's next annual meeting, except in the case of death, disability or change in control, and may not be sold for a period of five years or until such earlier date as the director leaves the Board. In April 2005 each non-employee director received 940 restricted shares of Common Stock pursuant to the plan. The Chairman of the Board does not participate in the Non-Employee Director Stock Compensation Plan.

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In addition, under the Non-Employee Director Stock Compensation Plan an option to purchase 2,000 shares of Common Stock is granted to each non-employee director as of the date of each annual meeting of shareholders. Each such option has an exercise price equal to the fair market value at the date of grant, has a term of 10 years and vests 50% after one year, 75% after two years and 100% after three years from the date of grant. On April 25, 2005 each non-employee director other than Mr. Queenan received an option to purchase 2,000 shares at an exercise price of \$26.61 per share. Mr. Queenan elected to continue to participate in the Crane Co. Retirement Plan for Non-Employee Directors (see description below), and therefore does not receive any stock option grants under the Non-Employee Director Stock Compensation Plan.

Non-employee directors also receive \$2,000 for each Board meeting attended. Non-employee members of the Executive Committee receive a supplemental annual retainer of \$2,000. Members of other committees receive \$2,000 for each committee meeting attended, and committee chairmen receive a supplemental annual retainer of \$10,000 for the Audit Committee and \$7,500 for the Management Organization and Compensation Committee and the Nominating and Governance Committee.

The Crane Co. Retirement Plan for Non-Employee Directors provides for a benefit upon retirement at or after age 65 equal to the participant's annual retainer in effect at the time service terminates, payable for a period of time equal to the number of years the participant has served on the Board and not as an employee. After two years of service, participants are 50% vested in benefits payable, and after each full year of service thereafter, participants are vested in an additional 10%. In the event of death, disability or change in control, participants are automatically 100% vested and, in the case of a change in control, a minimum of seven years of retirement benefits is payable. Additionally, a participant leaving the Board after a change in control would be entitled to receive, in lieu of installment payments, a lump sum cash payment such that the participant will retain, after all applicable taxes, the actuarial equivalent of the benefits payable under the plan. A former director may receive his benefits prior to age 65 on an actuarially reduced basis. The plan is unfunded and benefits thereunder are payable from the Company's general assets, either in the form of a joint and survivor annuity or, if the director so elects upon reaching age 55, in the form of a survivor annuity should the director die while in service. The Retirement Plan for Non-Employee Directors was terminated as to active directors when the Non-Employee Director Stock Compensation Plan was approved by shareholders in April 2000, but Mr. Queenan has elected to continue his participation in the Retirement Plan in lieu of any option grants under the Stock Compensation Plan. Former Crane Co. directors will continue to receive their retirement benefits under the Retirement Plan.

Share Ownership Guidelines for Directors. The Board of Directors has adopted share ownership guidelines which require each director to hold shares of Common Stock having a fair market value not less than five times the annual retainer payable to such director. A director must have attained such ownership level on the later of February 23, 2006 or the fifth anniversary of the director's first election as a director.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(3) Exhibits

Exhibit No.	Description
Exhibit 3	The Company's By Laws, as amended on April 3, 2001. (Previously filed)
Exhibit 4.1	Preferred Share Purchase Rights Agreement dated as of June 27, 1998. (Previously filed)
Exhibit 4.2	Indenture dated as of April 1, 1991 between the Registrant and the Bank of New York. (Previously filed)
Exhibit 10.1	The form of Employment / Severance Agreement between the Company and certain executive officers which provide for the continuation of certain employee benefits upon a change of control. (Previously filed)
Exhibit 10.2	The form of indemnification agreements entered into with each director and executive officer of the Company. (Previously filed)
Exhibit 11	Computation of net income per share (Previously filed)
Exhibit 13	Selected portions of the Annual Report to Shareholders for the year ended December 31, 2005. (Previously filed)
Exhibit 21	Subsidiaries of the Registrant. (Previously filed)
Exhibit 23	Consent of Independent Registered Public Accounting Firm.
Exhibit 31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a).

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Exhibit 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a).

Exhibit 32.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(b) or 15d-14(b).

Exhibit 32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b) or 15d-14(b).

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(b) Exhibits to Form 10-K Documents incorporated by reference :

(3) The Company's Certificate of Incorporation, as amended on May 25, 1999 contained in Exhibit 3A to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1999.

(4) Instruments Defining the Rights of Security Holders:

(a)(1) Note dated September 8, 2003 (incorporated by reference to Exhibit 4.1 to the Current Report on Form 8-K filed on September 8, 2003).

2) Credit Agreement dated as of July 22, 2003, among Crane Co., the Borrowing Subsidiaries party hereto, the Lenders party thereto, and JP Morgan Chase Bank, as Administrative Agent (incorporated by reference in Exhibit 10.1 to the Company's Current Report on Form 8-K filed August 29, 2003).

3) Credit Agreement dated as of January 21, 2005 among Crane Co., the Borrowing Subsidiaries party hereto, the Lenders party thereto, and JP Morgan Chase Bank, N.A. as Administrative Agent (incorporated by reference in Exhibit 10.1 to the Company's Current Report on Form 8-K filed January 24, 2005).

(10) Material Contracts:

(iii) Compensatory Plans

(a) The Crane Co. 1998 Non-Employee Director Restricted Stock Award Plan contained in Exhibit 4.1 to the Company's Registration Statement No. 333-50495 on Form S-8 filed with the Commission on April 20, 1998.

(b) The Crane Co. 2000 Non-Employee Director Stock Compensation Plan contained in Exhibit 10(a) to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000.

(c) The employment agreement with Eric C. Fast contained in Exhibit 10(j) to the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

(d) The Crane Co. 2001 Stock Incentive Plan contained in Exhibit 10(b) to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2001.

(e) The employment agreement, as amended, with Robert S. Evans contained in Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(f) The Crane Co. 2004 Stock Incentive Plan contained in Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(g) The Crane Co. Corporate EVA Incentive Compensation Plan contained in Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(h) The Crane Co. Retirement Plan for Non-Employee Directors, as amended December 5, 2005 contained in Exhibit 10.1 to the Company's Form 8-K filed January 23, 2006.

(i) The Crane Co. Time Sharing Agreement contained in Exhibit 10.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

All other exhibits are omitted because they are not applicable or the required information is shown elsewhere in this Annual Report on Form 10-K.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CRANE CO.
(Registrant)

By /s/ E.C. Fast
E.C. Fast
President and Chief Executive Officer

November 8, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

OFFICERS

/s/ J. Robert Vipond
J. Robert Vipond

By

/s/ J. A. Nano
J. A. Nano

Vice President, Finance and Chief Financial Officer

Vice President, Controller

(Principal Financial Officer)

(Principal Accounting Officer)

November 8, 2006

November 8, 2006

Exhibit Index

Exhibit No.	Description
Exhibit 23	Consent of Independent Registered Public Accounting Firm.
Exhibit 31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a).
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a).
Exhibit 32.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(b) or 15d-14(b).
Exhibit 32.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(b) or 15d-14(b).