

GSI LUMONICS INC  
Form 10-K/A  
June 30, 2003

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K/A**

Amendment No. 3

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2002

Commission File No. 000-25705

**GSI Lumonics Inc.**

*(Exact name of registrant as specified in its charter)*

**New Brunswick, Canada**  
*(State or other jurisdiction  
of incorporation or organization)*

**39 Manning Road**  
**Billerica, Massachusetts, USA**  
*(Address of principal executive offices)*

**98-0110412**  
*(I.R.S. Employer  
Identification No.)*

**01821**  
*(Zip Code)*

**(978) 439-5511**

*(Registrant's telephone number, including area code)*

**Securities Registered Pursuant to Section 12(b) of the Act:**

**None**

**Securities Registered Pursuant to Section 12(g) of the Act:**

**Common Stock, no par value**

*(Title of class)*

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of the Registrant's common shares held by non-affiliates of the Registrant, based on the closing price of the common shares on The NASDAQ Stock Market® on the last business day of the Registrant's most recently completed second fiscal quarter (June 28, 2002) was approximately \$261,848,010 (assumes officers, directors, and all shareholders beneficially owning 5% or more of the outstanding common shares are affiliates).

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There were approximately 40,806,464 of the Registrant's common shares, no par value, issued and outstanding on June 26, 2003.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12-b-2 of the Securities Exchange Act of 1934). YES  NO

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As used in this report, the terms we, us, our, GSI Lumonics and the company mean GSI Lumonics Inc. and its subsidiaries, unless the context indicates another meaning.

Unless otherwise noted, all dollar amounts in this report are expressed in United States dollars.

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**EXPLANATORY NOTE**

In accordance with Rule 12b-15 under the Securities Exchange Act of 1934, as amended, we are filing this Amendment No. 3 on Form 10-K/ A in response to comments received from the staff of the Securities and Exchange Commission in connection with their review of our proxy circular-prospectus contained in the Registration Statement on Form S-4 of GSLI Corp. Our Annual Report on Form 10-K for the fiscal year ended December 31, 2002 was filed on March 31, 2003 and on May 21, 2003 we filed an Amendment No. 2 on Form 10-K/ A in response to an earlier round of comments from the staff of the Securities and Exchange Commission.

In this filing we have specifically amended and restated Items 7 and 8 of Part II and Item 15 of Part IV (to reflect recently filed reports on Form 8-K and the inclusion of an updated consent of Ernst & Young LLP). Please note that we have not been requested to, and we are not, restating our financial results. The only changes made to Item 8 have been to notes 10, 11, 13 and 15 to the consolidated financial statements but, for ease of reference and consistency of presentation, we have elected to restate Item 8 in its entirety in this report.

This report speaks as of the original filing date of our Annual Report on Form 10-K (March 31, 2003) and, except as indicated below, has not been updated to reflect events occurring subsequent to that date. All information contained in this and our previous filings is subject to updating and supplementing as provided in our periodic reports filed with the Securities and Exchange Commission.

**PART I**

**Item 1. *Business of GSI Lumonics Inc.***

The text appearing under the heading *Recent Developments* is deleted in its entirety and replaced with the following:

**Recent Developments**

On March 31, 2003, our wholly-owned subsidiary GSLI Corp filed with the Securities and Exchange Commission a registration statement on Form S-4 containing a joint proxy circular-prospectus of the company and GSLI Corp which included a proposal to approve a plan of arrangement, the principal effect of which would be to restructure the company as a publicly traded United States domiciled corporation. Subsequently, GSLI Corp filed a series of amendments to the registration statement in response to comments received from the Securities and Exchange Commission and, on June 27, 2003, the registration statement was declared effective by the Securities and Exchange Commission.

A special meeting at which shareholders and optionholders of the company will be asked to vote on the plan of arrangement, originally scheduled to be held on Thursday, July 24, 2003, will now be held at 10:00 a.m. on Monday, August 4, 2003 at the Renaissance Bedford Hotel in Bedford, Massachusetts.

**The foregoing discussion is qualified by and subject to the more detailed information on the plan of arrangement, including the applicable reasons, mechanics, effects and risks associated therewith, contained in the registration statement on Form S-4 filed by GSLI Corp with the Securities and Exchange Commission.**

**PART II**

**Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations***

*You should read this discussion together with the consolidated financial statements and other financial information included in this report. This report contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those indicated in the forward-looking statements. Please see the *Special Note Regarding Forward Looking Statements* elsewhere in this report.*

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We design, develop, manufacture and market components, lasers and laser-based advanced manufacturing systems as enabling tools for a wide range of applications. Our products allow customers to meet demanding manufacturing specifications, including device complexity and miniaturization, as well as advances in materials and process technology. Major markets for our products include the medical, automotive, semiconductor and electronics industries. In addition, we sell our products and services to other markets such as light industrial and aerospace.

We completed a merger of equals with General Scanning, Inc. on March 22, 1999. The merger transaction has been accounted for as a purchase for accounting purposes and, accordingly, the operations of General Scanning, Inc. have been included in the consolidated financial statements from the date of merger.

*Results of Operations.* The following table sets forth items in the consolidated statement of operations as a percentage of sales for the periods indicated:

	Year Ended December 31,		
	2002	2001	2000
Sales	100.0%	100.0%	100.0%
Cost of goods sold	69.1	65.4	64.8
Gross profit	30.9	34.6	35.2
Operating expenses:			
Research and development	12.9	10.3	9.1
Selling, general and administrative	34.9	29.8	23.5
Amortization of purchased intangibles	3.2	2.1	1.3
Restructuring	4.0	1.2	2.7
Other	(0.6)	(0.1)	(0.8)
Operating expenses	54.4	43.3	35.8
Loss from operations	(23.5)	(8.7)	(0.6)
Gain (loss) on sale of assets and investments		(1.9)	20.5
Other income (expense)	(0.3)		
Interest income, net	1.3	1.7	0.9
Foreign exchange transaction gains (losses)	(0.5)	(0.1)	(0.8)
Income (loss) before income taxes	(23.0)	(9.0)	20.0
Income tax provision (benefit)	(5.6)	(3.1)	7.9
Net income (loss)	(17.4)%	(5.9)%	12.1%

Commencing in the first quarter of 2002, we classified service sales support and service management costs as selling, general and administrative expenses. The table above reflects the reclassification of service sales support and service management costs from cost of goods sold to selling, general and administrative expense for 2000 and 2001 to be comparative with the current period. The change was made to properly classify costs that we believed should be classified as selling, general and administrative costs rather than cost of sales. The primary components of the costs reclassified were the general management of the company's service organization, which included the vice president of that organization and management employees worldwide who report to him, sales and marketing activities for service products, training development and order entry support. The company continues to reflect all direct field costs for services as well as technical support costs in cost of sales.

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**Business Environment and Restructurings**

Several significant markets for our products have been in severe decline for the past two years. Our sales of systems for semiconductor and electronics applications and precision optics for telecommunications have declined. From 2000 through 2002, the company faced a 57% decline in revenues and responded by streamlining operations to reduce fixed costs. This decline continues to the present and is due to the downturn in general economic conditions, combined with our customers' current excess of manufacturing capacity and their customers' excess inventories of semiconductor and electronic components.

In response to the business environment, we have undertaken to restructure our operations in an effort to bring costs in line with our expectations for sales of systems for the semiconductor and telecommunications markets. Our emphasis has predominantly been on consolidation of operations at various locations and reducing overhead. The company expects to incur additional restructuring charges in the first three quarters of 2003 as it continues to reduce and consolidate operations around the world.

*2000*

During fiscal 2000, the company took total restructuring charges of \$15.1 million, \$12.5 million of which resulted from the company's determination to exit the high powered laser product line that was produced in its Rugby, United Kingdom facility. The \$12.5 million charge consisted of \$1 million to accrue employee severance for approximately 50 employees; \$3.8 million for reduction and elimination of the company's United Kingdom operation and worldwide distribution system related to high power laser systems; and \$7.7 million for excess capacity at three leased facilities in the United States and Germany where high power laser systems operations were conducted. The provisions for lease costs at our Livonia and Farmington Hills, Michigan facilities and in Germany related primarily to future contractual obligations under operating leases, net of expected sublease revenue on leases that the company cannot terminate. Additionally, for our Farmington Hills, Michigan and Maple Grove, Minnesota facilities, we accrued an anticipated loss on our contractual obligations to guarantee the value of the buildings. This charge was estimated as the excess of our cost to purchase the buildings over their estimated fair market value. The company also recorded a non-cash write-down of land and building in the United Kingdom of \$2 million, based on market assessments as to the net realizable value of the facility. Included in the expected savings in earnings and cash on an annual "go forward" basis was approximately \$1.1 million related to salaries and benefits of employees terminated in the company's Rugby, United Kingdom manufacturing facility as part of the elimination of this product line. In addition, the company recorded in cost of goods sold a reserve of \$8.5 million for raw materials, work-in-process, equipment, parts and demo equipment inventory that related to the high power laser product line in its Rugby, United Kingdom facility and other locations that supported this product line.

The remaining restructuring charge for fiscal 2000, \$0.6 million of compensation expense, resulted from the acceleration of options upon the sale of our Life Sciences business and MPG product line during that year.

Also during fiscal 2000, the company reversed a provision of \$5 million originally recorded at the time of the 1999 merger of General Scanning, Inc. and Lumonics Inc. At the time the \$5 million provision was recorded, the company intended to close its Rugby, United Kingdom facility and transfer those manufacturing activities to its Kanata, Ontario facility. As plans evolved, the company realized that it would cost too much to move the manufacturing and decided to not go through with its original plan. Thus, the company reversed the \$5 million that had initially been recorded for this proposed restructuring.

Cumulative cash draw-downs of \$6 million, a reversal of \$0.5 million recorded in the fourth quarter of 2001 for anticipated restructuring costs that will not be incurred and a non-cash draw-down of \$2.6 million have been applied against the total fiscal 2000 provision of \$15.1 million, resulting in a remaining balance at December 31, 2002 of \$6 million. All actions relating to the 2000 restructuring charge have been completed. The \$6 million accrual remaining at December 31, 2002 for the Farmington Hills, Michigan and the Maple Grove, Minnesota facilities is expected to be used during 2003 at the end of the lease terms to offset the anticipated loss on these leases upon purchase and eventual resale of the buildings.



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*2001*

In the fourth quarter of fiscal 2001, to further reduce capacity in response to declining sales, the company determined that the remaining functions located in its Farmington Hills, Michigan facility should be integrated with its Wilmington, Massachusetts facility and that its Oxnard, California facility should be closed. In addition, the company determined to integrate its Bedford, Massachusetts facility with its Billerica, Massachusetts manufacturing facility. The company took total restructuring charges of \$3.4 million. The \$3.4 million charge consisted of \$0.9 million to accrue employee severance for approximately 35 employees at the Farmington Hills, Michigan and Oxnard, California locations; \$1.8 million for excess capacity at five leased locations in the United States, Canada and Germany; and \$0.7 million for write-down of leasehold improvements and certain equipment associated with the exiting of leased facilities located in Bedford, Massachusetts. The lease costs primarily related to future contractual obligations under operating leases, net of expected sublease revenue on leases that the company cannot terminate. The expected effects of the 2001 restructuring were to better align our ongoing expenses and cash flows in light of reduced sales. The company anticipated savings of approximately \$2.4 million on an annual basis related to salaries and benefits of employees terminated at these facilities in connection with this restructuring.

Cumulative cash draw-downs of approximately \$2.4 million and non-cash draw-downs of \$0.7 million have been applied against the provision, resulting in a remaining provision balance of \$0.3 million as at December 31, 2002. The restructuring is complete, except for costs that are expected to be paid on the leased facilities in Munich, Germany (lease expiration January 2013), Oxnard, California (expected payment March 2003) and Nepean, Ontario (lease expiration January 2006).

*2002*

Two major restructuring plans were initiated in 2002, as the company continued to adapt to a lower level of sales. In the first quarter of 2002, the company made a determination to reduce fixed costs by transferring manufacturing operations at its Kanata, Ontario facility to other manufacturing facilities. Associated with this decision, the company incurred restructuring costs in the first, second and fourth quarters of 2002. At this time, the company believes that all cost associated with the closure of this facility have been recorded, as noted below.

During the first quarter of 2002, the company consolidated its electronics systems business from its facility in Kanata, Ontario into the company's existing systems manufacturing facility in Wilmington, Massachusetts and transferred its laser business from the company's Kanata, Ontario facility to its existing facility in Rugby, United Kingdom. The company then closed its Kanata, Ontario facility. The company took a total restructuring charge of \$2.7 million related to these activities in the first quarter of 2002. The \$2.7 million charge consisted of \$2.2 million to accrue employee severance and benefits for approximately 90 employees; \$0.3 million for the write-off of furniture, equipment and system software; and \$0.2 million for plant closure and other related costs. Future expense and cash outflow associated with the termination of the 90 employees will be avoided, improving income before tax and cash flow by approximately \$1.2 million per quarter. During the second quarter of fiscal 2002, the company recorded additional restructuring charges of \$1.4 million related to cancellation fees on contractual obligations of \$0.3 million, an aggregate write-down of land and building in Kanata, Ontario and Rugby, United Kingdom of \$0.8 million and leased facility costs of \$0.3 million at the Farmington Hills, Michigan and Oxnard, California locations. The lease costs primarily related to future contractual obligations under operating leases, net of expected sublease revenue on leases that the company cannot terminate. The write-downs of the land and building brings the properties offered for sale in line with market values and the recording of these write-downs has no effect on cash.

The second major restructuring plan in 2002 related to the refocusing of our Nepean, Ontario operations on the custom optics business as a result of the telecom industry's severe downturn. The company's executive team approved a plan to reduce capacity at its Nepean, Ontario facility and the company recorded a pre-tax restructuring charge of \$2.3 million in the fourth quarter of 2002 which included \$0.6 million to accrue employee severance and benefits for approximately 41 employees. Future expense and cash outflow associated with the 41 terminated employees will be avoided, improving quarterly income before tax and cash flow by approximately \$0.5 million per quarter. The company also wrote-off approximately \$0.2 million of excess fixed

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assets and wrote-down one of the Nepean, Ontario buildings by \$0.2 million to its estimated fair market value. Additionally, the company continued to evaluate accruals made in prior restructurings and we recorded charges of approximately \$0.8 million for an adjustment to earlier provisions for leased facilities in the United States and Germany. Specifically, the \$0.8 million in adjustments in the fourth quarter of 2002 related to earlier provisions for the leased facilities in Munich, Germany, Maple Grove, Minnesota and Farmington Hills, Michigan. We had originally estimated our restructuring reserve of \$0.5 million based upon the assumption that we would have subleased the Munich, Germany facility in 2003. We had received information from a real estate broker that the commercial office market in Munich, Germany had softened and that we would not recover our full lease rate when we finally sublease the building. As such we recorded an additional provision of \$0.5 million to cover a longer anticipated time required to sublease the space and to reflect the likelihood of subleasing at less than our existing lease rates. For the Maple Grove, Minnesota facility, we had subleased the entire building through January 2003. We had anticipated that we would find a buyer for this building by January 2003 and exercise our option to purchase the building and not have to pay the remaining lease costs. As this did not happen, we accrued the contractual lease costs through the end of the lease in June 2003, which are \$0.2 million. Similarly for the Farmington Hills, Michigan facility, we had anticipated selling the building sooner, but as this did not occur by the end of 2002, we accrued the costs for the unused space through the end of the lease in June 2003, which are \$0.1 million. The company also took a further write-down of \$0.3 million on the buildings in Kanata, Ontario and Rugby, United Kingdom and a \$0.1 million write-off for fixed assets in Kanata, Ontario and a \$0.1 million for the Maple Grove, Minnesota and Farmington Hills, Michigan facilities.

At December 31, 2002, the net book value of two facilities, one in Kanata, Ontario and the other in Nepean, Ontario, were reclassified as held for sale and included in other assets.

Cumulative cash draw-downs of approximately \$2.1 million and non-cash draw-downs of \$1.8 million have been applied against the provisions taken in 2002, resulting in a remaining provision balance of \$2.5 million at December 31, 2002. For severance related costs associated with these two restructuring actions, the actions are complete and the company does not anticipate taking additional restructuring charges and expects to finalize payment in 2003. The company will continue to evaluate the fair value of the buildings and fixed assets that were written down. The restructuring accrual is expected to be completely utilized during January 2013 at the end of the lease term for the Munich, Germany facility. The company estimated the restructuring charge for the Munich, Germany facility based on contractual payments required on the lease for the unused space, less what is expected to be received for subleasing. Because this is a long term lease that extends until 2013, the company will draw-down the amount accrued over the life of the lease. Future sublease market conditions may require the company to make further adjustments to this restructuring reserve.

The result of this restructuring activity was the establishment of our three new primary business segments: Components, Lasers and Laser Systems. In addition, improved working capital management provided substantially reduced investment in receivables and inventories.

**2002 Compared to 2001**

*Sales by Segment.* The following table sets forth sales in millions of dollars by our business segments for 2002 and 2001. The information was not available and impracticable to obtain to reclassify 2000 results into these new segments. In 2000, there were other businesses and product lines that were subsequently divested or discontinued that do not conform to the new segments, as such the information would not be comparable. Information for 2000 by segment is not presented.

	<b>2002</b>	<b>2001</b>
	<b>Sales</b>	<b>Sales</b>
Components	\$ 70.5	\$ 88.7
Lasers	23.7	39.1
Laser Systems	65.9	124.0
Other and intra-segment eliminations	(1.0)	(3.9)
<b>Total</b>	<b>\$ 159.1</b>	<b>\$ 247.9</b>

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Sales for 2002 decreased by \$88.8 million or 36% compared to 2001. The divestiture and discontinuation of product lines accounted for \$12 million of this reduction. But, the primary reason for the decline remains the deep recession in the market for semiconductor and electronic capital equipment and optical telecommunications components, which began midway through 2001. Sales have now stabilized at a level of approximately \$40 million per quarter since the third quarter of 2001.

Sales in the Components segment decreased in 2002 by \$18.2 million compared to 2001. The weakness in the telecommunications market sector was the primary cause for the decline. Sales from the product lines linked to that sector accounted for a combined \$9.6 million in sales reduction. Other factors were a \$6.1 million reduction in the Optical Scanning product line affected by the downturn of the semiconductor industry and the market for laser ophthalmology equipment and \$1.8 million decline in our GMAX product line affected by a slow down in Europe and North America. Discontinued product lines contributed another \$0.7 million in sales decrease against 2001.

Sales in the Lasers segment declined by \$15.4 million or 39% below 2001 results. The decline was due to a combination of repositioning the business out of high power automotive lasers into lower power lasers for medical and other markets, as well as the introduction of a new family of products. Our JK series and Excimer laser product lines accounted for \$10.8 million or 70% of the sales decline in this segment against 2001. Excimer laser sales declined as a result of the collapse of the telecommunications market. Discontinued product lines accounted for \$1.4 million of the 2002 sales decline.

The sales of Laser Systems have suffered the most with a \$58.1 million or 47% decline from 2001. Our Trim & Test, WaferMark and DrillStar product line sales decreased by a combined \$57.9 million primarily due to lower volume reflecting the downturn in the global semiconductor, electronics and telecom industries. These factors were partially offset by market acceptance of our Memory Repair product line, sales of which increased by \$10.9 million in 2002 from 2001. Discontinued and divested product lines accounted for \$10 million of the 2002 sales decline.

*Sales by Region.* We distribute our systems and services via our global sales and service network and through third-party distributors and agents. Our sales territories are divided into the following regions: the United States; Canada; Latin and South America; Europe, consisting of Europe, the Middle East and Africa; Japan; and Asia-Pacific, consisting of ASEAN countries, China and other Asia-Pacific countries. Sales are attributed to these geographic areas on the basis of the bill to customer location. Not infrequently, equipment is sold to large international companies, which may be headquartered in Asia-Pacific, but the sales of our systems are billed and shipped to locations in the United States. These sales are therefore reflected in United States totals in the table below. The following table shows sales in millions of dollars to each geographic region for 2002, 2001 and 2000.

	2002		2001		2000	
	Sales	% of total	Sales	% of total	Sales	% of total
United States	\$ 94.7	59%	\$ 119.3	48%	\$ 177.8	48%
Canada	1.9	1	11.4	5	20.2	5
Latin and South America	1.2	1	0.9		5.5	1
Europe	25.8	16	50.7	20	72.0	19
Japan	23.5	15	41.0	17	58.2	16
Asia-Pacific, other	12.0	8	24.6	10	40.2	11
<b>Total</b>	<b>\$ 159.1</b>	<b>100%</b>	<b>\$ 247.9</b>	<b>100%</b>	<b>\$ 373.9</b>	<b>100%</b>

The significant downturn in economic conditions that commenced in 2001, especially in the global semiconductor, electronics and telecom industries, continues to impact sales in all of our geographic regions. The 2002 sales decline of 20.6% in the United States was not as marked as the percent decline in other regions, because there was a relatively moderate sales decline of 23% in the Components segment, which is predominately in the United States, and there was a \$6.4 million sales increase in the United States in

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Memory Repair over 2001. Sales from the Components segment and Memory Repair accounted for respectively \$52.7 million or 56%, and \$12.5 or 13% of the sales recorded in the United States in 2002. Other products sold in the United States recorded a combined 40% decline in 2002. The decline in Canada in 2002 compared to 2001 relate primarily to the downturn of the optics and telecommunication market sectors. Europe, Japan and Asia Pacific all suffered from the downturn in the semiconductor and electronics markets. In 2000, all geographic regions had relatively strong sales. This was especially true for Japan and Asia Pacific, which experienced recovery in 2000 after the financial crisis and economic downturn of the 1990s.

*Backlog.* We define backlog as unconditional purchase orders or other contractual agreements for products for which customers have requested delivery within the next twelve months. Backlog was \$42 million at December 31, 2002, compared to \$50 million at December 31, 2001 and \$119 million at December 31, 2000.

*Gross Profit.* Gross profit was 30.9% in 2002 and 34.6% in 2001. Gross profit as a percentage of sales in 2002 decreased compared to 2001 primarily as a result of fixed costs representing a larger percentage of cost of sales in 2002 as compared to 2001. When sales dropped dramatically, fixed costs as a percentage of sales increased. Fixed costs for manufacturing and service were 18.1% of sales in 2002 versus 14.6% in 2001. These fixed costs of sales were higher, year over year, as a percentage of sales, despite decreasing by \$7.4 million, or 20%, from 2001 to 2002, because sales in the same period decreased by 36%. Fixed costs are not variable to sales and we cannot quickly reduce these expenses. Major items in fixed costs are salaries and benefits for non-direct labor, facility and occupancy costs (rent and buildings that are under long term contracts) and depreciation expense (which is spread over the life of the assets). We have tried through restructurings to reduce fixed costs over time, but we cannot reduce fixed costs as a one-for-one match to sales declines in any particular period. To the extent that we cannot reduce these fixed costs in the future at the same rate as any reduction in sales, we could experience lower margins. Favorable fluctuations as a percentage of sales in cost of materials (3%) and other costs of sales (1%) were offset by unfavorable fluctuations as a percentage of sales in direct service cost (3%) and inventory provision (1%).

Although the number of competitors in our marketplace remained relatively constant, demand for our products, particularly products in the markets served by our Laser Systems segment, decreased in 2002 from 2001. As a result, we faced increased competition for fewer potential sales. In an effort to reduce some of our slower moving inventory, we reduced prices on some of our products, primarily in lines in which the company does not expect to focus significant resources in the future. We anticipate that pricing pressure will continue in the future and that such pressure will continue to affect sales particularly in our Laser Systems segment. To attempt to improve our gross profit as a percentage of sales in the future, we have taken steps to reduce our fixed manufacturing costs and to add technology features to some of our products that, as a result, we believe may command a premium price, although no assurances can be given that we will be successful in improving or preventing a future decline in our gross profit percentage.

As a policy, we review inventory values, based on expected future usage, to ensure that inventory is recorded at the lower of cost or net realizable values. The company establishes a reserve in the event of excess inventory. In 2002, as sales declined, the company established additional inventory reserves for potential excess and obsolete inventory. The majority of these reserves were in our Laser Systems and Lasers segments. The company has initiated programs to try to sell this inventory and believes that, based on the stabilization of sales since the third quarter of 2001, the current inventory provisions are adequate, although no assurances can be given that such provisions will be adequate or that the markets that our products serve will not further deteriorate.

Commencing in the first quarter of 2002, we classified service sales support and service management costs as selling, general and administrative expenses. In prior years, we classified these costs as cost of goods sold. As such we have reclassified in the comparative statement of operations \$5.3 million in 2002 and \$5.1 million in 2001 from cost of goods sold to selling, general and administrative expenses. The reclassification was prepared on a consolidated basis only and is not available by segment.

*Research and Development Expenses.* Research and Development (R&D) expenses for 2002 were 12.9% of sales or \$20.4 million, compared to 10.3% of sales or \$25.6 million in 2001.

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The R&D expenses in the Components segment were \$4.4 million in 2002 compared to \$6.3 million in 2001. The decrease in R&D expenses of \$1.9 million in 2002 is due primarily to a \$1.3 million reduction in projects related to the telecommunications market.

The R&D expenses in the Lasers segment were \$2.8 million in 2002 compared to \$3 million in 2001. The modest reduction in R&D spending in 2002 in spite of lower sales confirm the company's commitment to grow the equipment sales in this segment.

The R&D expenses in the Laser Systems segment were \$12.4 million in 2002 compared to \$16.4 million in 2001. The decrease of \$4 million in 2002 reflects the completion of major projects and the impact of initiatives undertaken by the company to focus our spending on key potential growth areas.

R&D expenses for \$0.8 million in 2002 compared to none in 2001 were recorded at the corporate level. These expenses are mostly in support of our patent application management. In 2001 similar expenses were recorded at the factory level.

*Selling, General and Administrative Expenses.* Selling, General and Administrative (SG&A) expenses decreased by \$18.3 million to \$55.5 million or 34.9% of sales in 2002 compared to \$73.8 million or 29.8% of sales in 2001. There was a 31% reduction in SG&A headcount from December 31, 2001 to December 31, 2002. SG&A cost reductions, however, did not decline during 2002 proportionately as much as our sales, resulting in an increase in SG&A as a percentage of sales ratio from 2001 to 2002. Of the total decrease in SG&A expenses from 2001 to 2002, \$9 million or 49% of the decrease is attributable to reduced personnel costs, such as salaries and benefits, as a result of the reductions in headcount made during 2002 and mandatory shutdown days. Also, as a result of decreased hiring, recruiting expenses decreased by \$0.5 million. Lower commissions as a result of lower sales accounted for \$1.9 million or 10% of decrease in SG&A expenses from 2001 to 2002. Lower occupancy costs as a result of reductions in operating locations accounted for \$1.3 million or 8% of the decrease in SG&A spending year over year. Reductions in spending on consultants and temporary employees accounted for \$1.2 million or 6% of the decrease in SG&A expenses from 2001 to 2002. Lower spending on travel related expenses accounted for \$1 million or 5% of the decrease in SG&A expenses. Although legal expenses decreased by \$0.9 million from 2001 to 2002, they were still approximately \$2.5 million for the year ended 2002, as a result of expenses associated with the defense of two lawsuits that were settled in 2002. The balance of the decrease in SG&A expenses from 2002 to 2001 of approximately \$2.5 million was in a variety of areas as a result of cost cutting measures that were implemented.

As noted above, in 2002 service sales support and service management costs were reclassified to selling, general and administrative expenses from cost of goods sold. As this was done on a consolidated basis, it is not possible to breakdown SG&A expenses by segment.

*Amortization of Purchased Intangibles.* Amortization of purchased intangibles was \$5.1 million in 2002 compared to \$5.2 million in 2001. This slight decrease in the amortization in 2002 as compared to 2001 is due to the write-down of certain intangibles that occurred at the end of 2001.

*Restructuring.* As described above and in note 11 to the audited consolidated financial statements for the year ended December 31, 2002, we recorded restructuring charges of \$6.4 million in the year then ended and of \$2.9 million in the year ended December 31, 2001.

*Other.* Other includes a net benefit of \$0.7 million from settlement of two lawsuits during 2002 and royalty income of \$0.3 million. As more fully described in note 11 to the audited consolidated financial statements for the year ended December 31, 2002, during the fourth quarter of 2001, the company recorded a reduction of purchased intangibles related to technologies no longer a part of the business in the amount of \$1.8 million. Also, during 2001, the company recorded a benefit of \$0.3 million related to royalties earned on the divested OLT precision alignment system product line. The company also adjusted a \$19 million provision originally recorded the first quarter of fiscal 1999 related to litigation and recorded a benefit of \$1.6 million when the litigation was settled.

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*Loss from Operations.* The following table sets forth loss from operations in thousands of dollars by our business segments for the years ended December 31, 2002 and 2001.

	Year Ended December 31,	
	2002	2001
<b>Profit (loss) from operations before income taxes</b>		
Components	\$ 16,763	\$ 18,603
Lasers	(5,010)	4,425
Laser Systems	(18,732)	(23,712)
<b>Total by segment</b>	(6,979)	(684)
Unallocated amounts:		
Corporate expenses	19,754	12,983
Amortization of purchased intangibles	5,135	5,226
Restructuring and other	5,427	2,782
<b>Loss from operations</b>	<b>\$ (37,295)</b>	<b>\$ (21,675)</b>

*Gain (loss) on Sale of Assets and Investments.* During 2001, we sold our investment in shares of PerkinElmer, Inc. for a loss of \$4.8 million. There were no such items in 2002.

*Interest Income.* Interest income was \$2.7 million in 2002 compared to \$5.1 million in 2001. The decrease in interest income in 2002 was due to continuous declines in interest rates.

*Interest Expense.* Interest expense was \$0.7 million in 2002 compared to \$0.9 million in 2001. The decrease in interest expense in 2002 was due to lower balances of debt in 2002 than 2001. By the end of December 2002, the company had no bank debt.

*Other Expense.* In 2002, we recorded a write-down of approximately \$0.6 million related to an investment in OpNet Partners, L.P. See note 10 to the audited consolidated financial statements.

*Income Taxes.* The effective tax rate for 2002 was 24.5% of income before taxes, compared to an effective tax rate of 34.6% for 2001. Our tax rates in 2002 and 2001 reflect the fact that we do not recognize the tax benefit from losses in certain countries where future use of the losses is uncertain and other non-deductible costs. The company believes it is more likely than not that the remaining deferred tax assets will be realized principally through future taxable income and carry backs to taxable income in prior years. If the company does not return to profitability, we may be at risk to take further write-downs in our deferred tax assets.

*Net Income (Loss).* As a result of the forgoing factors, net loss during 2002 was \$27.7 million, compared with a net loss of \$14.7 million in 2001.

**2001 Compared to 2000**

*Sales.* The total sales in 2001 of \$247.9 million were \$126 million or 34% below the total sales in 2000. The divestitures of the LaserDyne, Custom Systems, Life Sciences, Metrology and Xymark product lines accounted for \$42.8 million or 34% of the decline. The discontinuation of the AM Series and other product lines accounted for \$35.2 million or 28% of the decline. We expect that sales from these divested and discontinued product lines will be negligible going forward. The balance of the 2001 sales decline as compared to the prior year was primarily due to the significant downturn in the markets we serve, especially in the semiconductor and electronics markets.

*Gross Profit.* Gross profit was 34.6% in 2001 and 35.2% in 2000. Gross profit in 2001 decreased compared to 2000 as a result of the economic downturn and fixed manufacturing and service overhead costs, which were not reflective of the lower sales volumes during the period. This was partially offset by lower inventory loss provisions in 2001 compared to 2000. In the fourth quarter of 2000, the company wrote off

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\$8.5 million of AM series inventory related to high power lasers for the auto industry that we discontinued and evaluated other inventory that resulted in a \$10.5 million increase in inventory provision.

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*Research and Development Expenses.* Research and Development (R&D) expenses were 10.3% of sales or \$25.6 million in 2001 and 9.1% of sales or \$33.9 million in 2000. During 2001 and 2000, R&D activities focused on products targeted at the electronics, semiconductor and telecommunications markets. The spending reduction in 2001 compared to 2000 is due primarily to a decision to focus R&D spending on core technologies combined with the divestitures of certain product lines in the second half of 2000 as well as Laserdyne and Custom Systems in 2001.

*Selling, General and Administrative Expenses.* Selling, General and Administrative (SG&A) expenses decreased to \$73.8 million or 29.8% of sales in 2001 compared to \$87.5 million or 23.5% of sales in 2000. The quarterly spending rate in 2001 was \$3.5 million lower in the fourth quarter of 2001 compared to the first quarter due to the impact of lower sales, discontinued product lines, cost reduction measures and mandatory factory shut down days.

*Amortization of Purchased Intangibles.* Amortization of purchased intangibles increased to \$5.2 million in 2001 from \$4.9 million in 2000. The increase in amortization from 2000 to 2001 is a result of amortizing intangible assets acquired from the acquisition of General Optics, which was partially offset by a reduction in amortization due to the sale of Life Sciences in October 2000.

*Restructuring.* As described above and in note 11 to the audited consolidated financial statements for the year ended December 31, 2002, we recorded restructuring charges of \$2.9 million in the year ended December 31, 2001 and \$10.1 million in the year ended December 31, 2000.

*Gain (loss) on Sale of Assets and Investments.* During 2001, we sold our investment in shares of PerkinElmer, Inc. for a loss of \$4.8 million. During 2000, we sold the net assets of the Life Sciences business for a non-operating gain of \$73.1 million and the operating assets of other product lines including View Engineering metrology product line, fiber-optics operations in Phoenix, Arizona and package coding product line in Hull, United Kingdom for a net gain of \$1.3 million. We also sold two facilities in the United States for a net gain of \$2.4 million.

*Interest Income.* Interest income was \$5.1 million in 2001 and \$4.8 million in 2000. The increase in interest income in 2001 was due to an increased average cash and investment balance compared to 2000 and due to the sale of the company's holding of PerkinElmer, Inc. stock and reinvestment of proceeds into short-term investments.

*Interest Expense.* Interest expense was \$0.9 million in 2001 compared to \$1.5 million in 2000. The decrease in interest expense in 2001 was due to lower balances of debt in 2001 as compared to 2000.

*Income Taxes.* The effective tax rate for 2001 was 34.6% of income before taxes, compared to an effective tax rate of 39.5% for 2000. Our tax rates in 2001 and 2000 reflect the fact that we do not recognize the tax benefit from losses in certain countries where future use of the losses is uncertain and other non-deductible costs.

*Net Income (Loss).* As a result of the forgoing factors, net loss during 2001 was \$14.7 million, compared with a net income of \$45.4 million in 2000.

## **Critical Accounting Policies and Estimates**

Our consolidated financial statements are based on the selection and application of significant accounting policies, which require management to make significant estimates and assumptions. We believe that the following are some of the more critical judgment areas in the application of our accounting policies that currently affect our financial condition and results of operations.

*Revenue Recognition.* We recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, risk of loss has passed to the customer and collection of the resulting receivable is probable. We design, market and sell our products as standard configurations. Accordingly, customer acceptance provisions for standard configurations are generally based on seller-specified criteria, which we demonstrate prior to shipment. Revenue on new products is deferred until we have established a track record of customer acceptance on these new products. When customer-specified



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objective criteria exist, revenue is deferred until customer acceptance if we cannot demonstrate the system meets these specifications prior to shipment. Should management determine that these customer acceptance provisions are not met for certain future transactions, revenue recognized for any reporting period could be affected.

*Stock Based Compensation.* We recognize compensation expense for stock options under the intrinsic value method, as allowed in APB 25. At this time, the company does not intend to include stock based compensation expense directly in the results of operations, except as required under APB 25, but to disclose the pro-forma effects of stock based compensation in the notes to the financial statements. If the accounting rules change to require the expensing of all stock based compensation, then our results of operations would be lower. See note 7 to the financial statements for the disclosure of the effects of stock based compensation.

*Allowance for Doubtful Accounts.* We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

*Inventory.* We write down inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. Sales volumes have been adversely impacted by the general economic downturn, and the semiconductor, electronics and telecommunication industries downturn in particular, and inventory has been affected accordingly. We have been implementing a program to reduce our inventory to desired levels. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

The company has in place policies to review inventory values to ensure that inventory is recorded at the lower of cost or net realizable values. The company regularly reviews inventory values based on expected future usage. If, using our best judgment and based on information available, there is excess inventory, the company will establish a reserve. As the sales demand for the company's products declines, the company establishes additional inventory reserves for potential excess and obsolete inventory. Historically, the majority of these reserves have been in product lines associated with our Laser and Laser Systems segments. The company has initiated programs to try to sell this inventory or to dispose of it, and believes that the current inventory provisions are adequate. The company does not realize significant proceeds or margins on the sale or other disposition of this inventory. Most of the inventory reserves we took in 2002 were indirectly related to the restructuring actions. The same root cause of lower demand for and sales of our products, which caused us to evaluate the inventory that we had on hand and to make adjustments in value as appropriate, also initiated management's decisions that restructuring actions were necessary to bring costs in line with sales.

In general, after the company establishes a reserve on inventory, various options are reviewed before a decision is made to dispose of the written-down excess inventory. The company may decide to keep the inventory to support anticipated sales, which may be outside the time frames of our reserve policy. We will review to see if the inventory can be used in other product lines or in research and development efforts. The company will determine if there is an outside market to which the parts can be moved, such as a scrap vendor. Much of our reserved inventory is highly customized and can not be sold for scrap or used in other products, and is ultimately disposed of for insignificant proceeds. Disposal of inventory is made after all other options for use of the written-down inventory have been exhausted.

Net inventory provisions included in cost of goods sold were \$20.8 million in fiscal 2000 and \$3.7 million in each of fiscal 2001 and fiscal 2002.

In 2000, the company recorded inventory provisions on various product lines, in addition to the \$8.5 million charge specifically relating to the high powered laser product line and described under the heading Business Environment and Restructurings above, of approximately \$12.3 million. There were many reasons for recording these provisions, including but not limited to: (i) ensuring compliance with internal company policies on valuing inventory and providing for reserves for excess and obsolescence; (ii) providing for

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inventory on products that were eliminated or planned to be eliminated in the near future; and (iii) providing for inventory where future sales forecasts had been reduced.

In 2001, the majority of the \$3.7 million in inventory provisions recorded were in the product lines affected by the downturn in the semiconductor markets. These were not related to a specific restructuring action.

In 2002, the company continued to evaluate the inventory provisions as sales did not recover as anticipated in the semiconductor and telecom industries. We recorded approximately \$3.7 million in inventory provisions. Only \$0.3 million was identified as part of the restructuring plan for the company's Kanata, Ontario operations and was recorded in cost of goods sold.

*Warranties.* We provide for the estimated costs of product warranties at the time revenue is recognized. Our estimate of costs to service the warranty obligations is based on historical experience and expectation of future conditions. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, revisions to the estimated warranty liability would be required.

*Restructuring.* During fiscal year 2002, 2001 and 2000, we recorded significant reserves in connection with our restructuring program. These reserves include estimates pertaining to employee separation costs and the settlements of contractual obligations resulting from our actions. Some of these accruals relate to costs of excess leased facilities that are under long-term leases. Our estimate of the reserve is based on estimates of market value of leased buildings, where we have made residual value guarantees, or of office rental rates in the future in various markets and the time required to sublease the space, both of which are subject to many variables, such as economic conditions and amount of space available in the market. Additionally, our restructuring reserve includes estimates to reduce owned buildings to market value. We are trying to sell these buildings, but there are many factors that could affect the fair market value or final value that we receive in any sale, as such there may be adjustments to our reserves. Although we do not anticipate significant changes, the actual costs may differ from these estimates.

*Deferred Taxes.* As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets totaling \$17.2 million within our December 31, 2002 consolidated balance sheet, after providing a valuation allowance of \$22.6 million, as presented in note 9 to the consolidated financial statements.

We assess the likelihood that our deferred tax assets will be recovered. To the extent that we believe that future recovery is not likely, we must establish a valuation allowance. To the extent we establish or increase a valuation allowance, we must include an expense within the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. The company has provided a valuation allowance against losses in the parent company and subsidiaries with an inconsistent history of taxable income and loss due to the uncertainty of their realization. In addition, the company has provided a valuation allowance on foreign tax credits, due to the uncertainty of generating foreign earned income to claim the tax credits. In the event that actual results differ from our estimates of future taxable income, or we adjust these estimates in future periods, we may need to establish an additional valuation allowance, which could impact our financial position and results of operations.

*Intangible Assets.* In assessing the recoverability of our intangible assets, we must make assumptions regarding estimated future operating results, cash flows, planned uses of technology and other factors to determine the fair value of the respective assets. During the fourth quarter of 2002, we reviewed the intangible assets for potential impairment, and determined that there was no adjustment needed. During the fourth quarter of 2001, we determined that the carrying value of our intangible assets was no longer fully recoverable based on these factors. As a result, we recognized an impairment charge of \$1.8 million in 2001. If our estimates or their related assumptions change in the future, we may require adjustments to the carrying value of the remaining assets.

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*Pension Plan.* The company's United Kingdom subsidiary maintains a defined benefit pension plan, whose membership was closed effective 1997. At year-end 2002, because of significant declines in the stock market and low interest rates, the market value of the plan assets was approximately \$5 million less than the projected benefit obligation.

The accounting rules applicable to our pension plan require amounts recognized in financial statements be determined on an actuarial basis, rather than as contributions are made to the plan. A significant element in determining our pension income or pension expense is the expected return on plan assets. We have assumed, based on the type of securities in which the plan assets are invested and the long-term historical returns of these investments, that the long-term expected return on pension assets will be 7% and its assumed discount rate will be 6%. Given our pension plan's current under-funded status, absent improved market conditions, we will be required to increase cash contributions to our pension plan in future years. Further declines in the stock market and lower rates of return could increase our required contributions.

Since the market value of our pension assets at year-end 2002 was less than the accumulated pension benefit obligation, the company recorded a \$3.9 million non-cash charge to other comprehensive income in stockholders' equity and an accrued long-term pension liability. This charge to equity did not affect net loss. The charge will only be reversed when the value of the pension assets exceed the accumulated pension benefit obligation as of a future measurement date.

In December 2002, the company notified plan participants that it intended to cease sponsoring the pension plan. Statutorily required consultations with the plan participants are being held, during which benefits continue to accrue. No final decision has been made by the pension plan trustees. The company, however, cannot currently quantify its liability in connection with the curtailment of the pension plan, which will depend on the timing and details of the curtailment and the actual settlements with the plan participants, if any.

## **Liquidity and Capital Resources**

### *Lines of Credit*

At December 31, 2002, the company had lines of credit denominated in United States and Canadian dollars with Fleet National Bank, or Fleet, Bank One and Canadian Imperial Bank of Commerce, or CIBC, and letters of credit with National Westminster Bank, or NatWest, for a total amount of available credit of \$12.1 million versus \$32.4 million at December 31, 2001. The company's agreement with Fleet provides for an \$8 million line of credit. At December 31, 2002, the company had a \$4 million line of credit with CIBC. NatWest provides a \$0.1 million bank guarantee for letters of credit used for VAT purposes in the United Kingdom. At December 31, 2002, marketable securities totaling \$14.5 million had been pledged as collateral for the Fleet and CIBC credit facilities under security agreements. The line of credit with Fleet expires on June 28, 2003. In addition to the customary representations, warranties and reporting covenants, the borrowings under the Fleet credit facility require the company to maintain a quarterly minimum tangible net worth of \$200 million. The line of credit with CIBC was reviewed by the company and a decision to cancel the line of credit was conveyed to CIBC prior to December 31, 2002. By giving CIBC appropriate advance notice, the company initiated its right to cancel the line of credit at any time at no cost, excluding breakage fees relating to the used and outstanding amounts under fixed loan instruments, which we do not expect to be material. The \$0.4 million remaining under the CIBC credit facility at March 28, 2003 should be cancelled by the end of the second quarter of 2003. The company also cancelled a credit facility with Bank One on December 20, 2002 without paying any breakage fees. North American inventories and receivables were pledged as collateral for the Bank One credit facility. Bank One continues to work on the release of all liens and obligations associated with the facility.

The company had approximately \$12.1 million denominated in Canadian dollars and United States dollars that are available for general purposes, under the credit facilities discussed above, at December 31, 2002. Of the available \$12.1 million at December 31, 2002, \$7.7 million was in use; consisting of \$3.8 million committed at Fleet Bank for use in foreign exchange transactions, \$2.9 million in Rugby, United Kingdom under the CIBC credit facilities and approximately \$0.8 million of bank guarantees and outstanding letters of

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credit under the CIBC credit facility and \$0.1 million with NatWest. Though the Fleet Bank amount of \$3.8 million is committed for support of foreign currency hedging contracts and not, therefore, available, it is not considered used for purposes of calculating interest payments. The aggregate unused portion of credit available under the credit facilities amounted to \$4.4 million at December 31, 2002. The Fleet line of credit is due on demand and bears interest based on either prime or LIBOR depending on the borrowing notification period. This resulted in an effective average rate of 1.79% for fiscal 2002.

*Cash Flows for the Years Ended December 31, 2002, 2001, 2000*

The company used \$19.3 million in cash during 2002 to close the year on December 31, 2002 with cash and cash equivalents of \$83.6 million compared to \$103 million at December 31, 2001 and \$113.9 million at December 31, 2000. In addition, short-term investments were \$29 million at December 31, 2002 a decrease of \$14.5 million compared to December 31, 2001. Long-term investments totaled \$37.4 million at December 31, 2002. Short-term, long-term and other investments consist principally of commercial paper, governments, short-term corporate debt, and banker's acceptances with original maturities greater than three months. The total of cash, cash equivalents and investments at December 31, 2002 was \$150 million.

We generated \$11.7 million in cash from operating activities during 2002. The net loss, after adjustments for non-cash items, resulted in a use of cash of \$10 million in 2002. Accounts receivable, inventories and other current assets generated a further \$29.8 million during 2002, which was offset by current liabilities using \$8.1 million. Accounts receivables contributed \$9.4 million due to a 17-day improvement in the average time of collection offset by the impact on receivables of a \$2.7 million sales increase in the fourth quarter of 2002 over the fourth quarter of 2001. Inventories contributed \$19.6 million due to a reduction in manufacturing activities caused by lower demand in 2002 and management's focus on disposing of slow moving inventory. These efforts resulted in inventory turns increasing to 3.0 at the end of 2002 from 2.3 at the end of 2001. The reduction in current liabilities is due to a lower manufacturing activities and lower spending due to a reduction in workforce. During 2001, we used \$17.5 million in operating activities. Net income, after adjustment for non-cash items, generated cash of \$12.8 million in 2001. Accounts receivable, inventories and other current assets generated a further \$57.4 million, which was more than offset by current liabilities using \$87.7 million. Accounts receivable contributed \$47.1 million as the 2001 balance dropped sharply as a result of a 56% decline in sales from the fourth quarter of 2000 to the fourth quarter of 2001, offset by a 5-day increase in the average time of collection. Inventories contributed \$8.9 million due to a reduction in manufacturing activities. However the reduction in inventory did not match the sales decline resulting in a decrease in inventory turns to 2.3 from 4.3 in December 2000. The usage in current liabilities reflects the downturn in manufacturing activities and the reduction in workforce. During 2000, we used \$10.2 million in operating activities. The net loss, after adjustment for non-cash items, resulted in the use of cash of \$19.9 million in 2000. Accounts receivable, inventories and other current assets used a further \$28.4 million, which was more than offset by current liabilities providing \$38.1 million. The usage of cash in accounts receivable is due to higher sales in 2000 partially offset by a 2-day improvement in the average time of collection. The usage in inventory reflects the increase in inventory to support higher demand. The increase in current liabilities is also due to higher spending associated with higher sales.

We used \$23.8 million in investing activities, including \$132.9 million of purchases of short-term and long-term investments and \$110 million of maturities of short and long-term investments during 2002. Investment in property, plant and equipment, net of disposals, used \$3 million and in cash and other assets generated \$2 million in 2002. During 2001, investing activities provided \$12.4 million, including \$109.4 million of purchases and \$85.8 million of maturities of short-term investments. During 2001, we generated \$38.5 million from the sale of our investment in PerkinElmer, Inc. and \$7.3 million from the sale of our Laserdyne and Custom Systems product lines to Laserdyne Prima (see note 2 to the audited consolidated financial statements for details of both transactions). Investment in property, plant and equipment used \$8.6 million in cash and other assets used \$1.2 million. During 2000, investing activities provided \$35.8 million, including \$57.7 million of purchases and \$45 million of maturities of short-term investments. During 2000, we generated \$65 million from the sale of business assets and invested \$10.1 million in property, plant and equipment. The acquisition of General Optics used \$7.1 million in cash in 2000.

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Cash flow used in financing activities was \$8.2 million for the year ended December 31, 2002 compared to \$6.3 million for the year ended December 31, 2001 and \$62.7 million that was provided by financing activities for the year ended December 31, 2000. We made net repayments of bank indebtedness during 2002 of \$6.4 million compared to \$4.1 million in 2001, and a scheduled payment of \$3 million on long-term debt in 2002 as compared to \$4 million on long-term debt in 2001. These were partially offset by \$1.2 million received in 2002 and \$1.8 million received in 2001 from the exercise of stock options and issuance of shares under the employee stock purchase plan. The net increase in cash in 2000 relates primarily to \$68.3 million net proceeds received from a public offering of 4.3 million common shares, \$8.7 million raised from the exercise of stock options and decrease in bank indebtedness and long-term debt of \$14.2 million.

*Other Liquidity Matters*

The company's final salary defined benefit pension plan in the United Kingdom had an excess of projected benefit obligation over the fair market value of plan assets of approximately \$5 million at December 31, 2002. The company's funding policy is to fund pensions and other benefits based on widely used actuarial methods as permitted by regulatory authorities. These factors are subject to many changes, including the performance of investments of the plan assets. Because of the current underfunding and potential changes in the future, the company may have to increase payments to fund the pension plan.

*Contractual Obligations*

The following summarizes our contractual obligations at December 31, 2002 and the effect such obligations are expected to have on liquidity and cash flow in future years in thousands.

<b>Contractual Obligations</b>	<b>Total</b>	<b>1st Year</b>	<b>2 - 3 Years</b>	<b>4 - 5 Years</b>	<b>After 5 Years</b>
Operating leases(1)	\$13,814	\$ 3,549	\$4,625	\$3,146	\$2,494
Unconditional purchase obligations	10,518	10,168	350		
Other long-term obligations(2)	2,318	189	376	374	1,379
<b>Total Contractual Cash Obligations</b>	<b>\$26,650</b>	<b>\$13,906</b>	<b>\$5,351</b>	<b>\$3,520</b>	<b>\$3,873</b>

(1) See note 12 to the audited consolidated financial statements.

(2) See note 6 to the audited consolidated financial statements.

We lease certain equipment and facilities under operating lease agreements that expire through 2013. The company leases two facilities (Maple Grove, Minnesota and Farmington Hills, Michigan) under operating lease agreements that expire in 2003, where at the end of the initial lease term, these leases require the company to renew the lease for a defined number of years at the fair market rental rate or purchase the property at the fair market value. The lessor may sell the facilities to a third party but the leases provide for a residual value guarantee of the first 85% of any loss the lessor may incur on its \$19.1 million investment in the buildings, which may become payable by the company upon the termination of the transaction, or the company may exercise its option to purchase the facilities for approximately \$19 million. As of December 31, 2002, residual value guarantees in connection with these leases totaled approximately \$16 million. Upon termination of the leases, the company expects to purchase the buildings for approximately \$19 million cash and then sell them for the combined estimated market value of the two buildings of approximately \$12.5 million to \$13.3 million. During the fourth quarter of fiscal 2000, the company took a charge of \$6 million associated with restructuring for excess capacity at the two leased facility locations, including the estimated residual value guarantees. In the fourth quarter of 2002, the company took an additional restructuring charge of \$0.1 million to increase the reserve for the decline in the estimated market values of the underlying buildings. The total expected value of the buildings at the end of the leases may vary, depending on whether or not the buildings are leased at time of sale and whether the buildings are sold to a buyer/owner or to an investor. The company will incur other costs such as lease and sales commissions. If market values for the two facilities were to decrease by 10%, our required provision would change by approximately \$1 million. The lease agreement requires, among other things, the company to maintain

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specified quarterly financial ratios and conditions. As of March 29, 2002, the company was in breach of the fixed charge coverage ratio, but on April 30, 2002, the company entered into a Security Agreement with the Bank of Montreal, or BMO pursuant to which the company deposited with BMO and pledged approximately \$18.9 million as security in connection with the operating leases discussed above in exchange for a written waiver from BMO and BMO Global Capital Solutions for any company defaults of or obligations to satisfy the specified financial covenants relating to the operating lease agreements until June 30, 2003. This item is included on the balance sheet in long-term investments.

The company only uses derivatives for hedging purposes. The following is a summary of the company's risk management strategies and the effect of these strategies on the company's consolidated financial statements.

The company has instituted a foreign currency cash flow hedging program to manage exposures to changes in foreign currency exchange rates associated with forecasted sales transactions. Currency forwards and swaps are used to fix the cash flow variable of local currency costs or selling prices denominated in currencies other than the functional currency. For hedged forecasted transactions, hedge accounting is discontinued if the forecasted transaction is no longer intended or expected to occur and any previously unrealized hedging gains or losses recorded in other comprehensive income are immediately recorded to earnings. Earnings impacts for all designated hedges are recorded in the consolidated statement of operations generally on the same line item as the gain or loss on the item being hedged. The company records all derivatives at fair value as assets or liabilities in the consolidated balance sheet, with classification as current or long-term depending on the duration of the instrument.

At December 31, 2002, the company had eleven foreign exchange forward contracts to purchase \$16.9 million United States dollars and one currency swap contract valued at \$8.7 million United States dollars with an aggregate fair value loss of \$0.5 million after-tax recorded in accumulated other comprehensive income and maturing at various dates in 2003. The ineffective portion of the derivative instruments totaled a combined loss of \$0.3 million and is recorded in the consolidated statements of operations in foreign exchange gain (loss). The company expects an estimated \$0.5 million to be reclassified into earnings during fiscal 2003. At December 31, 2001, the company had eight foreign exchange forward contracts to purchase \$17.8 million United States dollars and one foreign exchange option contract to purchase \$6.5 million United States dollars with an aggregate fair value gain of \$0.8 million dollars and maturing at various dates in 2002. At December 31, 2000, the company had four foreign exchange contracts to purchase \$6.5 million United States with a fair value loss of \$164,000 that matured and was recognized in earnings during the first quarter of 2001.

On March 31, 2003, the company completed the sale to a third party of its excess facility in Nepean, Ontario for a price of Cdn \$1.3 million (or approximately U.S.\$0.9 million based on March 2003 exchange rates). At March 28, 2003, the net book value of this facility of U.S.\$0.8 million is included in other assets. The estimated gain on the sale of this facility of approximately U.S.\$0.1 million will be recorded in our second quarter.

On April 21, 2003, the company announced that it has entered into a definitive agreement for the acquisition of the principal assets of Spectron Laser Systems, a subsidiary of Lumenis Ltd., located in Rugby, United Kingdom. The Spectron assets are being acquired for \$6.3 million in cash, subject to adjustment, and the assumption of certain liabilities. This transaction closed on May 7, 2003. The integration of Spectron into the company's Laser Group in Rugby, United Kingdom is scheduled for completion by the end of August, 2003. This acquisition is consistent with the company's strategy of expanding the product lines and technology in its laser and precision motion control components business groups. It is expected that this acquisition will be accretive to earnings in the fourth quarter of this year. The company expects to account for this transaction as a business combination under SFAS No. 141 *Business Combinations*.

On May 2, 2003, the company announced that it had acquired the principal assets of the Encoder division of Dynamics Research Corporation, located in Wilmington, Massachusetts. The Encoder division assets were acquired for \$3.3 million in cash, subject to adjustment, and the assumption of certain liabilities. The integration of the Encoder division into the company's Components Group in Billerica, Massachusetts is currently scheduled for completion by the end of August, 2003. This acquisition is consistent with the

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company's strategy to acquire new technologies and expand into new products complementary with our existing markets. The addition of the Encoder division assets represents the addition of technology and products that expand the company's offering of precision motion control components. It is currently expected that this acquisition will be accretive to earnings in the fourth quarter of this year. The company expects to account for this transaction as a business combination under SFAS No. 141 *Business Combinations*.

Our future liquidity and cash requirements will depend on numerous factors, including, but not limited to, the level of sales we will be able to achieve in the future, the introduction of new products and potential acquisitions of related businesses or technology. We believe that existing cash balances, together with cash generated from operations and available bank lines of credit, will be sufficient to satisfy anticipated cash needs to fund working capital and investments in facilities and equipment for the next two years. We are not aware of any events that could trigger a significant cash payment, except for items already accrued in the financial statements or noted above.

## **Related Party Transactions**

The company had the following transactions with related parties. The company recorded \$2.3 million as sales revenue from Sumitomo Heavy Industries Ltd., a significant shareholder in the year ended December 31, 2002 (2001 - \$4.2 million; 2000 - \$10.2 million) at amounts and terms approximately equivalent to third party transactions. Receivables from Sumitomo Heavy Industries Ltd. of \$0.5 million and \$0.6 million as at December 31, 2002 and 2001, respectively, are included in accounts receivable on the balance sheet.

On February 23, 2000, the company entered into an agreement with V2Air LLC relating to the use of the LLC aircraft for company purposes. The V2Air LLC is owned by the company's President and Chief Executive Officer, Charles D. Winston. Pursuant to the terms of the Agreement, the company is required to reimburse the V2Air LLC for certain expenses associated with the use of the aircraft for company business travel. During the most recently completed fiscal year, the company reimbursed V2Air LLC approximately \$145,000 (2001 - \$150,000) under the terms of this agreement.

In January of 2001, the company made an investment of \$2 million in a technology fund managed by OpNet Partners, L.P. During 2002, the company received a cash distribution (return of capital) from OpNet Partners in the amount of \$1.4 million. In the second quarter of 2002, the company wrote-down the investment by \$0.2 million to its estimated fair market value and wrote-off the remainder of the investment (\$0.4 million) in the fourth quarter of 2002. Richard B. Black, a member of the company's board of directors, is a general partner of OpNet Partners, L.P.

On April 26, 2002, the company entered into an agreement with Photoniko, Inc, a private photonics company in which one of the company's directors, Richard B. Black, was a director and stock option holder. As of August 16, 2002, Mr. Black was no longer a director or stock option holder of Photoniko, Inc. Under the agreement, the company provided a non-interest bearing unsecured loan of \$75,000 to Photoniko, Inc. to fund designated business activities at Photoniko, Inc. in exchange for an exclusive 90 day period to evaluate potential strategic alliances. In accordance with the terms of the agreement and the promissory note which was signed by Photoniko, Inc. on April 26, 2002, the loan was to be repaid in full to the company no later than August 28, 2002, but still remains outstanding. The company has provided a full reserve for this receivable.

## **Recent Pronouncements**

### *Business Combinations*

On January 1, 2002, the company implemented, on a prospective basis, Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* (SFAS 141). As a result, all business combinations initiated in the future will be accounted for under the purchase method. Also, SFAS 141 does not permit the company to recognize an assembled workforce asset. Therefore, the company reallocated its assembled workforce asset with a cost of \$2.8 million and a net carrying value of \$2 million at January 1, 2002 to other remaining long-lived assets arising from the merger with General Scanning, Inc. in 1999, including \$1.4 million to developed technology, \$0.5 million to property, plant and equipment and \$0.1 million to

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trademarks and trade names. The adoption of SFAS 141 did not have any other material impact on the company's financial position or cash flows. It will accelerate amortization by \$0.6 million per year for 2002 and 2003 and reduce amortization thereafter.

*Intangible Assets*

On January 1, 2002, the company implemented, on a prospective basis, SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). As a result, intangible assets with finite useful lives must now be amortized over their estimated lives to their estimated residual values and be reviewed for impairment according to SFAS 144. Goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. The adoption of SFAS 142 did not have a material impact on the company's financial position, as it does not possess goodwill or intangible assets with indefinite lives. It also did not have a material impact on the company's results of operations or cash flows.

*Impairment or Disposal of Long-Lived Assets*

On January 1, 2002, the company adopted SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). SFAS 144 applies to all long-lived assets, including discontinued operations, and develops one accounting model for long-lived assets to be disposed of by sale. SFAS 144 supersedes SFAS 121, and the accounting and reporting provisions of APB No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions (APB 30)*, for the disposal of a segment of a business. The adoption of SFAS 144 did not have a material impact on the company's financial position, results of operations or cash flows. During 2002 as a result of restructuring actions, the company wrote-down fixed assets by approximately \$1.1 million (see note 11 to the financial statements).

*Costs Associated with Exit or Disposal Activities*

In July 2002, SFAS No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146) was issued. SFAS 146 requires that a liability for costs associated with exit or disposal activities be recognized and measured initially at fair value only when the liability is incurred. SFAS 146 will be effective for exit or disposal activities initiated after December 31, 2002, and had no impact on the company's financial statements in 2002, but will impact the accounting treatment of future exit or disposal activities should they occur.

*Guarantor's Accounting for Guarantees*

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation). The Interpretation will significantly change current practice in the accounting for, and disclosure of, guarantees. Guarantees meeting the characteristics described in the Interpretation, which are not included in a long list of exceptions, are required to be initially recorded at fair value, which is different from the general current practice of recording a liability only when a loss is probable and reasonably estimable, as those terms are defined in FASB Statement No. 5, *Accounting for Contingencies*. The Interpretation also requires a guarantor to make significant new disclosures for virtually all guarantees even if the likelihood of the guarantor's having to make payments under the guarantee is remote. The initial recognition and initial measurement provisions of the Interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. Accounting for guarantees issued prior to December 31, 2002 should not be revised or restated. As discussed in Note 12 to the consolidated financial statements, the company has two existing operating lease agreements with terms that include residual value guarantees totaling approximately \$16 million.



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*Stock Based Compensation Transition and Disclosure*

In December 2002, SFAS No. 148 (SFAS 148), *Accounting for Stock-Based Compensation-Transition and Disclosure* was issued to amend SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of Statement 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. The transition guidance and annual disclosure provisions of SFAS 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The adoption of SFAS 148 will not have a material impact on our financial position, results of operations, or cash flows, because the company will continue to follow the guidance of APB 25 in recognizing stock compensation expense. The company will comply with the new disclosure requirements in its financial statements for the first quarter of 2003.

**Risk Factors**

The risks presented below may not be all of the risks that we may face. These are the factors that we believe could cause actual results to be different from expected and historical results. Other sections of this report include additional factors that could have an effect on our business and financial performance. The industry in which we compete is very competitive and changes rapidly. Sometimes new risks emerge and management may not be able to predict all of them, or be able to predict how they may cause actual results to be different from those contained in any forward-looking statements. You should not rely upon forward-looking statements as a prediction of future results.

*A prolonged economic slowdown will continue to put pressure on our ability to meet anticipated revenue levels.* We are in a broad-based economic slowdown affecting most technology sectors and semiconductors and electronics in particular. As a result, many of our customers continue to order low quantities. A large portion of our sales is dependent on the need for increased capacity or replacement of inefficient manufacturing processes, because of the capital-intensive nature of our customers' businesses. These also tend to lag behind in an economic recovery longer than other businesses. Because it is difficult to predict how long this slowdown will continue, we may not be able to meet anticipated revenue levels on a quarterly or annual basis.

*We have experienced operating losses and may not return to profitability.* We have incurred operating losses since 1998. For the years ended December 31, 2002 and 2001, we reported net losses of approximately \$27.7 million and \$14.7 million, respectively. For the year ended December 31, 2000, we did achieve overall profitability, even though we experienced operating losses of approximately \$2 million, primarily as a result of the sale of assets of company's Life Science business which resulted in a non-operating gain of \$73.1 million. Our operating losses in fiscal 2000 were attributable primarily to restructuring activities relating to the discontinuance of product lines in our high power laser business. No assurances can be given that we will not continue to sustain losses in the future and the market price of our common shares may decline as a result.

*Our inability to return to profitability may result in the loss of significant deferred tax assets.* In determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets requires subjective judgment and analysis. Our ability to utilize the full deferred tax assets that are recorded on our balance sheet is dependent on our achieving our planned profitability goals. If actual results differ from our plans or we do not achieve profitability, we may be required to increase the valuation allowance on our tax assets by increasing expenses, which may have a negative result on our operations.

*Our business depends significantly upon capital expenditures, including by manufacturers in the semiconductor, electronics, machine tool and automotive industries, each of which are subject to cyclical fluctuations.* The semiconductor and electronics, machine tool and automotive industries are cyclical and have historically experienced periods of oversupply, resulting in significantly reduced demand for capital equipment, including the products that we manufacture and market. The timing, length and severity of these cycles, and their impact on our business, are difficult to predict. For the foreseeable future, our operations will

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continue to depend upon capital expenditures in these industries, which, in turn, depend upon the market demand for their products. The cyclical variations in these industries have the most pronounced effect on our Laser Systems segment, due in large measure to that segment's historical focus on the semiconductor and electronics industries and the company's need to support and maintain a comparatively larger global infrastructure (and, therefore, lesser ability to reduce fixed costs) than in our other segments. Our margins, net sales, financial condition and results of operations have been and will likely continue to be materially adversely affected by continued or further downturns or slowdowns in the semiconductor and electronics, machine tool and automotive industries that we serve.

*The success of our business is dependant upon our ability to respond to fluctuations in demand for our products.* During a period of declining demand, we must be able quickly and effectively to reduce expenses while continuing to motivate and retain key employees. Our ability to reduce expenses in response to any downturn is limited by our need for continued investment in engineering and research and development and extensive ongoing customer service and support requirements. In addition, the long lead-time for production and delivery of some of our products creates a risk that we may incur expenditures or purchase inventories for products which we cannot sell. We attempt to manage this risk by employing inventory management practices such as outsourcing portions of the development and manufacturing processes, limiting our purchase commitments and focusing on production to order rather than to stock, but no assurances can be given that our efforts in this regard will be successful in mitigating this risk or that our financial condition or results of operations will not be materially adversely affected thereby.

During a period of increasing demand and rapid growth, we must be able to increase manufacturing capacity quickly to meet customer demand and hire and assimilate a sufficient number of qualified personnel. Our inability to ramp up in times of increased demand could harm our reputation and cause some of our existing or potential customers to place orders with our competitors rather than with us.

*Fluctuations in our customers' businesses, timing and recognition of revenues from customer orders and other factors beyond our control may cause our results of operations quarter over quarter to fluctuate, perhaps substantially.* Our revenues and net income, if any, in any particular period may be lower than revenues and net income, if any, in a preceding or comparable period. Factors contributing to these fluctuations, some of which are beyond our control, include:

fluctuations in our customers' businesses;

timing and recognition of revenues from customer orders;

timing and market acceptance of new products or enhancements introduced by us or our competitors;

availability of components from our suppliers and the manufacturing capacity of our subcontractors;

timing and level of expenditures for sales, marketing and product development; and

changes in the prices of our products or of our competitors' products.

We derive a substantial portion of our sales from products that have a high average selling price and significant lead times between the initial order and delivery of the product, which, on average, can range from ten to fourteen weeks. We may receive one or more large orders in one quarter from a customer and then receive no orders from that customer in the next quarter. As a result, the timing and recognition of sales from customer orders can cause significant fluctuations in our operating results from quarter to quarter. If our quarterly revenue or operating results fall below the expectations of investors or public market analysts, our common share price may decline as a result.

Gross profits realized on product sales vary depending upon a variety of factors, including production volumes, the mix of products sold during a particular period, negotiated selling prices, the timing of new product introductions and enhancements and manufacturing costs.

A delay in a shipment, or failure to meet our revenue recognition criteria, near the end of a fiscal quarter or year, due, for example, to rescheduling or cancellations by customers or to unexpected difficulties experienced by us, may cause sales in a particular period to fall significantly below our expectations and may

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materially adversely affect our operations for that period. Our inability to adjust spending quickly enough to compensate for any sales shortfall would magnify the adverse impact of that sales shortfall on our results of operations.

As a result of these factors, our results of operations for any quarter are not necessarily indicative of results to be expected in future periods. We believe that fluctuations in quarterly results may cause the market prices of our common shares, on The NASDAQ Stock Market® and the Toronto Stock Exchange, to fluctuate, perhaps substantially.

*Our reliance upon third party distribution channels subjects us to credit, inventory, business concentration and business failure risks beyond our control.* The company sells approximately 55% of its products through resellers (which include OEMs, systems integrators and distributors). Reliance upon third party distribution sources subjects us to risks of business failure by these individual resellers, distributors and OEMs, and credit, inventory and business concentration risks. In addition, our net sales depend in part upon the ability of our OEM customers to develop and sell systems that incorporate our products. Adverse economic conditions, large inventory positions, limited marketing resources and other factors affecting these OEM customers could have a substantial impact upon our financial results. No assurances can be given that our OEM customers will not experience financial or other difficulties that could adversely affect their operations and, in turn, our financial condition or results of operations.

*The steps we take to protect our intellectual property may not be adequate to prevent misappropriation or the development of competitive technologies or products by others that could harm our competitive position and materially adversely affect our results of operations.* Our future success depends in part upon our intellectual property rights, including trade secrets, know-how and continuing technological innovation. There can be no assurance that the steps we take to protect our intellectual property rights will be adequate to prevent misappropriation or that others will not develop competitive technologies or products. As of December 31, 2002, we held 113 United States and 73 foreign patents, and had filed 59 United States and 122 foreign patent applications, which are under review by the patent authorities. There can be no assurance that other companies are not investigating or developing other technologies that are similar to ours, that any patents will issue from any application filed by us or that, if patents do issue, the claims allowed will be sufficiently broad to deter or prohibit others from marketing similar products. In addition, there can be no assurance that any patents issued to us will not be challenged, invalidated or circumvented, or that the rights thereunder will provide a competitive advantage to us.

*Our success depends upon our ability to protect our intellectual property and to successfully defend against claims of infringement by third parties.* From time to time we receive notices from third parties alleging infringement of such parties' patent or other proprietary rights by our products. While these notices are common in the laser industry and we have in the past been able to develop non-infringing technology or license necessary patents or technology on commercially reasonable terms, there can be no assurance that we would in the future prevail in any litigation seeking damages or expenses from us or to enjoin us from selling our products on the basis of such alleged infringement, or that we would be able to develop any non-infringing technology or license any valid and infringed patents on commercially reasonable terms. In the event any third party made a valid claim against us or our customers for which a license was not available to us on commercially reasonable terms, we would be adversely affected. Our failure to avoid litigation for infringement or misappropriation of propriety rights of third parties or to protect our propriety technology could result in a loss of revenues and profits.

*The industries in which we operate are highly competitive and competition in our markets could intensify, or our technological advantages may be reduced or lost, as a result of technological advances by our competitors.* The industries in which we operate are highly competitive. We face substantial competition from established competitors, some of which have greater financial, engineering, manufacturing and marketing resources than we do. Our competitors can be expected to continue to improve the design and performance of their products and to introduce new products. There can be no assurance that we will successfully differentiate our current and proposed products from the products of our competitors or that the market place will consider our products to be superior to competing products. Because many of the components required to develop and

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produce a laser-based marking system are commercially available, barriers to entry into this market are relatively low and we expect new competitive product entries in this market. To maintain our competitive position in this market, we believe that we will be required to continue a high level of investment in engineering, research and development, marketing and customer service and support. There can be no assurance that we will have sufficient resources to continue to make these investments, that we will be able to make the technological advances necessary to maintain our competitive position, or that our products will receive market acceptance. We may not be able to compete successfully in the future, and increased competition may result in price reductions, reduced profit margins, loss of market share and an inability to generate cash flows that are sufficient to maintain or expand our development of new products.

*Our operations could be negatively affected if we lose key executives or employees or are unable to attract and retain skilled executives and employees as needed.* Our business and future operating results depend in part upon our ability to attract and retain qualified management, technical, sales and support personnel for our operations on a worldwide basis. The loss of key personnel could negatively impact our operations. Competition for qualified personnel is intense and we cannot guarantee that we will be able to continue to attract and retain qualified personnel.

*We may not develop, introduce or manage the transition to new products as successfully as our competitors.* The markets for our products experience rapidly changing technologies, evolving industry standards, frequent new product introductions, changes in customer requirements and short product life cycles. To compete effectively we must continually introduce new products that achieve market acceptance. Our future performance will depend on the successful development, introduction and market acceptance of new and enhanced products that address technological changes as well as current and potential customer requirements. Developing new technology is a complex and uncertain process requiring us to be innovative and to accurately anticipate technological and market trends. We may have to manage the transition from older products to minimize disruption in customer ordering patterns, avoid excess inventory and ensure adequate supplies of new products. The introduction by us or by our competitors of new and enhanced products may cause our customers to defer or cancel orders for our existing products, which may harm our operating results. Failed market acceptance of new products or problems associated with new product transitions could harm our business.

*Delays or deficiencies in research, development, manufacturing, delivery of or demand for new products or of higher cost targets could have a negative affect on our business, operating results or financial condition.* We are active in the research and development of new products and technologies. Our research and development efforts may not lead to the successful introduction of new or improved products. The development by others of new or improved products, processes or technologies may make our current or proposed products obsolete or less competitive. Our ability to control costs is limited by our need to invest in research and development. Because of intense competition in the industries in which we compete, if we were to fail to invest sufficiently in research and development, our products could become less attractive to potential customers and our business and financial condition could be materially and adversely affected. As a result of our need to maintain our spending levels in this area, our operating results could be materially harmed if our net sales fall below expectations. In addition, as a result of our emphasis on research and development and technological innovation, our operating costs may increase further in the future and research and development expenses may increase as a percentage of total operating expenses and as a percentage of net sales.

In addition, we may encounter delays or problems in connection with our research and development efforts. Product development delays may result from numerous factors, including:

changing product specifications and customer requirements;

difficulties in hiring and retaining necessary technical personnel;

difficulties in reallocating engineering resources and overcoming resource limitations;

changing market or competitive product requirements; and

unanticipated engineering complexities.

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New products often take longer to develop, have fewer features than originally considered desirable and achieve higher cost targets than initially estimated. There may be delays in starting volume production of new products and new products may not be commercially successful. Products under development are often announced before introduction and these announcements may cause customers to delay purchases of existing products until the new or improved versions of those products are available.

*We may not be able to find suitable targets or consummate acquisitions in the future, and there can be no assurance that the acquisitions we have made and do in the future make will provide expected benefits.* We have recently consummated two strategic acquisitions and intend in the future to continue to pursue other strategic acquisitions of businesses, technologies and products complementary to our own. Our identification of suitable acquisition candidates involves risks inherent in assessing the values, strengths, weaknesses, risks and profitability of acquisition candidates, including the effects of the possible acquisition on our business, diversion of management's attention from our core businesses and risks associated with unanticipated problems or liabilities. No assurances can be given that management's efforts in this regard will be sufficient, or that identified acquisition candidates will be receptive to our advances or, consistent with our acquisition strategy, accretive to earnings.

Should we acquire another business, the process of integrating acquired operations into our existing operations may result in unforeseen operating difficulties and may require the allocation of significant financial resources that would otherwise be available for the ongoing development or expansion of our existing business. We attempt to mitigate these risks by focusing our attention on the acquisition of businesses, technologies and products that have current relevancy to our existing lines of business and that are complementary to our existing product lines. Other difficulties we may encounter, and which we may or may not be successful in addressing, include those risks associated with the potential entrance into markets in which we have limited or no prior experience and the potential loss of key employees, particularly those of the acquired business.

*There is a risk that United States holders could be considered to hold shares in a passive foreign investment company under United States tax laws, which may have adverse tax consequences for United States holders of our shares.* Under United States tax laws, United States investors who hold stock in a passive foreign investment company, referred to in this report as a PFIC, may be subject to adverse tax consequences. Any non-United States corporation may be classified as a PFIC if 75% or more of its gross income in any year is considered passive income for United States tax purposes. For this purpose, passive income generally includes interest, dividends and gains from the sale of assets that produce these types of income. In addition, a non-United States corporation may be classified as a PFIC if the average percentage of the fair market value of its gross total assets during any year that produced passive income (based on the average of such values as at each quarter end of that year), or that were held to produce passive income, is at least 50% of the fair market value of its gross total assets.

The determination of whether a corporation is a PFIC is a fact-sensitive inquiry that depends, among other things, on the fair market value of its assets (and such value is subject to change from time to time). We believe that the company is not now and has not in the past been a PFIC. However, there is a risk that United States holders of our shares will be deemed to hold shares in a PFIC.

The tax consequences to United States holders of disposing of shares in a PFIC are as follows. All gains recognized on the disposition of PFIC shares by a United States shareholder are taxable as ordinary income. Additionally, at the time of disposition, the United States shareholder incurs an interest charge. The interest is computed at the rate for underpayments of tax, generally as though the gain had been included in the United States shareholder's gross income ratably over the period the United States shareholder held the PFIC's stock, but payment of the resulting tax had been delayed until the sale or distribution. Similar rules apply to excess distributions. An excess distribution is a current year distribution received by a United States shareholder on PFIC stock, to the extent the distribution exceeds his or her ratable portion of 125% of the average amount so received during the three preceding years. The portion of an actual distribution that is not an excess distribution is not taxed under the excess distribution rules, but rather is treated as a distribution subject to the normal tax rules. A United States shareholder may avoid the effect of the foregoing rules if he or she makes a

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qualified electing fund election or a mark-to-market election, but then becomes subject to the special rules that apply to such elections.

*Our classification as a controlled foreign corporation could have adverse tax consequences for significant United States shareholders.* A non-United States corporation, such as we are, will constitute a controlled foreign corporation, or CFC, for United States federal income tax purposes if United States shareholders owning (directly, indirectly, or constructively) 10% or more of the foreign corporation's total combined voting power collectively own (directly, indirectly, or constructively) more than 50% of the total combined voting power or total value of the foreign corporation's stock.

If we are treated as a CFC, this status should have no adverse effect on any shareholder who does not own (directly, indirectly, or constructively) 10% or more of the total combined voting power of all classes of our shares. If, however, we are treated as a CFC for an uninterrupted period of thirty (30) days or more during any taxable year, any United States shareholder who owns (directly, indirectly, or constructively) 10% or more of the total combined voting power of all classes of our shares on any day during the taxable year, and who directly or indirectly owns any shares on the last day of the year in which we are a CFC, will have to include in its gross income for United States federal income tax purposes its pro rata share of the company's subpart F income (primarily consisting of investment income such as dividends, interest and capital gains on the sale of assets producing such income) relating to the period during which we are or were a CFC.

In addition, if we were treated as a CFC, any gain realized on the sale of our shares by such a shareholder would be treated as ordinary income to the extent of the shareholder's proportionate share of the undistributed earnings and profits of the company accumulated during the shareholder's holding period while we are a CFC. If the United States shareholder is a corporation, however, it may be eligible to credit against its United States tax liability with respect to these potential inclusions foreign taxes paid on the earnings and profits associated with the included income.

We do not believe that we are currently, or have ever been, a CFC. However, no assurances can be given that we will not become a CFC in the future.

*We depend on limited source suppliers that could cause substantial manufacturing delays and additional cost if a disruption in supply occurs.* While we attempt to mitigate risks associated with our reliance on single suppliers by actively managing our supply chain, we do obtain some components used in our business segments from a single source. We also rely on a limited number of independent contractors to manufacture subassemblies for some of our products, particularly in our Laser Systems segment. Despite our and their best efforts, there can be no assurance that our current or alternative sources will be able to continue to meet all of our demands on a timely basis. If suppliers or subcontractors experience difficulties that result in a reduction or interruption in supply to us, or fail to meet any of our manufacturing requirements, our business would be harmed until we are able to secure alternative sources, if any, on commercially reasonable terms.

Each of our suppliers can be replaced, either by contracting with another supplier or through internal production of the part or parts previously purchased in the market, but no assurances can be given that we would be able to do so quickly enough to avoid an interruption or delay in delivery of our products to our customers and any associated harm to our reputation and customer relationships. Unavailability of necessary parts or components, or suppliers of the same, could require us to reengineer our products to accommodate available substitutions. Any such actions would likely increase our costs and could have a material adverse effect on manufacturing schedules, product performance and market acceptance, each or all of which could be expected to have a material adverse effect on our financial condition or results of operations.

*Production difficulties and product delivery delays could materially adversely affect our business, operating results or financial condition.* We assemble our products at our facilities in the United States, Canada and the United Kingdom. If use of any of our manufacturing facilities were interrupted by natural disaster or otherwise, our operations could be negatively affected until we could establish alternative

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production and service operations. In addition, we may experience production difficulties and product delivery delays in the future as a result of:

changing process technologies;

ramping production;

installing new equipment at our manufacturing facilities; and

shortage of key components.

*Our operations in foreign countries subject us to risks not faced by companies operating exclusively in the United States.* In addition to operating in the United States, Canada and the United Kingdom, we currently have sales and service offices in France, Germany, Italy, Japan, Singapore, Hong Kong, Korea, Taiwan, Malaysia and the Philippines. By the end of the second quarter of 2003, we intend to close our offices in France, Italy, Hong Kong, Malaysia and the Philippines, but we may in the future expand into other international regions. During 2002 and 2001, approximately 41% and 52% of our revenue, respectively, were derived from our international operations.

Because of the scope of our international operations, we are subject to risks, which could materially impact our results of operations, including:

foreign exchange rate fluctuations;

longer payment cycles;

greater difficulty in collecting accounts receivable;

use of different systems and equipment;

difficulties in staffing and managing foreign operations and diverse cultures;

protective tariffs;

trade barriers and export/import controls;

transportation delays and interruptions;

reduced protection for intellectual property rights in some countries; and

the impact of recessionary foreign economies.

We cannot predict whether the United States or any other country will impose new quotas, tariffs, taxes or other trade barriers upon the importation of our products or supplies or gauge the effect that new barriers would have on our financial position or results of operations.

We do not believe that travel advisories or health concerns have had a material effect on our business to date. However, no assurances can be given that future travel advisories or health concerns will not have an impact on our business.

*If the economic and political conditions in United States and globally do not improve or if the economic slowdown continues, we may continue to experience material adverse impacts on our business, operating results and financial condition.* Our business is subject to the effects of general economic and political conditions globally. Our revenues and operating results have declined partially due to continuing unfavorable economic conditions as well as uncertainties arising out of the threatened terrorist attacks on the United States, including the potential worsening or extension of the current global economic slowdown, the economic consequences of protracted military action or additional terrorist activities and associated political instability and the impact of heightened security concerns on domestic and international travel and commerce. In particular, due to these uncertainties we are subject to:

the risk that future tightening of immigration controls may adversely affect the residence status of non-United States engineers and other key technical employees in our United States facilities or our ability to hire new non-United States employees in such facilities; and



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the risk of more frequent instances of shipping delays.

*Increased governmental regulation of our business could materially adversely affect our business, operating results and financial condition.*

We are subject to the laser radiation safety regulations of the Radiation Control for Health and Safety Act administered by the National Center for Devices and Radiological Health, a branch of the United States Food and Drug Administration. Among other things, these regulations require a laser manufacturer to file new product and annual reports, to maintain quality control and sales records, to perform product testing, to distribute appropriate operating manuals, to incorporate design and operating features in lasers sold to end-users and to certify and label each laser sold to end-users as one of four classes (based on the level of radiation from the laser that is accessible to users). Various warning labels must be affixed and certain protective devices installed depending on the class of product. The National Center for Devices and Radiological Health is empowered to seek fines and other remedies for violations of the regulatory requirements. We are subject to similar regulatory oversight, including comparable enforcement remedies, in the European markets we serve.

Changes in governmental regulations may reduce demand for our products or increase our expenses. We compete in many markets in which we and our customers must comply with federal, state, local and international regulations, such as environmental, health and safety and food and drug regulations. We develop, configure and market our products to meet customer needs created by those regulations. Any significant change in regulations could reduce demand for our products, which in turn could materially adversely affect our business, operating results and financial condition.

*Defects in our products or problems arising from the use of our products together with other vendors' products may seriously harm our business and reputation.* Products as complex as ours may contain known and undetected errors or performance problems. Defects are frequently found during the period immediately following introduction and initial implementation of new products or enhancements to existing products. Although we attempt to resolve all errors that we believe would be considered serious by our customers before implementation, our products are not error-free. These errors or performance problems could result in lost revenues or customer relationships and could be detrimental to our business and reputation generally. In addition, our customers generally use our products together with their own products and products from other vendors. As a result, when problems occur in a combined environment, it may be difficult to identify the source of the problem. These problems may cause us to incur significant warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems. To date, defects in our products or those of other vendors' products with which ours are used by our customers have not had a material negative effect on our business. However, we cannot be certain that a material negative effect will not occur in the future.

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**Item 8. *Financial Statements and Supplementary Data***

**GSI LUMONICS INC.**

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**AUDITORS REPORT**

To the Stockholders of

GSI Lumonics Inc.

We have audited the consolidated balance sheets of GSI Lumonics Inc. as of December 31, 2002 and 2001 and the consolidated statements of operations, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2002. Our audits also included the financial statement schedule listed at Item 15 of this Form 10-K Annual Report. These financial statements and the schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States and Canada. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2002 and 2001 and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2002 in accordance with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

The Company changed its method of accounting for business combinations, goodwill and other intangible assets and impairment or disposal of long-lived assets in 2002, as described in note 1.

On February 21, 2003, we reported without reservation to the shareholders on the Company's consolidated financial statements prepared in accordance with Canadian generally accepted accounting principles.

ERNST & YOUNG LLP  
Chartered Accountants

Ottawa, Canada,  
February 21, 2003  
(except with respect to  
note 15, which is  
as at June 26, 2003)

**Table of Contents****GSI LUMONICS INC.****CONSOLIDATED BALANCE SHEETS**

(United States GAAP and in thousands of United States dollars, except share amounts)

	As of December 31,	
	2002	2001
<b>ASSETS</b>		
Current		
Cash and cash equivalents (note 13)	\$ 83,633	\$ 102,959
Short-term investments (note 13)	28,999	43,541
Accounts receivable, less allowance of \$2,681 (2001 \$3,034) (notes 4 and 10)	33,793	39,919
Income taxes receivable	8,431	9,224
Inventories (note 3)	39,671	57,794
Deferred tax assets (note 9)	9,763	15,097
Other current assets (note 3)	4,448	8,528
	<u>208,738</u>	<u>277,062</u>
Total current assets	208,738	277,062
Property, plant and equipment, net of accumulated depreciation of \$21,453 (2001 \$20,575) (note 3)	26,675	32,482
Deferred tax assets (note 9)	7,443	6,537
Other assets (note 3)	3,360	1,539
Long-term investments (note 13)	37,405	
Intangible assets, net of amortization of \$16,217 (2001 \$11,857) (note 3)	13,467	19,067
	<u>\$ 297,088</u>	<u>\$ 336,687</u>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current		
Bank indebtedness (note 4)	\$	\$ 6,171
Accounts payable	9,235	10,839
Accrued compensation and benefits	6,523	7,515
Other accrued expenses (note 3)	20,845	25,096
Current portion of long-term debt (note 5)		2,654
	<u>36,603</u>	<u>52,275</u>
Total current liabilities	36,603	52,275
Deferred compensation (note 6)	2,129	2,082
Accrued minimum pension liability (note 8)	3,875	
	<u>42,607</u>	<u>54,357</u>
Total liabilities	42,607	54,357
Commitments and contingencies (note 12)		
Stockholders' equity (note 7)		
Common shares, no par value; Authorized shares: unlimited; Issued and outstanding: 40,785,922 (2001 40,556,130)	304,713	303,504
Additional paid-in capital	2,592	2,592
Accumulated deficit	(41,270)	(13,546)
Accumulated other comprehensive loss	(11,554)	(10,220)
	<u>254,481</u>	<u>282,330</u>
Total stockholders' equity	254,481	282,330
	<u>\$ 297,088</u>	<u>\$ 336,687</u>

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

**Table of Contents****GSI LUMONICS INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(United States GAAP and in thousands of United States dollars, except share amounts)

	Capital Stock		Additional Paid-In- Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive	Total	Comprehensive
	# Shares	Amount			Income (Loss)		Income (Loss)
	(000 s)						
<b>Balance, December 31, 1999</b>	34,299	\$ 222,865	\$	\$(44,225)	\$ (6,910)	\$ 171,730	
Net income				45,377		45,377	\$ 45,377
Issuance of capital stock							
public offering	4,300	70,137				70,137	
stock options	1,564	8,665				8,665	
Unrealized loss on equity securities, net of tax of \$2,905					(5,395)	(5,395)	(5,395)
Compensation expense			759			759	
Foreign currency translation adjustments					(2,006)	(2,006)	(2,006)
<b>Balance, December 31, 2000</b>	40,163	301,667	759	1,152	(14,311)	289,267	37,976
Net loss				(14,698)		(14,698)	(14,698)
Issuance of capital stock							
stock options	344	1,503				1,503	
employee stock purchase plan	51	334				334	
Other	(2)						
Tax benefit associated with stock options			1,433			1,433	
Cumulative effect of change in accounting policy for cash flow hedges					(164)	(164)	(164)
Realized loss on derivative instruments designated and qualifying as foreign currency cash flow hedging instruments, net of tax of \$0					164	164	164
Unrealized gain on cash flow hedging instruments, net of tax of \$567					793	793	793
Unrealized gain on equity securities, net of tax of \$1,221					2,269	2,269	2,269
Reclassification adjustment for loss on sale of equity securities, net of tax of \$1,683					3,126	3,126	3,126
Translation loss on liquidation of a subsidiary, net of tax of \$0.					723	723	723

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Stock-based compensation			400			400	
Foreign currency translation adjustments					(2,820)	(2,820)	(2,820)
<b>Balance, December 31, 2001</b>	40,556	303,504	2,592	(13,546)	(10,220)	282,330	(10,607)
Net loss				(27,724)		(27,724)	(27,724)
Issuance of capital stock							
stock options	133	648				648	
employee stock purchase plan	97	561				561	
Unrealized gain on investments, net of tax of \$0					312	312	312
Realized gain on cash flow hedging instruments, net of tax of \$567					(793)	(793)	(793)
Unrealized loss on cash flow hedging instruments, net of tax of \$0					(521)	(521)	(521)
Additional minimum pension liability, net of tax of \$0					(3,875)	(3,875)	(3,875)
Foreign currency translation adjustments					3,543	3,543	3,543
<b>Balance, December 31, 2002</b>	40,786	\$304,713	\$2,592	\$(41,270)	\$(11,554)	\$254,481	\$(29,058)

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

**Table of Contents****GSI LUMONICS INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(United States GAAP and in thousands of United States dollars, except per share amounts)**

	<b>Year Ended December 31,</b>		
	<b>2002</b>	<b>2001</b>	<b>2000</b>
Sales	\$ 159,070	\$ 247,904	\$ 373,864
Cost of goods sold (note 11)	109,876	162,122	242,393
Gross profit	49,194	85,782	131,471
Operating expenses:			
Research and development	20,444	25,634	33,931
Selling, general and administrative	55,483	73,815	87,459
Amortization of purchased intangibles	5,135	5,226	4,851
Restructuring (note 11)	6,448	2,930	10,141
Other (note 11)	(1,021)	(148)	(2,945)
Total operating expenses	86,489	107,457	133,437
Loss from operations	(37,295)	(21,675)	(1,966)
Gain (loss) on sale of assets and investments (note 2)		(4,809)	76,786
Interest income	2,744	5,084	4,802
Interest expense	(701)	(897)	(1,457)
Foreign exchange transaction losses	(825)	(175)	(3,122)
Other expense (note 10)	(628)		
Income (loss) before income taxes	(36,705)	(22,472)	75,043
Income tax provision (benefit) (note 9)	(8,981)	(7,774)	29,666
Net income (loss)	\$ (27,724)	\$ (14,698)	\$ 45,377
Net income (loss) per common share:			
Basic	\$ (0.68)	\$ (0.36)	\$ 1.19
Diluted	\$ (0.68)	\$ (0.36)	\$ 1.13
Weighted average common shares outstanding (000 s)	40,663	40,351	38,187
Weighted average common shares outstanding and dilutive potential common shares (000 s)	40,663	40,351	40,000

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



**Table of Contents****GSI LUMONICS INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(United States GAAP and in thousands of United States dollars)**

	Year Ended December 31,		
	2002	2001	2000
<b>Cash flows from operating activities:</b>			
Net income (loss) for the year	\$ (27,724)	\$ (14,698)	\$ 45,377
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Loss (gain) on sale of assets and investments	62	5,267	(76,786)
Translation loss on liquidation of a subsidiary		723	
Stock-based compensation		400	759
Reduction of long-lived assets	2,510	2,483	2,137
Depreciation and amortization	10,919	11,918	12,172
Deferred income taxes	4,267	6,688	(3,613)
Changes in current assets and liabilities:			
Accounts receivable	9,356	47,083	(14,061)
Inventories	19,632	8,917	(13,506)
Other current assets	840	1,403	(844)
Accounts payable, accruals, and taxes (receivable) payable	(8,145)	(87,662)	38,145
Cash provided by (used in) operating activities	11,717	(17,478)	(10,220)
<b>Cash flows from investing activities:</b>			
Acquisition of businesses, net of cash acquired (note 2)			(7,138)
Sale of assets and investments		45,822	64,962
Additions to property, plant and equipment, net	(2,952)	(8,639)	(10,142)
Proceeds from the sale and maturity of short-term and other investments	110,014	85,834	45,031
Purchase of short-term and other investments	(132,877)	(109,355)	(57,710)
Decrease (increase) in other assets	1,979	(1,219)	838
Cash provided by (used in) investing activities	(23,836)	12,443	35,841
<b>Cash flows from financing activities:</b>			
Payments of bank indebtedness	(6,441)	(4,117)	(10,131)
Repayment of long-term debt	(3,000)	(4,000)	(4,114)
Issue of share capital (net of issue costs)	1,209	1,837	76,986
Cash provided by (used in) financing activities	(8,232)	(6,280)	62,741
Effect of exchange rates on cash and cash equivalents	1,025	416	224
Increase (decrease) in cash and cash equivalents	(19,326)	(10,899)	88,586
Cash and cash equivalents, beginning of year	102,959	113,858	25,272
Cash and cash equivalents, end of year	\$ 83,633	\$ 102,959	\$ 113,858

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



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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**As of December 31, 2002**

**(United States GAAP and tabular amounts in thousands of United States dollars except share amounts)**

**1. Significant Accounting Policies**

***Nature of operations***

We design, develop, manufacture and market components, lasers and laser-based advanced manufacturing systems as enabling tools for a wide range of applications. Our products allow customers to meet demanding manufacturing specifications, including device complexity and miniaturization, as well as advances in materials and process technology. Major markets for our products include the medical, automotive, semiconductor, and electronics industries. In addition, we sell our products and services to other markets such as light industrial and aerospace. The Company's principal markets are in North America, Europe, Japan and Asia-Pacific.

***Basis of presentation***

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

***Basis of consolidation***

The consolidated financial statements include the accounts of GSI Lumonics Inc. and its wholly owned subsidiaries (the Company). Intercompany accounts and transactions are eliminated.

***Comparative amounts***

Certain prior year amounts have been reclassified to conform to the current year presentation in the financial statements for the year ended December 31, 2002. These reclassifications had no effect on the previously reported results of operations or financial position.

***Use of estimates***

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

***Cash equivalents***

Cash equivalents are investments held to maturity with original maturities of three months or less. Cash equivalents, consisting principally of commercial paper, short-term corporate debt, and banker's acceptances, are stated at amortized cost, which approximates fair value. The Company does not believe it is exposed to any significant credit risk on its cash equivalents.

***Investments***

Short-term, long-term and other investments consist principally of commercial paper, governments, short-term corporate debt, and banker's acceptances with original maturities greater than three months for short-term investments and greater than twelve months for long-term investments. The Company has classified these investments as available-for-sale securities that are stated at estimated fair value based upon

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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

market quotes. Unrealized holding gains and losses on available-for-sale securities are excluded from earnings and reported as a component of accumulated other comprehensive income until realized.

***Inventories***

Inventories, which include materials and conversion costs, are stated at the lower of cost (primarily first-in, first-out) or market. Market is defined as replacement cost for raw materials and net realizable value for other inventories.

***Property, plant and equipment***

Property, plant and equipment are stated at cost and the declining-balance and straight-line methods are used to determine depreciation and amortization over estimated useful lives. Estimated useful lives for buildings and improvements range from 5 to 39 years and for machinery and equipment from 3 to 15 years. Leasehold improvements are amortized over the lesser of their useful lives or the lease term, including option periods expected to be utilized.

***Intangible assets***

Intangibles assets include purchased trademarks and trade names, which are amortized on a straight-line basis over periods from three to ten years from the date of acquisition. Patents and purchased technology are stated at cost and are amortized on a straight-line basis over the expected life of the asset, up to 19 years.

***Impairment of long-lived assets***

When events and circumstances warrant a review, the Company evaluates the carrying values of long-lived assets and purchased intangibles in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). The carrying value of a long-lived asset and purchased intangible is considered impaired when the anticipated undiscounted cash flow from such asset is less than its carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair value. Fair value is determined using anticipated discounted cash flows.

***Revenue recognition***

We recognize product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, risk of loss has passed to the customer and collection of the resulting receivable is probable. We design, market and sell our products as standard configurations. Accordingly, customer acceptance provisions for standard configurations are generally based on seller-specified criteria, which we demonstrate prior to shipment. Revenue on new products is deferred until we have established a track record of customer acceptance on these new products. When customer-specified objective criteria exist, revenue is deferred until customer acceptance if we cannot demonstrate the system meets these specifications prior to shipment. The Company recognizes installation revenue when installation has been completed.

Revenue associated with service or maintenance contracts is recognized ratably over the life of the contract, which is generally one year.

***Product Warranty***

We generally warrant our products for a period of up to 12 months for material and labor to repair and service the system. A provision for the estimated cost related to warranty is recorded at the time revenue is recognized.

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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Our estimate of costs to service the warranty obligations is based on historical experience and expectation of future conditions. To the extent we experience increased warranty claims or increased costs associated with servicing those claims, revisions to the estimated warranty liability would be made.

***Stock based compensation***

The Company uses the intrinsic value method for accounting for its stock option plans as proscribed in APB 25.

***Foreign currency translation***

The financial statements of the parent corporation and its subsidiaries outside the United States have been translated into United States dollars in accordance with the Financial Accounting Standards Board Statement No. 52, *Foreign Currency Translation*. Assets and liabilities of foreign operations are translated from foreign currencies into United States dollars at the exchange rates in effect on the balance sheet date. Revenues and expenses are translated at the average exchange rate in effect for the period. Accordingly, gains and losses resulting from translating foreign currency financial statements are reported as a separate component of other comprehensive income in stockholders equity. Foreign currency transaction gains and losses are included in net income.

***Derivative financial instruments***

As of January 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), which was issued in June 1998 and its amendments, Statements 137 and 138, issued in June 1999 and June 2000, respectively.

As a result, the Company recognizes all derivative financial instruments, such as interest rate swap contracts and foreign exchange contracts, in the consolidated financial statements at fair value regardless of the purpose or intent for holding the instrument. Changes in the fair value of derivative financial instruments are either recognized periodically in income or in stockholders equity as a component of comprehensive income depending on whether the derivative financial instrument qualifies for hedge accounting and, if so, whether it qualifies as a fair value hedge or cash flow hedge. Generally, changes in fair value of derivatives accounted for as fair value hedges are recorded in income along with the portions of the changes in fair values of the hedged items that relate to the hedged risk(s). Changes in fair values of derivatives accounted for as cash flow hedges, to the extent they are effective as hedges, are recorded in other comprehensive income net of deferred taxes. Changes in fair value of derivatives used as hedges of the net investment in foreign operations are reported in other comprehensive income as part of the cumulative translation adjustment. Changes in fair values of derivatives not qualifying as hedges are reported in income.

The Company accounted for the accounting change as a cumulative effect of a change in accounting principle. The Company recorded a transition adjustment loss of \$164 thousand in other comprehensive income as a result of adopting SFAS 133. The loss was recognized in earnings during the period ended March 30, 2001, and at that time the underlying hedged transactions were realized.

Prior to January 1, 2001, the Company used foreign exchange contracts and interest rate swap contracts for hedging purposes. For foreign currency forward contracts hedging firm commitments, the effects of movements in currency exchange rates on those instruments were recognized when the related operating revenue was recognized. The discounts or premiums on the instruments were amortized to income over the lives of the contracts using the straight-line method. Realized gains and losses were included in other assets and liabilities and recognized in income when the future transaction occurred or at the time the transaction was no longer expected to occur. For interest rate swap contracts, payments and receipts under such contracts were recognized as adjustments to interest expense on a basis that matched them with the fluctuations in the

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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

interest receipts and payments under floating rate financial assets and liabilities. Unrealized gains or losses on interest rate swap contracts were not recognized in income.

***Income taxes***

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

***Recent accounting pronouncements***

***Business Combinations***

On January 1, 2002, the Company implemented, on a prospective basis, Statement of Financial Accounting Standards ( SFAS ) No. 141, *Business Combinations* ( SFAS 141 ). As a result, all business combinations initiated in the future will be accounted for under the purchase method. Also, SFAS 141 does not permit the Company to recognize an assembled workforce asset. Therefore, the Company reallocated its assembled workforce asset with a cost of \$2.8 million and a net carrying value of \$2 million at January 1, 2002 to other remaining long-lived assets arising from the merger with General Scanning, Inc. in 1999, including \$1.4 million to developed technology, \$0.5 million to property, plant and equipment and \$0.1 million to trademarks and trade names. The adoption of SFAS 141 did not have any other material impact on the Company's financial position or cash flows. It will accelerate amortization by \$0.6 million per year for 2002 and 2003 and reduce amortization thereafter.

***Intangible Assets***

On January 1, 2002, the Company implemented, on a prospective basis, SFAS No. 142, *Goodwill and Other Intangible Assets* ( SFAS 142 ). As a result, intangible assets with finite useful lives must now be amortized over their estimated lives to their estimated residual values and be reviewed for impairment according to SFAS 144. Goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. The adoption of SFAS 142 did not have a material impact on the Company's financial position, as it does not possess goodwill or intangible assets with indefinite lives. It also did not have a material impact on the Company's results of operations or cash flows.

***Impairment or Disposal of Long-Lived Assets***

On January 1, 2002, the Company adopted SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ( SFAS 144 ). SFAS 144 applies to all long-lived assets, including discontinued operations, and develops one accounting model for long-lived assets to be disposed of by sale. SFAS 144 supersedes SFAS 121, and the accounting and reporting provisions of APB No. 30, *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* ( APB 30 ), for the disposal of a segment of a business. The adoption of SFAS 144 did not have a material impact on the Company's financial position, results of operations or cash flows. During 2002 as a result of restructuring actions, the Company wrote-down fixed assets by approximately \$1.1 million (see note 11).

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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Costs Associated with Exit or Disposal Activities*

In July 2002, SFAS No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* ( SFAS 146 ) was issued. SFAS 146 requires that a liability for costs associated with exit or disposal activities be recognized and measured initially at fair value only when the liability is incurred. SFAS 146 will be effective for exit or disposal activities initiated after December 31, 2002, and had no impact on the Company's financial statements in 2002, but will impact the accounting treatment of future exit or disposal activities should they occur.

*Guarantor's Accounting for Guarantees*

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation). The Interpretation will significantly change current practice in the accounting for, and disclosure of, guarantees. Guarantees meeting the characteristics described in the Interpretation which are not included in a long list of exceptions are required to be initially recorded at fair value, which is different from the general current practice of recording a liability only when a loss is probable and reasonably estimable, as those terms are defined in FASB Statement No. 5, *Accounting for Contingencies*. The Interpretation also requires a guarantor to make significant new disclosures for virtually all guarantees even if the likelihood of the guarantor's having to make payments under the guarantee is remote. The initial recognition and initial measurement provisions of the Interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. Accounting for guarantees issued prior to December 31, 2002 should not be revised or restated. As discussed in Note 12 to the consolidated financial statements, the Company has two existing operating lease agreements with terms that include residual value guarantees totaling approximately \$16 million, both entered into before December 31, 2002, and, therefore, not required to be revised or restated.

*Stock Based Compensation Transition and Disclosure*

In December 2002, SFAS No. 148 ( SFAS 148 ), *Accounting for Stock-Based Compensation-Transition and Disclosure* was issued to amend SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of Statement 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. The transition guidance and annual disclosure provisions of SFAS 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The adoption of SFAS 148 will not have a material impact on our financial position, results of operations, or cash flows, because the Company will continue to follow the guidance of APB 25 in recognizing stock compensation expense. The Company will comply with the new disclosure requirements in the financial statement for the first quarter of 2003.

**2. Business Combinations and Divestitures**

*Purchases*

On September 21, 2000, the Company acquired all outstanding shares of General Optics, Inc. ( General Optics ), a privately held precision optics company located in Moorpark, California. The purchase price of \$13.5 million was comprised of cash of \$6.9 million paid on closing, note payable valued at \$6.4 million, discounted at an imputed interest rate of 6.23%, and costs of acquisition of \$0.2 million. The note payable was settled in two installments, due September 21, 2001 and 2002. The transaction has been accounted for as a purchase and, accordingly, the operations of General Optics have been included in the consolidated financial statements from the date of acquisition. The excess of the purchase price over the fair value of net identifiable

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

tangible assets acquired was recorded as acquired technology to be amortized over its estimated useful life of 10 years.

***Divestitures***

On April 2, 2001, the Company completed the sale of operating assets of the Laserdyne and Custom Systems product lines for cash proceeds of approximately \$7.3 million. Sales for these product lines were \$3 million and \$24.3 million for the years ended December 31, 2001 and December 31, 2000, respectively.

On October 1, 2000, the Company sold the net assets of its Life Sciences business to Packard BioScience Company ( Packard ) for \$39.3 million in cash and approximately 4.5 million shares of unregistered Packard common stock valued at \$43.3 million by management. To determine the fair value of the stock, a number of factors were considered, including a valuation. The value of the stock reflected a discount from the quoted market value of Packard's registered common stock that was traded on the NASDAQ National Market. The Life Sciences business comprised working capital of approximately \$3.5 million and fixed and other intangible assets of approximately \$1.2 million. The Company recorded a non-operating gain of \$73.1 million (\$47.3 million after tax), or \$1.24 per share, as a result of this transaction. Sales for the Life Sciences business for the nine months ended September 30, 2000 were \$13.1 million and for the year ended December 31, 1999 were \$13.8 million. On November 13, 2001, Packard was acquired by PerkinElmer, Inc. As a result, the shares of Packard owned by the Company were converted into the right to receive 0.311 of a share of PerkinElmer, Inc. at the quoted market value of \$27.285 per share. The Company sold these shares on November 19, 2001 for proceeds of \$38.5 million and recorded a loss of \$4.8 million.

During the third quarter of 2000, the Company sold two facilities in the United States for \$12.5 million cash and recorded a net gain of \$2.4 million.

During the second quarter of 2000, the Company sold operating assets of its View Engineering metrology product line, fiber-optics operations in Phoenix, Arizona and package coding product line in Hull, United Kingdom for an aggregate of \$13 million cash and recorded a net gain of \$1.3 million.

**3. Supplementary Balance Sheet Information**

The following tables provide the details of selected balance sheet items as at December 31:

***Inventories***

	<u>2002</u>	<u>2001</u>
Raw materials	\$ 16,380	\$ 29,779
Work-in-process	7,468	8,028
Finished goods	11,114	12,918
Demo inventory	4,709	7,069
	<u>          </u>	<u>          </u>
Total inventories	<u>\$ 39,671</u>	<u>\$ 57,794</u>



**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Property, Plant and Equipment, net*

	<u>2002</u>	<u>2001</u>
Cost:		
Land, buildings and improvements	\$ 12,102	\$ 18,167
Machinery and equipment	36,026	34,890
	<u>          </u>	<u>          </u>
Total cost	48,128	53,057
Accumulated depreciation	(21,453)	(20,575)
	<u>          </u>	<u>          </u>
Net property, plant and equipment	<u>\$ 26,675</u>	<u>\$ 32,482</u>

*Other Assets*

	<u>2002</u>	<u>2001</u>
Short term other assets:		
Note receivable	\$ 563	\$ 1,125
Investment (note 10)		1,500
Prepaid expenses and other	3,885	5,903
	<u>          </u>	<u>          </u>
Total	<u>\$4,448</u>	<u>\$8,528</u>
	<u>          </u>	<u>          </u>
Long term other assets:		
Investment (note 10)	\$	\$ 500
Note receivable		563
Deposits and other	425	476
Facilities available for sale (note 11)	2,935	
	<u>          </u>	<u>          </u>
Total	<u>\$3,360</u>	<u>\$1,539</u>
	<u>          </u>	<u>          </u>

The note receivable bears interest at the prime rate and will be received in quarterly installments of \$0.3 million, ending in June 2003.

At December 31, 2002, the Company had two facilities that were classified as available for sale. One is a 75,000 square foot facility in Kanata, Ontario and the other is a 17,000 square foot facility in Nepean, Ontario. Both of these facilities became available for sale in 2002, as a result of restructuring actions that occurred (Note 11). These buildings are recorded at their estimated fair market value (approximately \$2.2 million for the Kanata, Ontario property and \$0.7 million for Nepean, Ontario).

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Intangible assets consist of the following:

	December 31, 2002		December 31, 2001	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Patents and acquired technology	\$ 28,660	\$(15,850)	\$ 27,174	\$(10,809)
Assembled workforce			2,814	(786)
Trademarks and trade names	1,024	(367)	936	(262)
Total cost	29,684	\$(16,217)	30,924	\$(11,857)
Accumulated amortization	(16,217)		(11,857)	
Net intangible assets	\$ 13,467		\$ 19,067	

Amortization of intangible asset expense subsequent to December 31, 2002 is:

2003	\$ 5,135
2004	1,970
2005	1,137
2006	1,137
2007	1,137
Thereafter	2,951
Total amortization expense	\$13,467

**Other Accrued Expenses**

	2002	2001
Accrued warranty	\$ 3,383	\$ 4,027
Deferred revenue	3,404	2,148
Accrued restructuring (note 11)	8,790	8,827
Other	5,268	10,094
Total	\$20,845	\$25,096

**Accrued Warranty**

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	Year Ended December 31,	
	2002	2001
Balance at the beginning of the period	\$ 4,027	\$ 7,107
Charged to costs and expenses	5,624	9,551
Use of provision	(6,358)	(12,507)
Foreign currency exchange rate changes	90	(124)
	<u>          </u>	<u>          </u>
Balance at the end of the period	\$ 3,383	\$ 4,027
	<u>          </u>	<u>          </u>

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. Bank Indebtedness**

At December 31, 2002, the Company had lines of credit denominated in US and Canadian dollars with Fleet National Bank ( Fleet ), Bank One and Canadian Imperial Bank of Commerce ( CIBC ) and letters of credit ( LC ) with National Westminster Bank ( NatWest ), for a total amount of available credit of \$12.1 million versus \$32.4 million at December 31, 2001. The Company's agreement with Fleet provides for an \$8 million line of credit and its agreement with CIBC provides for a \$4 million line of credit. The previous \$13 million line of credit with CIBC expired on June 28, 2002, and the new CIBC credit facility eliminated the Company's requirement to meet certain financial covenants which were required under the previous credit facility. NatWest provides a \$0.1 million bank guarantee for LC used for VAT purposes in the United Kingdom. Marketable securities totaling \$14.5 million have been pledged as collateral for the Fleet and CIBC credit facilities under security agreements. The line of credit with Fleet expires on June 28, 2003. In addition to the customary representations, warranties and reporting covenants, the borrowings under the Fleet credit facility require the Company to maintain a quarterly minimum tangible net worth of \$200 million. The line of credit with CIBC was reviewed by the Company and a decision to cancel the line of credit was conveyed to CIBC prior to December 31, 2002. By giving CIBC appropriate advance notice, the Company initiated its right to cancel the line of credit at any time at no cost, excluding breakage fees relating to the used and outstanding amounts under fixed loan instruments, which we do not expect to be material. The line of credit with CIBC should be eliminated by the end of the second quarter in 2003. The Company also cancelled its credit facility with Bank One on December 20, 2002 without paying any breakage fees. North American inventories and receivables were pledged as collateral for the Bank One credit facility. Bank One continues to work on the release of all liens and obligations associated with the facility.

At December 31, 2002, the Company has approximately \$12.1 million denominated in Canadian dollars and US dollars that are available for general purposes, under the credit facilities discussed above. Of the available \$12.1 million, \$7.7 million was in use at December 31, 2002, consisting of \$3.8 million committed at Fleet Bank for use in foreign exchange transactions, \$2.9 million in Rugby, United Kingdom under the CIBC credit facilities and approximately \$0.8 million of bank guarantees and outstanding letters of credit under the CIBC credit facility and \$0.1 million with NatWest. Though the Fleet Bank amount of \$3.8 million is committed for support of foreign currency hedging contracts and not available, it is not considered used for the purpose of calculating interest payments. At December 31, 2002, the aggregate unused portion of credit available under the credit facilities amounts to \$4.4 million. The CIBC credit facility is currently a demand facility with interest based on the prime rate. The Fleet line of credit is due on demand and bears interest based on either prime or LIBOR depending on the borrowing notification period. This resulted in an effective average rate of 1.79% for fiscal 2002.

The Company had a line of credit at December 31, 2001 of approximately \$32.4 million that was denominated in Canadian dollars, US dollars, British Sterling and Japanese Yen. The line of credit available for general purposes was \$32.4 million. As at December 31, 2001, there was an outstanding balance of approximately \$6.2 million under the line of credit and outstanding letters of credit and other discretionary lines of \$4.9 million. The line of credit was due on demand and bore interest based on prime, which resulted in an effective average rate of 1.68% for fiscal 2001. Borrowings were limited to the sum of eligible accounts receivable under 90 days and North American inventories. Accounts receivable and inventories were pledged as collateral for the bank indebtedness under general security agreements. As of December 31, 2001, the Company was in breach of one of the financial covenants, the interest coverage ratio, for which no borrowings were made under the facility. The bank issued a waiver of this non-compliance, which would have allowed the Company to draw on the line of credit if needed.

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. Long-term Debt**

There was no long-term debt at December 31, 2002. In 2001, long-term debt includes a note payable with a face value of \$3 million (2000 \$7 million), non-interest bearing, to the former shareholders of General Optics. The note payable was discounted at an imputed interest rate of 6.23% and was settled on September 21, 2002.

Total cash interest paid on all long-term debt during the year ended December 31, 2002 was \$0.3 million (2001 \$0.5 million; 2000 \$1.2 million).

**6. Deferred Compensation**

Certain officers and employees have deferred payment of a portion of their compensation until termination of employment or later. Interest on the outstanding balance is credited quarterly at the prime rate, which averaged 4.7% during the year ended December 31, 2002 (2001 6.9%). The portion of deferred compensation estimated to be due within one year is included in accrued compensation and benefits.

**7. Stockholders Equity*****Capital stock***

The authorized capital of the Company consists of an unlimited number of common shares without nominal or par value. During 2001, the Company reduced its common shares outstanding for 2,309 shares that were not claimed since the merger.

***Accumulated other comprehensive loss***

The following table provides the details of accumulated other comprehensive loss at December 31;

	<u>2002</u>	<u>2001</u>
Unrealized gain on investments (net of tax of \$0)	\$ 312	\$
Unrealized gain (loss) on cash flow hedging (net of tax of \$0 for 2002 and \$567 for 2001)	(521)	793
Accumulated foreign currency translations	(7,470)	(11,013)
Additional minimum pension liability (net of tax of \$0)	(3,875)	
	<u>          </u>	<u>          </u>
Total	\$ (11,554)	\$ (10,220)
	<u>          </u>	<u>          </u>

***Net income (loss) per common share***

Basic income (loss) per common share was computed by dividing net income (loss) by the weighted-average number of common shares outstanding during the year. For diluted income per common share, the denominator also includes dilutive outstanding stock options and warrants determined using the treasury stock method. As a result of the net losses for the years ended December 31, 2002 and 2001, the effect of converting options and warrants was antidilutive.

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Common and common equivalent share disclosures are:

	Year Ended December 31,		
	2002	2001	2000
	(In thousands)		
Weighted average common shares outstanding	40,663	40,351	38,187
Dilutive potential common shares			1,813
Diluted common shares	40,663	40,351	40,000
Options and warrants excluded from diluted income per common share as their effect would be antidilutive	3,676	3,633	252

**Shareholder rights plan**

On April 12, 1999, the Board of Directors adopted a Shareholders Rights Plan (the "Plan"). Under this Plan one Right has been issued in respect of each common share outstanding as of that date and one Right has been and will be issued in respect of each common share issued thereafter. Under the Plan, each Right, when exercisable, entitles the holder to purchase from the Company one common share at the exercise price of Cdn\$200, subject to adjustment and certain anti-dilution provisions (the "Exercise Price"). At the annual meeting of the shareholders held on May 9, 2002, the shareholders adopted a resolution to approve the continued existence of the Plan.

The Rights are not exercisable and cannot be transferred separately from the common shares until the "Separation Time", which is defined as the eighth business day (subject to extension by the Board) after the earlier of (a) the "Stock Acquisition Date" which is generally the first date of public announcement that a person or group of affiliated or associated persons (excluding certain persons and groups) has acquired beneficial ownership of 20% or more of the outstanding common shares, or (b) the date of commencement of, or first public announcement of the intent of any person or group of affiliated or associated persons to commence, a Take-over Bid. At such time as any person or group of affiliated or associated persons becomes an "Acquiring Person" (a "Flip-In Event"), each Right shall constitute the right to purchase from the Company that number of common shares having an aggregate Market Price on the date of the Flip-In Event equal to twice the Exercise Price, for the Exercise Price (such Right being subject to anti-dilution adjustments).

So long as the Rights are not transferable separately from the common shares, the Company will issue one Right with each new common share issued. The Rights could have certain anti-takeover effects, in that they would cause substantial dilution to a person or group that attempts to acquire the Company on terms not approved by the Board of Directors.

**Stock options**

In conjunction with the merger with General Scanning, Inc., the Company adopted outstanding options held by employees under nonqualified and incentive stock options plans of General Scanning, Inc. and issued 2,051,903 stock options of the Company in exchange. At December 31, 2002, options to purchase 630,677 shares of common stock remained outstanding under the assumed General Scanning, Inc. stock option plans. In addition, the Company adopted outstanding warrants for the purchase of common stock issued to non-employee members of the General Scanning, Inc. Board of Directors. The warrants are subject to vesting as determined by a committee of the Board of Directors at the date of grant and expire ten years from the date of grant. During the year ended December 31, 2002, none were granted, cancelled or exercised. At December 31, 2002, 51,186 warrants, of which all are exercisable, remain outstanding at prices ranging from \$9.65 to \$15.41 per share. The warrants are included in the stock option activity table in this note.



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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Lumonics Inc. had three (3) stock option plans in existence for key employees and for directors prior to the merger with General Scanning, Inc., known as the May 1994 Executive Management Plan ( May 1994 Plan ), the September 1994 Key Employee and Director Plan ( September 1994 Plan ) and the 1995 Stock Option Plan ( 1995 Option Plan ). Outstanding options under these three plans vest over periods of one to four years beginning on the date of grant. The options expire over a period of two to ten years beginning at the date of grant. With respect to the May 1994 Plan, a total of 700,000 options were authorized for issuance under the plan and at December 31, 2000, there were no options outstanding under the plan. With respect to the September 1994 Plan, a total of 1,094,000 options were authorized for issuance under the plan and at December 31, 2000, there were no options outstanding under the plan. All outstanding options under the May 1994 Plan and the September 1994 Plan expired on September 14, 2001. No additional options will be granted under the May 1994 Plan or the September 1994 Plan. With respect to the 1995 Option Plan, a total of 4,906,000 options have been authorized for issuance under the plan.

The 1995 Option Plan referenced above, which was established in September 1995 by Lumonics Inc. for the benefit of employees (including contract employees), consultants, and directors of the Company, remained in place following the merger with General Scanning, Inc. in 1999 and as of the date of this Form 10-K, is the only Company stock option plan under which new options may be granted. Subject to the requirements of the 1995 Option Plan, the Compensation Committee or in lieu thereof, the Board of Directors, has the authority to select those directors, consultants, and employees to whom options will be granted, date of the grant, the number of options to be granted and other terms and conditions of the Options. The exercise price of options granted under the 1995 Option Plan must be equal to the closing price of the Company's common shares on The Toronto Stock Exchange, or in lieu thereof, The NASDAQ Stock Market®, on the day immediately preceding the date of grant. The exercise period of each option is determined by the Compensation Committee but may not exceed 10 years from the date of grant. The 1995 Option Plan initially authorized the issuance of a maximum of 406,000 options to purchase common shares. This authorization was increased to: 1,906,000 on May 6, 1997, 2,906,000 on May 11, 1999, and 4,906,000 on May 8, 2000; with all such increases being approved by the shareholders. Currently, a maximum of 4,906,000 options to purchase common shares are permitted to be issued under the 1995 Option Plan. The Compensation Committee has the power to amend, modify, or terminate the 1995 Option Plan provided that optionee's rights are not materially adversely affected and subject to any approvals required under the applicable regulatory requirements. At December 31, 2002, 424,801 (2001 626,113) options were available for grant under the 1995 Option Plan.

In July 1999, the Company offered employee option holders an exchange of one option for each two options outstanding with exercise prices over \$9.00 or Cdn\$13.32. Under this exchange 243,597 options with exercise price of \$4.63 or Cdn\$6.95 per share, the then-current market price of the stock, were granted with a new vesting schedule, and 487,194 options were cancelled. The Company is accounting for the replacement options as variable from July 1, 2000, in accordance with Financial Accounting Standard Board Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation - an Interpretation of APB Opinion No. 25*, until the options are exercised, forfeited or expire unexercised. Because the market price of the Company's stock has decreased since July 1, 2000, there was no material impact on its financial position and results of operations.

During 2001, the Company accelerated vesting of certain options and recorded compensation expense of \$0.2 million (2000 \$0.6 million) in results of operations.



**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Stock option activity for the years ended December 31, 2002, 2001 and 2000 is presented below.

	<b>Options (thousands)</b>	<b>Weighted Avg. Exercise Price</b>
Outstanding at December 31, 1999	3,978	\$ 6.71
Granted	1,037	18.99
Exercised	(1,564)	5.54
Forfeited	(366)	8.30
	<hr/>	<hr/>
Outstanding at December 31, 2000	3,085	11.20
Granted	1,835	9.37
Exercised	(344)	4.38
Forfeited	(943)	12.61
	<hr/>	<hr/>
Outstanding at December 31, 2001	3,633	10.45
Granted	736	8.58
Exercised	(133)	4.78
Forfeited	(560)	11.81
	<hr/>	<hr/>
Outstanding at December 31, 2002	3,676	\$10.11
	<hr/>	<hr/>
Exercisable at December 31, 2002	1,686	\$10.22
	<hr/>	<hr/>

The following summarizes outstanding and exercisable options outstanding on December 31, 2002:

<b>Range of Exercise Prices</b>	<b>Options Outstanding</b>			<b>Exercisable Options</b>	
	<b>Number of Options (000 s)</b>	<b>Weighted Average Remaining Life</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Options Exercisable (000 s)</b>	<b>Weighted Average Exercise Price</b>
\$ 1.75 to \$ 4.63	667	3.5 years	\$ 4.41	571	\$ 4.41
\$ 4.68 to \$ 8.27	222	4.3 years	\$ 7.31	95	\$ 6.39
\$ 8.35 to \$ 8.90	505	5.1 years	\$ 8.41	16	\$ 8.81
\$ 8.93 to \$ 8.93	886	4.3 years	\$ 8.93	223	\$ 8.93
\$ 8.98 to \$14.66	799	4.9 years	\$11.65	446	\$13.05
\$14.85 to \$20.31	597	3.9 years	\$18.65	335	\$18.37
	<hr/>			<hr/>	
	3,676			1,686	
	<hr/>			<hr/>	

Options outstanding include 221,771 options denominated in Canadian dollars with a weighted average exercise price of \$16.09 Canadian.

***Employee Stock Purchase Plan***

At the Annual General Meeting of Stockholders on May 8, 2001, the Stockholders approved the adoption of the Employee Stock Purchase Plan (the Purchase Plan ). A total of 300,000 common shares have been reserved for issuance under the Purchase Plan. The Company will make open market purchases and/or issue treasury common shares to satisfy employee subscriptions under the Purchase Plan. Under the terms of the Purchase Plan, employees can choose to have up to 7% of their base earnings withheld to purchase the Company's common stock. The Purchase Plan provides for consecutive offering periods during which payroll deductions may be accumulated for the purchase of common shares. The initial offering period commenced on July 1, 2001 and ended on December 31, 2001. Thereafter, each offering period will continue for a period of

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

six months following commencement, as determined by the Compensation Committee. The purchase price per share at which shares will be sold in an offering period under the Purchase Plan is the lower of 85% of the Fair Market Value of a common share at the beginning of the offering period or 85% of the Fair Market Value of a common share at the end of the offering period. Fair Market Value, as defined by the Purchase Plan, is the weighted average sale price of the shares for the five (5) day period preceding the grant date and the exercise date. During the two offerings in the period ended December 31, 2002, 95,269 shares were issued under the Purchase Plan at an average cost of \$5.89 per share (2001 51,529 with average cost of \$6.48).

***Pro forma stock based compensation***

Had compensation cost for the Company's stock option plans and employee stock purchase plan been determined consistent with SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts below.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Net income (loss):			
As reported	\$ (27,724)	\$ (14,698)	\$ 45,377
Pro forma	\$ (31,336)	\$ (17,832)	\$ 42,520
Basic net income (loss) per share:			
As reported	\$ (0.68)	\$ (0.36)	\$ 1.19
Pro forma	\$ (0.77)	\$ (0.44)	\$ 1.11
Diluted income (loss) per share:			
As reported	\$ (0.68)	\$ (0.36)	\$ 1.13
Pro forma	\$ (0.77)	\$ (0.44)	\$ 1.07

The fair value of options was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Risk-free interest rate	3.1%	4.1%	5.1%
Expected dividend yield			
Expected lives upon vesting	1.0 years	1.0 years	1.0 years
Expected volatility	67%	70%	100%
Weighted average fair value per share	\$ 5.27	\$ 4.82	\$ 12.48

The fair value of the employees' purchase rights under the employee stock purchase plan was estimated using the Black-Scholes option-model with the following assumptions: dividend yield of nil (2001 nil); an expected life of 6 months (2001 6 months); expected volatility of 67% (2001 70%); and risk-free interest rate of 1.75% (2001 3.45%). The weighted-average fair value of those purchase rights granted in 2002 was \$3.71 (2001 \$2.98).

**8. Employee Benefit Plans*****Defined Benefit Pension Plan***

The Company's subsidiary in the United Kingdom maintains a pension plan, known as the GSI Lumonics Ltd. United Kingdom Pension Scheme Retirement Savings Plan. The plan has two components: the Final Salary Plan, which is a defined benefit plan, and the Retirement Savings Plan, which is a defined contribution plan. Effective April 1997, membership to the Final Salary Plan was closed. Benefits under this plan are based on the employees' years of service and compensation. The Company's funding policy is to fund



**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

pensions and other benefits based on widely used actuarial methods as permitted by regulatory authorities. The funded amounts reflect actuarial assumptions regarding compensation, interest and other projections. The assets of this plan consist primarily of equity and fixed income securities of U.K. and foreign issuers.

In December 2002, the Company notified plan participants that it no longer wants to sponsor the final salary plan. Consultations are underway and the final outcome of these matters has not yet been determined.

Pension and other benefit costs reflected in the consolidated statements of operations are based on the projected benefit method of valuation. Within the consolidated balance sheet, pension plan benefit liabilities are included in accrued compensation and benefits.

The net periodic pension cost for the defined benefit pension plan was determined as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Service cost benefits earned	\$ 216	\$ 393	\$ 442
Interest cost on projected plan benefits	837	827	847
Premiums and expenses	135	151	149
Expected return on plan assets	(814)	(873)	(945)
	<u>          </u>	<u>          </u>	<u>          </u>
Net Periodic Pension Cost	\$ 374	\$ 498	\$ 493
	<u>          </u>	<u>          </u>	<u>          </u>

The assumptions used to develop the actuarial present value of the accrued pension benefits (obligations) were as follows:

	<u>2002</u>	<u>2001</u>
Discount Rate	6.0%	7.0%
Rate of Compensation Increase	3.0%	4.0%
Long-Term Rate of Return on Plan Assets	7.0%	7.0%

The estimates are based on actuarially computed best estimates of pension asset long-term rates of return and long-term rate of obligation escalation. Variances between these estimates and actual experience are amortized over the employees' average remaining service life.

The most recent actuarial valuation of the plan was performed as at November 30, 2000. The extrapolation as at December 31 indicates the actuarial present value of the pension benefit obligation; the net assets available to provide for these benefits, at market value; and the funded status of the plan were as follows:

	<u>2002</u>	<u>2001</u>
<b>Change in benefit obligation:</b>		
Projected benefit obligation at beginning of year	\$ 11,633	\$ 12,917
Service cost	216	393
Interest cost	837	827
Plan participants' contributions	158	118
Actuarial changes in assumptions and experience	2,205	(1,345)
Benefits paid	(278)	(922)
Foreign currency exchange rate changes	1,345	(355)

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Projected benefit obligation at end of year	<u>\$ 16,116</u>	<u>\$ 11,633</u>
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**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<u>2002</u>	<u>2001</u>
<b>Change in plan assets:</b>		
Market value of plan assets at beginning of year	\$ 11,270	\$ 12,917
Actual return on plan assets	(1,642)	(569)
Employer contributions	625	180
Plan participants' contributions	158	118
Benefits paid	(278)	(922)
Foreign currency exchange rate changes	1,029	(358)
Other	(82)	(96)
	<u>          </u>	<u>          </u>
Market value of plan assets at end of year	\$ 11,080	\$ 11,270
	<u>          </u>	<u>          </u>
<b>Funded Status and Net Amounts Recognized:</b>		
Excess of projected benefit obligation over plan assets	\$ 5,036	\$ 363
Unrecognized actuarial gain (loss)	(4,823)	126
	<u>          </u>	<u>          </u>
Net amount recognized	\$ 213	\$ 489
	<u>          </u>	<u>          </u>
Amount recognized in the balance sheet consists of:		
Accrued compensation and benefits	\$ 213	\$
Accrued minimum pension liability	3,875	
Accumulated other comprehensive loss	(3,875)	
	<u>          </u>	<u>          </u>
Net amount recognized	\$ 213	\$ 489
	<u>          </u>	<u>          </u>

**Defined Contribution Plans**

The Company has defined contribution employee savings plans in Canada, the United Kingdom, and the United States. In the United States, the provisions of Section 401(k) of the Internal Revenue Code under which its United States employees may make contributions govern the plan. The Company matches the contributions of participating employees on the basis of percentages specified in each plan. Company matching contributions to the plans were \$1.9 million in 2002 (2001 \$2.4 million; 2000 \$2.7 million).

**9. Income Taxes**

Details of the income tax provision (benefit) are as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
<b>Current</b>			
Canadian	\$ (2,676)	\$ (1,575)	\$ 2,197
International	(10,572)	(12,887)	31,082
	<u>          </u>	<u>          </u>	<u>          </u>
	(13,248)	(14,462)	33,279
<b>Deferred</b>			
Canadian	1,942	(1,123)	4,089

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International	2,325	7,811	(7,702)
	<u>4,267</u>	<u>6,688</u>	<u>(3,613)</u>
Income tax provision (benefit)	\$ (8,981)	\$ (7,774)	\$29,666



**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The income tax provision (benefit) reported differs from the amounts computed by applying the Canadian rate to income (loss) before income taxes. The reasons for this difference and the related tax effects are as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Expected Canadian tax rate	38.6%	41.7%	44.0%
Expected income tax provision (benefit)	\$(14,168)	\$(9,370)	\$33,019
Non-deductible expenses	195	2,782	2,885
International tax rate differences	(141)	(788)	(3,632)
Losses and temporary differences the benefit of which has not been recognized	6,176	1,222	3,554
Previously unrecognized losses and temporary differences	(873)	(2,162)	(6,549)
Other items	(170)	542	389
	<u>          </u>	<u>          </u>	<u>          </u>
Reported income tax provision (benefit)	\$ (8,981)	\$(7,774)	\$29,666
	<u>          </u>	<u>          </u>	<u>          </u>

Deferred income taxes result principally from temporary differences in the recognition of certain revenue and expense items for financial and tax reporting purposes. Significant components of the Company's deferred tax assets and liabilities as at December 31 are as follows:

	<u>2002</u>	<u>2001</u>
<b>Deferred tax assets</b>		
Operating tax loss carryforwards	\$ 18,943	\$ 11,556
Compensation related deductions	1,769	1,690
Tax credits	4,990	4,525
Restructuring and other accrued liabilities	5,092	5,916
Deferred revenue	543	690
Inventory	4,397	8,918
Tax effect of UK pension liability	1,162	
Book and tax differences on fixed assets	488	1,103
Intangibles	1,811	286
Share issue costs	575	962
	<u>          </u>	<u>          </u>
Total deferred tax assets	39,770	35,646
Valuation allowance for deferred tax assets	(22,564)	(13,445)
	<u>          </u>	<u>          </u>
Net deferred tax assets	17,206	22,201
	<u>          </u>	<u>          </u>
<b>Deferred tax liabilities</b>		
Unrealized gain on hedging activities		567
Intangibles		
	<u>          </u>	<u>          </u>
Net deferred income tax asset	\$ 17,206	\$ 21,634
	<u>          </u>	<u>          </u>
<b>Allocated as follows:</b>		
Net deferred income tax asset short-term	9,763	15,097
Net deferred income tax asset long-term	7,443	6,537
	<u>          </u>	<u>          </u>

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Net deferred income tax asset	\$ 17,206	\$ 21,634
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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company has provided a valuation allowance of \$22.6 million against losses in the parent company and subsidiaries with an inconsistent history of taxable income and loss due to the uncertainty of their realization. In addition, the Company has provided a valuation allowance on foreign tax credits, due to the uncertainty of generating foreign earned income to claim the tax credits. The Company believes it is more likely than not that the remaining deferred tax assets will be realized principally through future taxable income and carry backs to taxable income in prior years. If actual results differ from those expected, or if we do not achieve profitability, we may be required to increase the valuation allowance on our tax assets by taking a charge to the consolidated statements of operations, which may have a material adverse effect on our results of operations.

As at December 31, 2002, the Company had loss carry forwards of approximately \$57.6 million available to reduce future years' income for tax purposes. Of this amount, approximately \$1.7 million expires between 2003 and 2006, \$13.6 million expires in 2007, \$9.4 million expires between 2020 and 2022 and \$32.9 million can be carried forward indefinitely.

Undistributed earnings of the Company's foreign subsidiaries amounted to approximately \$53.6 million at December 31, 2002. The Company has not recorded a provision for withholding tax on undistributed earnings of foreign subsidiaries, as the Company currently has no plans to repatriate those earnings. Determination of the amount of unrecognized deferred tax liabilities is not practicable because of the complexities associated with its hypothetical calculation.

Income taxes paid during 2002 were \$1.7 million (2001 \$33.3 million; 2000 \$4.3 million).

**10. Related Party Transactions**

The Company had the following transactions with related parties. The Company recorded \$2.3 million as sales revenue from Sumitomo Heavy Industries Ltd., a significant shareholder in the year ended December 31, 2002 (2001 \$4.2 million; 2000 \$10.2 million) at amounts and terms approximately equivalent to third party transactions. Receivables from Sumitomo Heavy Industries Ltd. of \$0.5 million and \$0.6 million as at December 31, 2002 and 2001, respectively, are included in accounts receivable on the balance sheet.

On February 23, 2000, the Company entered into an Agreement with V2Air LLC relating to the use of the LLC aircraft for Company purposes. The V2Air LLC is owned by the Company's President and Chief Executive Officer, Charles D. Winston. Pursuant to the terms of the Agreement, the Company is required to reimburse the V2Air LLC for certain expenses associated with the use of the aircraft for Company business travel. During the most recently completed fiscal year, the Company reimbursed V2Air LLC approximately \$145,000 (2001 \$150,000) under the terms of such Agreement.

In January of 2001, the Company made an investment of \$2 million in a technology fund managed by OpNet Partners, L.P. During 2002, the Company received a cash distribution (return of capital) from OpNet Partners in the amount of \$1.4 million. In the second quarter of 2002, the Company wrote-down the investment by \$0.2 million to its estimated fair market value and wrote-off the remainder of the investment (\$0.4 million) in the fourth quarter of 2002. Richard B. Black, a member of the Company's Board of Directors, is a General Partner of OpNet Partners, L.P.

On April 26, 2002, the Company entered into an agreement with Photoniko, Inc, a private photonics company in which one of the Company's directors, Richard B. Black, was a director and stock option holder. As of August 16, 2002, Mr. Black was no longer a director or stock option holder of Photoniko, Inc. Under the agreement, the Company provided a non-interest bearing unsecured loan of \$75,000 to Photoniko, Inc. to fund designated business activities at Photoniko, Inc. in exchange for an exclusive 90 day period to evaluate potential strategic alliances. In accordance with the terms of the agreement and the promissory note which was signed by Photoniko, Inc. on April 26, 2002, the loan was to be repaid in full to the Company no later than August 28, 2002, but still remains outstanding. The Company has provided a full reserve for this receivable.

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. Restructuring and other**

	Year Ended December 31,		
	2002	2001	2000
Restructuring charges	\$ 6,448	\$ 3,380	\$ 15,147
Reversal of restructuring charges		(450)	(5,006)
<b>Total restructuring charges</b>	<b>6,448</b>	<b>2,930</b>	<b>10,141</b>
Other reduction of purchased intangibles		1,759	
Other royalties	(276)	(348)	(275)
Other legal settlements	(745)	(1,559)	(2,670)
<b>Total other</b>	<b>\$(1,021)</b>	<b>\$ (148)</b>	<b>\$(2,945)</b>

**Restructuring charges**

From 2000 through 2002, the Company faced a 57% decline in revenues and responded by streamlining operations to reduce fixed costs.

*2000*

During fiscal 2000, the Company took total restructuring charges of \$15.1 million, \$12.5 million of which resulted from the Company's determination to exit the high powered laser product line that was produced in its Rugby, United Kingdom facility. The \$12.5 million charge consisted of \$1 million to accrue employee severance for approximately 50 employees; \$3.8 million for reduction and elimination of the Company's United Kingdom operation and worldwide distribution system related to high power laser systems; and \$7.7 million for excess capacity at three leased facilities in the United States and Germany where high power laser systems operations were conducted. The provisions for lease costs at our Livonia and Farmington Hills, Michigan facilities and in Germany related primarily to future contractual obligations under operating leases, net of expected sublease revenue on leases that the Company cannot terminate. Additionally, for our Farmington Hills, Michigan and Maple Grove, Minnesota facilities, we accrued an anticipated loss on our contractual obligations to guarantee the value of the buildings. This charge was estimated as the excess of our cost to purchase the buildings over their estimated fair market value. The Company also recorded a non-cash write-down of land and building in the United Kingdom of \$2 million, based on market assessments as to the net realizable value of the facility. In addition, the Company recorded in cost of goods sold a reserve of \$8.5 million for raw materials, work-in-process, equipment, parts and demo equipment inventory that related to the high power laser product line in its Rugby, United Kingdom facility and other locations that supported this product line.

The remaining restructuring charge for fiscal 2000, \$0.6 million of compensation expense, resulted from the acceleration of options upon the sale of our Life Sciences business and MPG product line during that year.

Also during fiscal 2000, the Company reversed a provision of \$5 million originally recorded at the time of the 1999 merger of General Scanning, Inc. and Lumonics Inc. At the time the \$5 million provision was recorded, the Company intended to close its Rugby, United Kingdom facility and transfer those manufacturing activities to its Kanata, Ontario facility. As plans evolved, the Company realized that it would cost too much to move the manufacturing and decided to not go through with its original plan. Thus, the Company reversed the \$5 million that had initially been recorded for this proposed restructuring.

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Cumulative cash draw-downs of \$6 million, a reversal of \$0.5 million recorded in the fourth quarter of 2001 for anticipated restructuring costs that will not be incurred and a non-cash draw-down of \$2.6 million have been applied against the total fiscal 2000 provision of \$15.1 million, resulting in a remaining balance at

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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

December 31, 2002 of \$6 million. All actions relating to the 2000 restructuring charge have been completed. The \$6 million accrual remaining at December 31, 2002 for the Farmington Hills, Michigan and the Maple Grove, Minnesota facilities, is expected to be used during 2003 at the end of the lease terms to offset the anticipated loss on these leases upon purchase and eventual resale of the buildings.

*2001*

In the fourth quarter of fiscal 2001, to further reduce capacity in response to declining sales, the Company determined that the remaining functions located in its Farmington Hills, Michigan facility should be integrated with its Wilmington, Massachusetts facility and that its Oxnard, California facility should be closed. In addition, the Company determined to integrate its Bedford, Massachusetts facility with its Billerica, Massachusetts manufacturing facility. The Company took total restructuring charges of \$3.4 million. The \$3.4 million charge consisted of \$0.9 million to accrue employee severance for approximately 35 employees at the Farmington Hills, Michigan and Oxnard, California locations; \$1.8 million for excess capacity at five leased locations in the United States, Canada and Germany; and \$0.7 million write-down of leasehold improvements and certain equipment associated with the existing of leased facilities located in Bedford, Massachusetts. The lease costs primarily related to future contractual obligations under operating leases, net of expected sublease revenue on leases that the Company cannot terminate. The expected effects of the restructuring were to better align our ongoing expenses and cash flows in light of reduced sales.

Cumulative cash draw-downs of approximately \$2.4 million and non-cash draw-downs of \$0.7 million have been applied against the provision, resulting in a remaining provision balance of \$0.3 million as at December 31, 2002. The restructuring is complete, except for costs that are expected to be paid on the leased facilities in Munich, Germany (lease expiration January 2013), Oxnard, California (expected payment March 2003) and Nepean, Ontario (lease expiration January 2006).

*2002*

Two major restructuring plans were initiated in 2002, as the Company continued to adapt to a lower level of sales. In the first quarter of 2002, the Company made a determination to reduce fixed costs by transferring manufacturing operations at its Kanata, Ontario facility to other manufacturing facilities. Associated with this decision, the Company incurred restructuring costs in the first, second, and fourth quarters of 2002. At this time, the Company believes that all costs associated with the closure of this facility have been recorded, as noted below.

During the first quarter of 2002, the Company consolidated its electronics systems business from its facility in Kanata, Ontario into the Company's existing systems manufacturing facility in Wilmington, Massachusetts and transferred its laser business from the Company's Kanata, Ontario facility to its existing facility in Rugby, United Kingdom. In addition, the Company closed its Kanata, Ontario facility. The Company took a total restructuring charge of \$2.7 million related to these activities in the first quarter of 2002. The \$2.7 million charge consisted of \$2.2 million to accrue employee severance and benefits for approximately 90 employees; \$0.3 million for the write-off of furniture, equipment and system software; and \$0.2 million for plant closure and other related costs. During the second quarter of fiscal 2002, the Company recorded additional restructuring charges of \$1.4 million related to cancellation fees on contractual obligations of \$0.3 million, a write-down of land and building in Kanata, Ontario and Rugby, United Kingdom of \$0.8 million, and also leased facility costs of \$0.3 million at the Farmington Hills, Michigan and Oxnard, California locations. The lease costs primarily related to future contractual obligations under operating leases, net of expected sublease revenue on leases that the Company cannot terminate. The write-downs of the building brings the properties offered for sale in line with market values and the recording of these write-downs has no effect on cash.

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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The second major restructuring plan in 2002 related to our refocusing of the Nepean, Ontario operations on its custom optics business as a result of the telecom industry's severe downturn. The Company's executive team approved a plan to reduce capacity at its Nepean, Ontario facility and the Company recorded a pre-tax restructuring charge of \$2.3 million in the fourth quarter of 2002 which included \$0.6 million to accrue employee severance and benefits for approximately 41 employees. The Company also wrote-off approximately \$0.2 million of excess fixed assets and wrote-down one of the Nepean, Ontario buildings by \$0.2 million to its estimated fair market value. Additionally, the Company continued to evaluate accruals made in prior restructurings and we recorded charges of approximately \$0.8 million for an adjustment to earlier provisions for leased facilities in the United States and Germany. Specifically, the \$0.8 million in adjustments in the fourth quarter of 2002 related to earlier provisions for the leased facilities in Munich, Germany, Maple Grove, Minnesota and Farmington Hills, Michigan. We had originally estimated our restructuring reserve of \$0.5 million based upon the assumption that we would have subleased the Munich, Germany facility in 2003. We had received information from a real estate broker that the commercial office market in Munich, Germany had softened and that we would not recover our full lease rate when we finally sublease the building. As such we recorded an additional provision of \$0.5 million to cover a longer anticipated time required to sublease the space and to reflect the likelihood of subleasing at less than our existing lease rates. For the Maple Grove, Minnesota facility, we had subleased the entire building through January 2003. We had anticipated that we would find a buyer for this building by January 2003 and exercise our option to purchase the building and not have to pay the remaining lease costs. As this did not happen, we accrued the contractual lease costs through the end of the lease in June 2003, which are \$0.2 million. Similarly for the Farmington Hills, Michigan facility, we had anticipated selling the building sooner, but as this did not occur by the end of 2002, we accrued the costs for the unused space through the end of the lease in June 2003, which are \$0.1 million. The Company also took a further write-down of \$0.3 million on the buildings in Kanata, Ontario and Rugby, United Kingdom and a \$0.1 million write-off for fixed assets in Kanata, Ontario and a \$0.1 million for the Maple Grove, Minnesota and Farmington Hills, Michigan facilities.

At December 31, 2002, the net book value of two facilities, one in Kanata, Ontario and the other in Nepean, Ontario, were reclassified as held for sale and included in other assets (note 3).

Cumulative cash draw-downs of approximately \$2.1 million and non-cash draw-downs of \$1.8 million have been applied against the provisions taken in 2002, resulting in a remaining provision balance of \$2.5 million at December 31, 2002. For severance related costs associated with these two restructuring actions, the actions are complete and the Company does not anticipate taking additional restructuring charges and expects to finalize payment in 2003. The Company will continue to evaluate the fair value of the buildings and fixed assets that were written down. The restructuring accrual is expected to be completely utilized during January 2013 at the end of the lease term for the Munich, Germany facility. The Company estimated the restructuring charge for the Munich, Germany facility based on contractual payments required on the lease for the unused space, less what is expected to be received for subleasing. Because this is a long term lease that extends until 2013, the Company will draw-down the amount accrued over the life of the lease. Future sublease market conditions may require the Company to make further adjustments to this restructuring reserve.

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The following table summarizes changes in the restructuring provision.

	<u>Severance</u>	<u>Facilities</u>	<u>Other</u>	<u>Total</u>
	(In millions)			
Provision at December 31, 1999	\$ 2.8	\$ 3.9	\$ 3.4	\$ 10.1
Charges during 2000	1.6	9.7	3.8	15.1
Cash draw-downs 2000	(1.8)	(1.0)	(1.5)	(4.3)
Reversals during 2000	(0.8)	(2.3)	(1.9)	(5.0)
Non-cash draw-down 2000	(0.6)	(2.0)		(2.6)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Provision at December 31, 2000	1.2	8.3	3.8	13.3
Charges during 2001	0.9	2.5		3.4
Cash draw-downs 2001	(1.2)	(1.6)	(3.8)	(6.6)
Reversals during 2001		(0.5)		(0.5)
Non-cash draw-down 2001		(0.7)		(0.7)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Provision at December 31, 2001	0.9	8.0		8.9
Charges during 2002	2.8	3.1	0.5	6.4
Cash draw-downs 2002	(2.5)	(1.6)	(0.5)	(4.6)
Non-cash draw-down 2002		(1.9)		(1.9)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Provision at December 31, 2002	\$ 1.2	\$ 7.6	\$	\$ 8.8
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

**Other**

During 2002, the Company recorded a net benefit of \$0.7 million related to two litigation settlements. During 2002, the Company earned \$0.3 million in royalties related to OLT precision alignment product line that was divested.

During the fourth quarter of 2001, the Company recorded a reduction of purchased intangibles related to technologies no longer a part of the business in the amount of \$1.8 million in accordance with the policy described in note 1. The Company performed an assessment of the carrying values of intangible assets, including trademark and trade names, assembled workforce and developed technology, recorded in connection with its merger of equals with General Scanning, Inc. in 1999. The assessment was performed in light of the abandonment of certain technologies in 2001 that had been in development or production since the date of the merger and also the significant economic downturn. As a result of the assessment, it was determined that a portion of the intangible assets no longer had value and should be written-down to reflect the lower carrying value. The Company has determined that the remaining intangible asset balances at that time would continue to be amortized on a straight-line basis over the remaining useful lives established at the time of the related acquisition, as the remaining useful lives of these intangible assets has not changed.

During 2001, the Company recorded a benefit of \$0.3 million related to royalties earned on the sale of the OLT precision alignment system product line. During the three months ended April 2, 1999, the Company recorded a provision of \$19 million to accrue damages and legal fees, through to appeal, relating to the action against General Scanning, Inc., which was reflected as a reduction in net assets acquired at the time of the March 22, 1999 merger. The Court of Appeals affirmed the judgment on April 18, 2001 and the Company paid approximately \$15.3 million in May 2001 in satisfaction of the judgment and adjusted its accrual related to this litigation and recorded a benefit of \$1.6 million when the litigation was settled.



**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

During 2000, the Company recorded a benefit of \$0.2 million related to royalties earned on the sale of the OLT precision alignment system product line and \$2.7 million received for licensing some of the Company's technology.

**12. Commitments and Contingencies*****Operating leases***

The Company leases certain equipment and facilities under operating lease agreements that expire through 2013. The facility leases require the Company to pay real estate taxes and other operating costs. For the year ended December 31, 2002, lease expense was approximately \$3.5 million (2001 \$5.6 million, 2000 \$4.7 million).

The Company leases two facilities under operating lease agreements that expire in 2003. At the end of the initial lease term, these leases require the Company to renew the lease for a defined number of years at the fair market rental rate or purchase the property at the fair market value. The lessor may sell the facilities to a third party but the leases provide for a residual value guarantee of the first 85% of any loss the lessor may incur on its \$19.1 million investment in the buildings, which may become payable by the Company upon the termination of the transaction, or the Company may exercise its option to purchase the facilities for approximately \$19 million. As of December 31, 2002, residual value guarantees in connection with these leases totaled approximately \$16 million. Upon termination of the leases, the Company expects to purchase the buildings for approximately \$19 million in cash and then to sell them for the combined estimated market value of the two buildings of approximately \$12.5 to \$13.3 million. During the fourth quarter of fiscal 2000, the Company took a charge of \$6 million associated with restructuring for excess capacity at the two leased facility locations, including the estimated residual value guarantees. In the fourth quarter of 2002, the Company took an additional restructuring charge of \$0.1 million to increase the reserve for the decline in the estimated market values of the underlying buildings. The total expected value of the buildings at the end of the leases may vary, depending on whether or not the buildings are leased at time of sale and whether the buildings are sold to a buyer/owner or to an investor. The Company will incur other costs such as lease and sales commissions. The lease agreement requires, among other things, the Company to maintain specified quarterly financial ratios and conditions. As of March 29, 2002, the Company was in breach of the fixed charge coverage ratio, but on April 30, 2002, the Company entered into a Security Agreement with the Bank of Montreal ( BMO ) pursuant to which the Company deposited with BMO and pledged approximately \$18.9 million as security in connection with the operating leases discussed above in exchange for a written waiver from BMO and BMO Global Capital Solutions for any Company defaults of or obligations to satisfy the specified financial covenants relating to the operating lease agreements until June 30, 2003. This item is included on the balance sheet in long-term investments. The table of future minimum operating lease payments below excludes any payments relating to these guarantees.

Minimum lease payments under operating leases expiring subsequent to December 31, 2002 are:

2003	\$ 3,549
2004	2,474
2005	2,151
2006	1,608
2007	1,538
Thereafter	2,494
	Total minimum lease payments
	\$ 13,814

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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company has sublease agreements on certain leased facilities and will receive \$1.4 million from 2003 to 2012.

***Recourse receivables***

In Japan, where it is customary to do so, the Company discounts certain customer notes receivable at a bank with recourse. The Company's maximum exposure was \$1.4 million at December 31, 2002 (2001 \$0.6 million). The book value of the recourse receivables approximates fair value. During 2002, the Company received cash proceeds relating to the discounted receivables of \$5.7 million (2001 \$9.8 million). Recourse receivables are included in accounts receivable on the balance sheet.

***Legal proceedings and disputes***

*Electro Scientific Industries, Inc. v. GSI Lumonics Inc. et al.* On March 16, 2000, Electro Scientific Industries, Inc. filed an action for patent infringement in the United States District Court for the Central District of California against the Company and Dynamic Details Inc., an unrelated party that is one of the Company's customers. Electro Scientific alleged that the Company offered to sell and import into the United States the GS-600 high speed laser drilling system and that Dynamic Details possessed and used a GS-600 System. It further alleged that Dynamic Details' use of the GS-600 laser system infringed Electro Scientific's United States patent 5,847,960 and that the Company had actively induced the infringement of, and contributorily infringed, the patent. Electro Scientific sought an injunction, unspecified damages, trebling of those damages, and attorney fees. The Company indemnified Dynamic Details with respect to these allegations. On August 14, 2001, the United States District Court for the Central District of California granted the Company's motion for summary judgment of non-infringement and denied Electro Scientific's motion for summary judgment of infringement. In the ruling, the Court concluded that the GS-600 system did not literally infringe the asserted claims of the alleged Electro Scientific patent, nor did it infringe under the doctrine of equivalents. On September 7, 2001, Electro Scientific appealed the District Court's decision on the summary judgment motions and oral arguments were heard on May 7, 2002. On October 7, 2002, the Court of Appeals vacated the summary judgment ruling of non-infringement of the District Court and remanded the matter back to the District Court for additional claim construction. In November 2002, the Company reached an agreement with Electro Scientific Industries Inc. and Dynamic Details pursuant to which the case was dismissed without prejudice. In connection with the agreement, the Company paid Electro Scientific Industries an amount that was not material to the Company's results of operations or financial position.

*Other.* As the Company has disclosed since 1994, a party has commenced legal proceedings in the United States against a number of United States manufacturing companies, including companies that have purchased systems from the Company. The plaintiff in the proceedings has alleged that certain equipment used by these manufacturers infringes patents claimed to be held by the plaintiff. While the Company is not a defendant in any of the proceedings, several of the Company's customers have notified the Company that, if the party successfully pursues infringement claims against them, they may require the Company to indemnify them to the extent that any of their losses can be attributed to systems sold to them by the Company. Due to (i) the relatively small number of systems sold to any one of the Company's customers involved in this litigation, (ii) the low probability of success by the plaintiff in securing judgment(s) against the Company's customers and (iii) the existence of a countersuit that seeks to invalidate the patents that are the basis for the litigation, the Company does not believe that the outcome of any of these claims individually will have a material adverse effect upon the Company's financial condition or results of operations. No assurances can be given, however, that these or similar claims, if successful and taken in the aggregate would not have a material adverse effect upon the Company's financial condition or results of operations.

The Company is also subject to various legal proceedings and claims, which arise in the ordinary course of business. The Company does not believe that the outcome of these claims will have a material adverse

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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

effect upon the Company's financial conditions or result of operations but there can be no assurance that any such claims, or any similar claims, would not have a material adverse effect upon the Company's financial condition or results of operations.

***Risks and uncertainties***

The Company uses financial instruments that potentially subject it to concentrations of credit risk. Such instruments include cash equivalents, securities available-for-sale, trade receivables and financial instruments used in hedging activities. The Company does not believe it is exposed to any significant credit risk on these instruments.

Certain of the components and materials included in the Company's laser systems and optical products are currently obtained from single source suppliers. There can be no assurance that a disruption of this outside supply would not create substantial manufacturing delays and additional cost to the Company.

There is no concentration of credit risk related to the Company's position in trade accounts receivable. Credit risk, with respect to trade receivables, is minimized because of the diversification of the Company's operations, as well as its large customer base and its geographical dispersion.

The Company's operations involve a number of other risks and uncertainties including, but not limited to, the cyclicity of the semiconductor and electronics markets, rapidly changing technology, and international operations.

**13. Financial instruments**

***Cash equivalents, short-term and long-term investments***

At December 31, 2002, the Company had \$53.3 million invested in cash equivalents denominated in United States dollars with average maturity dates between January 2, 2003 and March 24, 2003. At December 31, 2001, the Company had \$79.8 million cash equivalents denominated in United States dollars with average maturities between January 7, 2002 and March 01, 2002.

At December 31, 2002 the Company had \$29 million in short-term investments and \$37.4 million in long-term investments invested in United States dollars with maturity dates between January 6, 2003 and November 23, 2004. As discussed in Note 4 to the financial statements, \$14.5 million of short-term investments are pledged as collateral for the Fleet and CIBC credit facilities at December 31, 2002 and \$18.9 million of the long-term investments is pledged as security for the lease agreements with BMO as described in Note 12 above. At December 31, 2001 the Company had \$43.5 million invested in short-term investments denominated in United States dollars with maturity dates between January 24, 2002 and May 6, 2002.

***Derivative financial instruments***

The Company only uses derivatives for hedging purposes. The following is a summary of the Company's risk management strategies and the effect of these strategies on the Company's consolidated financial statements.

The Company has instituted a foreign currency cash flow hedging program to manage exposures to changes in foreign currency exchange rates associated with forecasted sales transactions. Currency forwards and swaps are used to fix the cash flow variable of local currency costs or selling prices denominated in currencies other than the functional currency. For hedged forecasted transactions, hedge accounting is discontinued if the forecasted transaction is no longer intended or expected to occur, and any previously unrealized hedging gains or losses recorded in other comprehensive income are recorded to earnings immediately. Earnings impacts for all designated hedges are recorded in the consolidated statement of



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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

operations generally on the same line item as the gain or loss on the item being hedged. The Company records all derivatives at fair value as assets or liabilities in the consolidated balance sheet, with classification as current or long-term depending on the duration of the instrument.

At December 31, 2002, the Company had eleven foreign exchange forward contracts to purchase \$16.9 million U.S. dollars and one currency swap contract fair valued at \$8.7 million U.S. dollars with an aggregate fair value loss of \$0.5 million after-tax recorded in accumulated other comprehensive income and maturing at varying dates in 2003. The ineffective portion of the derivative instruments totalled a combined loss of \$0.3 million and is recorded in the consolidated statements of operations in foreign exchange gain (loss). The Company expects an estimated \$0.5 million to be reclassified into earnings during fiscal 2003. At December 31, 2001, the Company had eight foreign exchange forward contracts to purchase \$17.8 million U.S. dollars and one foreign exchange option contract to purchase \$6.5 million U.S. dollars and an aggregate fair value gain of \$0.8 million and maturing at various dates in 2002. At December 31, 2000, the Company had four foreign exchange contracts to purchase \$6.5 million with a fair value loss of \$164 thousand that matured and was recognized in earnings during the first quarter of 2001.

**14. Segment Information**

***General description***

During 2002, the Company changed the way it manages its business to reflect a growing focus on its three core businesses: components, lasers and laser systems. In classifying operational entities into a particular segment, the Company aggregated businesses with similar economic characteristics, products and services, production processes, customers and methods of distribution. Segment information for the 2001 year has been restated to conform to the current year's presentation. Segment information for the 2000 year has not been restated because it is impracticable to do so. In 2000, there were other businesses and product lines that have been subsequently divested or discontinued that do not conform to the new segments, as such the information would not be comparable.

The Executive Committee ( EC ) has been identified as the chief operating decision maker in assessing the performance of the segments and the allocation of resources to the segments. The EC evaluates financial performance based on measures of profit or loss from operations before income taxes excluding the impact of amortization of purchased intangibles, acquired in-process research and development, restructuring and other, gain (loss) on sale of assets and investments, interest income, interest expense, and foreign exchange transaction losses. Certain corporate-level operating expenses, including corporate marketing, finance, and administrative expenses, are not allocated to operating segments. Intersegment sales are based on fair market values. All intersegment profit, including any unrealized profit on ending inventories, is eliminated on consolidation. The accounting policies of the segments are the same as those described in note 1.

The Company's operations include three reportable operating segments: the Components segment (Components); the Laser segment (Laser Group); and the Laser Systems segment (Laser Systems).

**Components** The Company's component products are designed and manufactured at our facilities in Billerica, Massachusetts, Nepean, Ontario and Moorpark, California and are sold directly, or, in some territories, through distributors, to original equipment manufacturers ( OEMs ). Products include optical scanners and subsystems used by OEMs for applications in materials processing, test and measurement, alignment, inspection, displays, imaging, graphics, vision, rapid prototyping, and medical use such as dermatology and ophthalmology. The Components Group also manufactures printers for certain medical end products such as defibrillators, patient care monitors and cardiac pacemaker programmers, as well as film imaging subsystems for use in CAT scans and magnetic resonance imaging systems. Under the trade name, WavePrecision, we also manufacture precision optics supplied to OEM customers for applications in

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

aerospace and semiconductor. Major markets are medical, semiconductor, and electronics, light industrial and aerospace.

**Laser Group** The Company designs and manufactures a wide range of lasers at our Rugby, United Kingdom facility for sale in the merchant market to end-users, OEMs and systems integrators. We also use some of these products in the Company's own laser systems. The Laser Group also derives significant revenues from providing parts and technical support for lasers in its installed base at customer locations. These lasers are primarily used in material processing applications (cutting, welding and drilling) in light automotive, electronics, aerospace, medical and light industrial markets. The lasers are sold worldwide directly in North America and Europe, and through distributors in Japan, Asia Pacific and China. Sumitomo Heavy Industries Ltd. (a significant shareholder of the Company) is our distributor in Japan. Specifically, our pulsed and continuous wave Nd:YAG lasers are used in a variety of medical, light automotive and industrial settings.

**Laser Systems** The Company's laser systems are designed and manufactured at our Wilmington, Massachusetts facility and are sold directly, or, in some territories, through distributors, to end users, usually semiconductor integrated device manufacturers and electronic component and assembly manufacturers. The Laser Systems Group also derives significant revenues from servicing systems in its installed base at customer locations. System applications include laser repair to improve yields in the production of dynamic random access memory chips ( DRAMs ), permanent marking systems for silicon wafers and individual dies for traceability and quality control, circuit processing systems for linear and mixed signal devices, as well as for certain passive electronic components, and printed circuit boards ( PCB ) manufacturing systems for via hole drilling, solder paste inspection and component placement inspection.

In 2001, the Company had reported its WavePrecision division as a separate business segment. During 2002, with restructuring actions taken as a result of the collapse of the telecom market sector, the Company has placed this group in its Components segment. At the end of 2002, WavePrecision did not meet the criteria of a business segment, as defined in SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

**Segments**

Information on reportable segments is as follows:

	<b>Year Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
<b>Sales</b>		
Components	\$ 70,436	\$ 88,689
Laser Group	23,748	39,119
Laser Systems	65,906	123,969
Intersegment sales elimination	(1,020)	(3,873)
<b>Total</b>	<b>\$ 159,070</b>	<b>\$ 247,904</b>
<b>Profit (loss) from operations before income taxes</b>		
Components	\$ 16,763	\$ 18,603
Laser Group	(5,010)	4,425
Laser Systems	(18,732)	(23,712)
<b>Total by segment</b>	<b>(6,979)</b>	<b>(684)</b>

**Table of Contents****GSI LUMONICS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Year Ended December 31,	
	2002	2001
Unallocated amounts:		
Corporate expenses	19,754	12,983
Amortization of purchased intangibles	5,135	5,226
Restructuring and other	5,427	2,782
<b>Loss from operations</b>	<b>\$(37,295)</b>	<b>\$(21,675)</b>

The EC does not review asset information on a segmented basis and the Company does not maintain assets on a segmented basis, therefore a breakdown of assets by segments is not included.

***Geographic segment information***

The Company attributes revenues to geographic areas on the basis of the customer location. Long-lived assets include property, plant and equipment and intangibles, but exclude other assets, long-term investments and deferred tax assets are attributed to geographic areas in which Company assets reside.

	Year Ended December 31,					
	2002		2001		2000	
Revenues from external customers:						
USA	\$ 94,654	59%	\$ 119,321	48%	\$ 177,813	48%
Canada	1,883	1%	11,410	5%	20,159	5%
Europe	25,804	16%	50,745	20%	71,973	19%
Japan	23,460	15%	40,956	17%	58,173	16%
Latin and South America	1,249	1%	852	0%	5,563	1%
Asia-Pacific, other	12,020	8%	24,620	10%	40,183	11%
Total	<b>\$ 159,070</b>	<b>100%</b>	<b>\$ 247,904</b>	<b>100%</b>	<b>\$ 373,864</b>	<b>100%</b>

	As at December 31,	
	2002	2001
Long-lived assets and goodwill:		
USA	\$ 24,158	\$ 29,754
Canada	6,625	9,404
Europe	11,540	11,484
Japan	618	686
Asia-Pacific, other	136	221

Total	\$43,077	\$51,549
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**15. Subsequent Events**

On March 28, 2003, a registration statement was filed whereby the Company proposed its shareholders consider a Plan of Arrangement which, if approved and effected, would restructure the Company as a publicly traded United States domiciled corporation. On May 16, 2003, June 18, 2003 and again on June 26, 2003, the Company filed amendments to the registration statement in response to comments received from the Securities and Exchange Commission.



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**GSI LUMONICS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

On March 31, 2003, the Company completed the sale to a third party of its excess facility in Nepean, Ontario for a price of Cdn \$1.3 million (or approximately U.S.\$0.9 million based on March 2003 exchange rates). At March 28, 2003, the net book value of this facility of U.S.\$0.8 million is included in other assets. The estimated gain on the sale of this facility of approximately U.S.\$0.1 million will be recorded in our second quarter.

On April 21, 2003, the Company announced that it has entered into a definitive agreement for the acquisition of the principal assets of Spectron Laser Systems, a subsidiary of Lumenis Ltd., located in Rugby, United Kingdom. The Spectron assets are being acquired for \$6.3 million in cash, subject to adjustment, and the assumption of certain liabilities. This transaction closed on May 7, 2003. The integration of Spectron into the Company's Laser Group in Rugby, United Kingdom is scheduled for completion by the end of August, 2003. The Company expects to account for this transaction as a business combination under SFAS No. 141 *Business Combinations*.

On May 2, 2003, the Company announced that it had acquired the principal assets of the Encoder division of Dynamics Research Corporation, located in Wilmington, Massachusetts. The Encoder division assets were acquired for \$3.3 million in cash, subject to adjustment, and the assumption of certain liabilities. The integration of the Encoder division into the Company's Components Group in Billerica, Massachusetts is currently scheduled for completion by the end of August, 2003. The Company expects to account for this transaction as a business combination under SFAS No. 141 *Business Combinations*.

**Table of Contents****GSI LUMONICS INC.****SUPPLEMENTARY FINANCIAL INFORMATION**

(United States GAAP and in thousands of United States dollars, except share amounts)  
(Unaudited)

	Three Months Ended			
	December 31, 2002	September 27, 2002	June 28, 2002	March 29, 2002
	(Unaudited)			
Sales	\$45,099	\$37,419	\$ 39,664	\$36,888
Gross profit	13,408	11,310	12,203	12,273
Net income	(4,577)	(5,415)	(11,112)	(6,620)
Net income per common share:				
Basic	\$ (0.11)	\$ (0.13)	\$ (0.27)	\$ (0.16)
Diluted	\$ (0.11)	\$ (0.13)	\$ (0.27)	\$ (0.16)

	Three Months Ended			
	December 31, 2001	September 28, 2001	June 29, 2001	March 30, 2001
Sales	\$ 42,378	\$41,277	\$76,542	\$87,707
Gross profit	10,214	10,518	30,917	34,133
Net income	(14,575)	(8,487)	3,585	4,779
Net income per common share:				
Basic	\$ (0.36)	\$ (0.21)	\$ 0.09	\$ 0.12
Diluted	\$ (0.36)	\$ (0.21)	\$ 0.09	\$ 0.12

Subsequent to Q2 2002, the Company made a reclassification of \$0.5 million from cost of goods sold to selling, general and administrative expenses, effective for the period ending June 30, 2002. This reclassification did not effect the net loss presented for Q2 2002.

**Part IV****Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K****List of Financial Statements**

The financial statements required by this item are listed in Item 8, Financial Statements and Supplementary Data herein.

**List of Financial Statement Schedules**

See Schedule II-Valuation and Qualifying Accounts. All other schedules are omitted because they are not applicable, not required or the required information is shown in the consolidated financial statements or notes thereto.

**Table of Contents****List of Exhibits**

See the company's SEC filings on Edgar at: <http://www.sec.gov/> for all Exhibits.

Exhibit Number	Description
2.1	Amended and Restated Agreement and Plan of Merger, dated as of October 27, 1998, by and among the Registrant, Grizzly Acquisition Corp., New Grizzly Acquisition Corp. and General Scanning, Inc. Pursuant to Item 601(b)(2) of Regulation S-K, the Schedules referred to in the Merger Agreement are omitted. The Registrant hereby undertakes to furnish a supplemental a copy of any omitted Schedule to the Commission upon request.(4)
2.2	Purchase and Sale Agreement and Joint Escrow Instructions, dated as of February 29, 2000, by and between Alexandria Real Estate Equities, Inc., and General Scanning, Inc., including amendments.(8)
2.3	Asset Purchase Agreement, dated as of August 19, 2000, between GSI Lumonics Life Science Trust, GSI Lumonics Trust, Inc. and Packard BioScience Company.(7)
3.1	Certificate and Articles of Continuance of the Registrant dated March 22, 1999.(4)
3.2	By-Law No.1 of the Registrant.(4)
4.1	Line of Credit Agreement between the Registrant and CIBC dated April 8, 1998 and accepted April 15, 1998.(4)
4.2	Rights Agreement, dated as of April 12, 1999 between GSI Lumonics Inc. and Montreal Trust Company of Canada, as Rights Agent.(12)
4.3	1981 Stock Option Plan of GSI.(1)
4.4	1992 Stock Option Plan of GSI.(1)
4.5	1995 Directors Warrant Plan of GSI.(1)
4.6	1994 Key Employees and Directors Stock Option Plan of the Registrant.(4)
4.7	1995 Stock Option Plan for Employees and Directors of the Registrant.(6)
4.8	GSI Lumonics Inc. Employee Stock Purchase Plan.(11)
4.9	Restatement of the 1995 Stock Option Plan for Employees and Directors of the Registrant.(13)
4.10	Security Agreement between the Registrant and the Bank of Montreal dated April 30, 2002.(14)
4.11	Waiver to Certain of the Operative Agreements between the Registrant and GSI Lumonics Corporation on one part and BMO Global Capital Solutions and the Bank of Montreal on the other part dated April 30, 2002.(14)
4.12	Loan Agreement among General Scanning, Inc., GSI Lumonics Corporation and Fleet National Bank dated June 28, 2002.(14)
4.13	Secured Revolving Time Note between General Scanning, Inc. and Fleet National Bank dated June 28, 2002.(14)
4.14	Security Agreement between General Scanning, Inc. and Fleet National Bank dated June 28, 2002.(14)
4.15	Credit Line Letter Agreement between the Registrant and Canadian Imperial Bank of Commerce dated June 28, 2002.(14)
4.16	Amendment to Credit Line Letter Agreement between the Registrant and Canadian Imperial Bank of Commerce dated June 28, 2002.(14)
10.1	Lease Agreement between JRF II Associates Ltd. Partnership and Lumonics Corporation dated September 24, 1991.(4)
10.2	Industrial Space Lease between Lumonics Corporation and The Travelers Insurance Company dated March 17, 1992.(4)
10.3	Lease Agreement between Lumonics Corporation and Sisilli dated June 1994.(4)
10.4	GSI Lease dated July 31, 1996, as amended to date, between View Engineering, Inc. and Donald J. Devine as Trustee under the Donald J. Devine Trust Agreement.(2)
10.5	Lease dated July 15, 1997, as amended to date, between GSI and The Wilmington Realty Trust.(3)

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Exhibit Number	Description
10.6	Severance Agreement between the Registrant and Patrick D. Austin dated April 13, 1998.(4)
10.7	Split Dollar Compensation Agreement dated September 13, 1997 between GSI and Charles D. Winston.(3)
10.8	Key Employee Retention Agreement between GSI and Victor H. Woolley, dated May 1, 1997.(4)
10.9	Settlement Agreement dated June 12, 1998 between GSI and Robotic Vision Systems, Inc.(4)
10.10	Severance Agreement between the Registrant and Charles D. Winston dated April 21, 1999.(5)
10.11	Severance Agreement between the Registrant and Kurt Pelsue dated April 21, 1999.(5)
10.12	OEM Supply Agreement between the Registrant and Sumitomo Heavy Industries, Ltd. dated August 31, 1999.(5)
10.18	Employment Agreement between the Registrant and Charles D. Winston dated January 1, 2000.(8)
10.19	Severance Agreement between the Registrant and Thomas Swain dated May 24, 2001.(9)
10.20	Severance Agreement between the Registrant and Charles Winston dated May 24, 2001.(9)
10.21	Severance Agreement between the Registrant and Victor Woolley dated May 24, 2001.(9)
10.22	Severance Agreement between the Registrant and Eileen Casal dated May 24, 2001.(9)
10.23	Severance Agreement between the Registrant and Linda Palmer dated May 24, 2001.(9)
10.24	Severance Agreement between the Registrant and Kurt A. Pelsue dated May 24, 2001.(10)
10.25	Severance Agreement between the Registrant and Alfonso DaSilva dated July 9, 2001.(10)
10.26	Separation Agreement and General Release between the Registrant and Patrick D. Austin dated August 21, 2001.(10)
10.29	Amendment to Employment and Severance Agreements between the Registrant and Charles D. Winston dated February 26, 2002.(13)
10.30	Employment Agreement between the Registrant and Victor H. Woolley dated June 25, 2002.(14)
10.31	Termination Amendment to Severance Agreement between the Registrant and Victor H. Woolley dated June 25, 2002.(14)
10.32	Agreement of Purchase and Sale of property between the Registrant and Marcomm Fibre Optics, Inc. dated March 7, 2003.(15)
21.1	Subsidiaries of the Registrant.(15)
23.1	Consent of Independent Chartered Accountants.
99	Selected Consolidated Financial Statements and Notes in U.S. Dollars and in accordance with Canadian Generally Accepted Accounting Principles.
99.1	Management's Discussion and Analysis of Financial Condition and Results of Operations Canadian Supplement.
99.2	Chief Executive Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.3	Chief Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Incorporated by reference to the Registration Statement of General Scanning, Inc. on Form S-1, filed August 11, 1995.
- (2) Incorporated by reference to the Annual Report on Form 10-K of General Scanning, Inc. for the year ended December 31, 1996.
- (3) Incorporated by reference to the Annual Report on Form 10-K of General Scanning, Inc. for the year ended December 31, 1997.
- (4) Incorporated by reference to the Registration Statement on Form S-4/ A (Amendment No. 2) of Lumonics Inc., filed February 11, 1999.
- (5) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 1999.

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- (6) Incorporated by reference to the Company's Registration Statement on Form S-8 filed August 4, 2000.
- (7) Incorporated by reference to the Company's Current Report on Form 8-K filed October 16, 2000.
- (8) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2000.
- (9) Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 29, 2001.
- (10) Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 28, 2001.
- (11) Incorporated by reference to the Company's Registration Statement on Form S-8 filed November 16, 2001.
- (12) Incorporated by reference to the Company's Registration Statement on Form 8-A filed January 24, 2002.
- (13) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2001.
- (14) Incorporated by reference to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 28, 2002.
- (15) Incorporated by reference to the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

**Reports on Form 8-K**

Form 8-K dated November 12, 2002 Item 9, Regulation FD Disclosure

Disclosed, and included as an exhibit, written communication comprised of slides which were provided and disseminated in both written and oral form to participants in a series of investor presentations delivered in Canada by officers of the company during the week of November 4, 2002.

Form 8-K dated April 22, 2003 Item 5, Other Events

Disclosed, and included as an exhibit, a press release announcing that the company will acquire the principal assets of Spectron Laser Systems, a subsidiary of Lumenis, Ltd., for a purchase price of \$6.3 million in cash.

Form 8-K dated May 6, 2003 Item 5, Other Events

Disclosed, and included as an exhibit, a press release announcing that the company had acquired the principal assets of the Encoder division of Dynamics Research Corporation for a purchase price of \$3.3 million in cash.

Form 8-K dated May 7, 2003 Item 9, Regulation FD Disclosure

Disclosed, and included as an exhibit, written communication comprised of slides which were provided and disseminated in both written and oral form to participants in a series of investor presentations delivered by officers of the company beginning on May 7, 2003.

Form 8-K dated May 23, 2003 Item 5, Other Events

Disclosed, and included as an exhibit, a press release announcing that the company's annual general meeting of shareholders will be held on Tuesday, June 24 in Bedford, Massachusetts.

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**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant, GSI Lumonics Inc., has duly caused this Form 10-K/A to be signed on its behalf by the undersigned, thereunto duly authorized.

GSI LUMONICS INC.

By: /s/ CHARLES D. WINSTON

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Charles D. Winston  
*President and Chief Executive Officer*

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**CERTIFICATIONS PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY  
ACT OF 2002**

I, Charles D. Winston, certify that:

1. I have reviewed this annual report on Form 10-K/A of GSI Lumonics Inc.;
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual 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 annual report is being prepared;
  - 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 annual report (the Evaluation Date); and
  - c) presented in this annual 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 annual 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.

/s/ CHARLES D. WINSTON

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Charles D. Winston  
*President and Chief Executive Officer*

Date: June 27, 2003

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**CERTIFICATIONS PURSUANT TO**

**SECTION 302 OF THE  
SARBANES-OXLEY ACT OF 2002**

I, Thomas R. Swain, certify that:

1. I have reviewed this annual report on Form 10-K/A of GSI Lumonics Inc.;
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual 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 annual report is being prepared;
  - 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 annual report (the Evaluation Date); and
  - c) presented in this annual 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 annual 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.

/s/ THOMAS R. SWAIN

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Thomas R. Swain  
*Vice President, Finance and Chief Financial Officer*

Date: June 27, 2003



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**GSI LUMONICS INC.**

**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**

<b>Description</b>	<b>Balance at Beginning of Period</b>	<b>Charged to Costs and Expenses</b>	<b>Charged to Other Accounts</b>	<b>Deductions</b>	<b>Balance at End of Period</b>
Year ended December 31, 2000					
Allowance for doubtful accounts	\$3,197	\$ 935	\$	\$(1,374)	\$2,758
Year ended December 31, 2001					
Allowance for doubtful accounts	\$2,758	\$1,130	\$	\$ (854)	\$3,034
Year ended December 31, 2002					
Allowance for doubtful accounts	\$3,034	\$ 209	\$	\$ (562)	\$2,681