

CYBEROPTICS CORP
Form 10-K
March 14, 2006
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

☒ ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) of the Securities Exchange
Act of 1934 for the Year Ended December 31, 2005.

☐ TRANSITION PURSUANT TO SECTION 13 or 15(d) of the Securities Exchange
Act of 1934 for the transition period from _____ to _____.

COMMISSION FILE NO. (0-16577)

CYBEROPTICS CORPORATION

(Exact name of registrant as specified in its charter)

Minnesota

(State or other jurisdiction of
incorporation or organization)

41-1472057

(I.R.S. Employer
Identification No.)

**5900 Golden Hills Drive
MINNEAPOLIS, MINNESOTA**

(Address of principal executive offices)

55416

(Zip Code)

(763) 542-5000

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Exchange Act: None

Securities registered pursuant to Section 12(g) of the Exchange Act:

Common Stock, no par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES ☐ NO ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

YES ☐ NO ☒

Securities registered pursuant to Section 12(b) of the Exchange Act: None Securities registered pursuant to Section 12(g) of the Exchange Act: None

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) 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. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ☐ NO ☒

As of February 28, 2006, there were 8,925,659 shares of the registrant's Common Stock, no par value, issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE:

The responses to items 10, 11, 12 and 13 herein are incorporated by reference to certain information in the Company's Definitive Proxy Statement for its Annual Meeting of Shareholders to be held May 15, 2006.

CYBEROPTICS CORPORATION FORM 10-K For the Fiscal Year Ended December 31, 2005

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PART I.

ITEM 1. DESCRIPTION OF BUSINESS

Background

CyberOptics® Corporation was founded in 1984 by Dr. Steven K. Case (Chairman of the Board of CyberOptics and full-time employee), a former professor at the University of Minnesota, with the goal of commercializing technology for non-contact three-dimensional sensing. Our world headquarters are located at 5900 Golden Hills Drive in Golden Valley, Minnesota.

We are a leading global supplier of optical process control sensors and inspection systems that are used to control the manufacturing process and to ensure the quality of electronic circuit boards manufactured by our customers using surface mount technology (SMT). We also manufacture and sell sensors that assist with yield improvement, and the placement and transport of wafers during semiconductor fabrication. Our products assist the global SMT and semiconductor industries in meeting the rigorous quality demands for printed circuit board assembly and semiconductor wafers. Using a variety of proprietary technologies such as lasers, optics and machine vision, combined with software, electronics and mechanical design, our products enable manufacturers to increase production volume, product yields and quality by measuring the characteristics and placement of components both during and after the manufacturing process.

Our business is organized in two operating segments. Our Electronic Assembly segment designs, manufactures and sells optical process control sensors and inspection systems for the electronics assembly equipment market. Our Semiconductor segment designs, manufactures and sells optical and other process control sensors and related equipment for the semiconductor capital equipment market.

Most of our products (87% of revenue in 2005) are developed and sold for use in SMT electronic circuit board assembly or with equipment used in SMT electronic circuit board assembly as part of our Electronic Assembly segment. We sell products in this market both as sensor components that are incorporated into products manufactured by other companies for sale to circuit board assembly companies, and as more complete systems that are sold directly to circuit board assembly companies. Our sensor products are sold to manufacturers of pick-and-place machines to align electronic surface mount components during placement on the circuit board and to solder paste printer companies to align stencils with circuit boards. Our systems products are sold to contract manufacturers and other companies with surface mount assembly lines, to control quality as in-line systems. These systems level products are used by manufacturers of circuit boards to measure screen printed solder paste, to inspect circuit boards and components after component placement, to confirm proper placement after full assembly of circuit boards and to inspect solder joints on printed circuit boards.

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Our Semiconductor segment develops and sells products that assist with yield improvement in semiconductor fabrication, and for use with the robotic equipment that handles semiconductor wafers during the semiconductor fabrication process. In addition, we sell a frame grabber product line for general industrial applications. These product lines are sold through CyberOptics Semiconductor, Inc. which was formed from the CyberOptics, Inc. combination of HAMA Sensors, Inc. and Imagenation® Corporation, companies acquired in 1999 and 2000. Semiconductor products were 13% of total revenues in 2005.

Market Conditions Recent Development of the Business

Our operations are heavily influenced by market conditions in worldwide electronics markets, and particularly in the SMT electronic assembly segment of these markets. These markets have been very cyclical, with periods of strong growth followed by periods of excess capacity and reduced levels of capital spending. Periods of growth in the electronics equipment markets from 1997 through the second quarter of 1998, from the third and fourth quarters of 1999 to the second quarter of 2001, and from the third quarter of 2003 through the third quarter of 2004, resulted in strong sales of our products, particularly OEM sensor products. Because of the particularly dramatic decline starting in the second quarter of 2001, we took aggressive cost reduction actions during 2001, 2002 and 2003, reducing our worldwide employment by over 50% from 2001 peaks, and closing or downsizing facilities. Although our operations have recovered through several periods beginning in 2003, we have maintained the reduced cost structure to enhance our results.

Because of improving market conditions, we reported substantially increased sales in 2003 over 2002, particularly of our sensor products. The strong market continued through the third quarter of 2004, with steady increases in order rates, and a 94% increase in sales of our sensor products from 2003 to 2004. At the same time, we increased levels of sales of our systems products, particularly to original design manufacturer customers (ODM s) in China.

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In a new market use, we began selling our end-user systems products for use in inspection of assembly of DRAM memory modules during 2004. To further capitalize on the rapidly growing ODM electronics markets in China, we incorporated a wholly owned subsidiary in China during the fourth quarter of 2004 and continued a focused sales effort during 2004 on sales of system level products to ODM s in China and throughout Asia. With several new or enhanced product offerings and a strong market during the first three quarters of 2004, our sales increased 63% to \$58 million in 2004, and we reported strong earnings. We reported our second highest quarterly revenue in the history of the Company in the quarter ended September 30, 2004.

Nevertheless, toward the end of the third quarter of 2004, the global markets for electronics again began to soften. Although the economies in the countries where most of our products are sold continue to be strong, the semiconductor market began to weaken and with it the circuit board production market. We began seeing reduced order rates toward the end of the third quarter and those reduced rates continued through the second quarter of 2005. Order rates began to increase in the third quarter of 2005 and continued to improve throughout the fourth quarter of 2005.

Consistent with our past practice, we continued to invest heavily throughout 2005 in new product development. We began shipping a new sensor to DEK International, GmbH, an important new original equipment manufacturer, for their industry leading line of solder paste screen printers. We launched an enhanced version of our industry leading SE 300 solder paste inspection system, the SE 300 Ultra, and began work on an enhanced version of our Flex series automated optical inspection system. We introduced an EPV 5 sensor for end users to retrofit their existing pick and place machines from a significant manufacturer in the pick and place market. Finally, we introduced a new automated leveling sensor to assist with yield improvement in the semiconductor fabrication process.

Although we cannot predict with precision the trends and procurement cycles for capital equipment in markets for electronic inspection, we believe that the markets will remain strong for the next several quarters and that the new products positioned for introduction will support improved performance in 2006.

Objective

Our objective is to develop complete surface mount technology process control solutions for our customers. We intend to build upon our innovative products in systems for solder paste inspection, automated optical inspection and component alignment, with new sensing products that will be embedded inside SMT production equipment. We eventually intend to tie these products together as a full-line process control solution. We believe our new embedded process verification (EPV) sensor will eventually gain acceptance among manufacturers of pick and place machines as a further enhancement to inspection and control. During 2005, additional steps were taken towards embedding sensing

products inside production equipment. We introduced an EPV 5 sensor for end users to retrofit their existing pick and place machines from a significant manufacturer in the pick and place market. We introduced a new InPrinter Inspection Camera for DEK International GmbH to be mounted inside their industry leading screen printer to ensure accurate board registration as well as to provide DEK with upgraded capability for solder paste and stencil inspection. We have established an office in China to further penetrate the growing market for manufacturing production equipment there and to increase the percentage of worldwide production lines that use inspection in their production process to improve production yields and reduce cost.

During 2004 and 2005, our Semiconductor Products group introduced the new WaferSense Automatic Leveling Sensor (ALS), the first of a series in the WaferSense product line. WaferSense is a family of wireless, waferlike precision measurement tools for in-situ setup, calibration and process optimization in semiconductor processing equipment. We are currently working on several new additions to the WaferSense product line.

Our ability to implement our strategy effectively is subject to numerous uncertainties and risks, including market conditions in the global SMT circuit board assembly and semiconductor fabrication capital equipment markets and our timely completion of development and successful commercial introduction of planned new products. We cannot assure you that our efforts will be successful.

OPERATIONS AND PRODUCTS

We develop, manufacture and sell intelligent, non-contact sensors and systems for process control and inspection. Our products are used primarily in the SMT electronic assembly and semiconductor fabrication sectors of the electronics industry and enable manufacturers to increase operating efficiencies, product yields and quality. In addition to proprietary hardware designs that combine precision optics, various light sources and multiple detectors, our products incorporate software that controls the hardware and filters and converts raw data into application specific information. Our product offerings are sold both to original equipment manufacturers that supply the SMT and semiconductor fabrication industries and to end-user customers who use our SMT Systems products directly for process and quality control in the circuit board manufacturing process.

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SMT Electronic Assembly Sensors

Our SMT electronic assembly sensor product line, which has generated the largest component of our sales during the past eight years, is a family of sensors that uses similar technology, but that are customized for each customer and incorporated into the products of equipment manufactured by our customers for use in SMT circuit board assembly. We work closely with our original equipment manufacturer customers to integrate sensors into their equipment.

LaserAlign. Our LaserAlign sensor family has accounted for the vast majority of sales in the SMT electronic assembly sensors product line. These sensors are sold for incorporation into component placement machines used in the SMT production line that are manufactured by a number of different OEM customers. Sales of these products, including service repairs, to Juki Corporation and Assembleon B.V., accounted for approximately 25% and 13% of our revenue in 2005, respectively, and approximately 22% and 19% of our revenue in 2004, respectively. Accordingly, revenues and operations are currently heavily influenced by the level of purchases from these two customers (including Assembleon B.V. purchases of Board Align Camera see below) and by the cyclical nature of the SMT production industry.

The LaserAlign family of products aligns components during transport on a pick-and-place machine prior to placement on a circuit board. After solder paste has been deposited and inspected, extremely small surface mount components known as chip capacitors and resistors are placed on the solder pads by component placement machines. LaserAlign sensors are incorporated into the placement heads of component placement machines to ensure accurate component placement at high production speeds. Various high-speed component placement machines use between one and twenty LaserAlign sensors per machine. LaserAlign integrates an intelligent sensor, composed of a laser, optics and detectors with a microprocessor and software for making specific measurements. LaserAlign enables quick and accurate alignment of each component as it is being transported by the pick-and-place arm for surface mount assembly. Using non-contact technology, LaserAlign facilitates orientation and placement of components at higher speeds than can be achieved using conventional mechanical or machine vision component centering systems.

The LaserAlign sensor is offered in several different configurations to satisfy the requirements of the different machines on which it is used. The latest version of the LaserAlign sensor technology was introduced in a new sensor for Assembleon B.V. during 2003. Revenue from new product shipments of LaserAlign sensors has been a principal contributor to our growth during the past five years and accounted for 30% of our

revenue in 2005, 32% in 2004 and 30% in 2003.

BoardAlign Camera (BA Camera). The BA Camera, which is incorporated directly into the placement head of component placement machines, identifies fiducial markings on a circuit board and aligns the board in the component placement machine prior to component placement. The BA Camera was introduced in a sensor for Assembleon B.V. during 2003 to be incorporated into their latest version component placement machine. Revenue from shipments of BA Camera sensors to Assembleon B.V. accounted for approximately 6%, 9% and 5% of our revenue in 2005, 2004 and 2003, respectively.

InPrinter Inspection Camera. The InPrinter Inspection Camera, which is mounted directly in screen printers manufactured by DEK International GmbH, identifies fiducial markings on a circuit board to ensure accurate board registration prior to placement of solder paste, as well as to provide an upgraded capability for 2D solder paste and stencil inspection. The Inprinter Inspection Camera was introduced for DEK International GmbH during the third quarter 2005. Revenue from shipments of the InPrinter Inspection Camera accounted for approximately 3% of our revenue in 2005.

SMT Systems Products

Our SMT systems product line consists of stand-alone measurement and inspection systems used in the SMT electronic assembly industry for process control and inspection. These systems are sold directly to end-user manufacturing customers that use them in a production line or along-side a production line to maintain process and quality control. Our products incorporate proprietary sensors as well as substantial, off the shelf, translation or robotics hardware and complete computer systems or processors with internally developed software.

SE 300 and SE 300 Ultra. The SE 300 is an in-line system that measures in three dimensions the amount of solder paste applied to the circuit board after the first step of the SMT assembly process. Because of the small size of the components that must be placed on each pad of solder paste and the density of components placed on the circuit board, a significant amount of SMT assembly problems are related to the quality of solder paste deposition. Misplaced solder paste or excess or inadequate amounts of paste can lead to improper connections or bridges between leads causing an entire circuit board to malfunction.

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We first introduced the SE 300 in March 2000 and recorded our first revenues from sale of the SE 300 in the fourth quarter of 2000. The SE 300 is designed to inspect the height, area and volume of 100% of a circuit board at production line speeds and with resolution that allows it to measure the smallest chip scale packages and micro ball array component sites. The SE 300 can be retrofitted and integrated into most SMT production lines, providing real time quality control immediately after a printed circuit board leaves the screen printer and before component placement commences. We have made a number of improvements to the SE 300 since its introduction in 2000.

During 2005, we introduced the SE 300 Ultra, an enhanced version of our SE 300 product that offers faster inspection speeds, a conveyor that can accommodate a greater range of board sizes than the SE 300, flexible conveyor options and additional defect review options in run-time software. In addition, we introduced a sensor upgrade for the SE 300 that will provide some of the performance improvements that are available in the SE 300 Ultra. Revenues from shipments of the SE 300, SE 300 Ultra and sensor upgrades accounted for 25% of our revenue in 2005, 26% of our revenue in 2004 and 29% in 2003.

Automated Optical Inspection (Flex) Products. The Flex series of Automated Optical Inspection (AOI) products was initially introduced in the fourth quarter of 2000 and incorporates in-process technology acquired from Kestra, Ltd in 1999. These in-line products measure and inspect circuit boards after component placement to determine whether all components are present, that all components have been placed correctly and measure the quality of solder joints after reflow. The principal advantage of the Flex series AOI products is ease of use for the operator compared to other AOI machines and the low level of false calls.

We have introduced a number of versions of the Flex series AOI products since their initial introduction in 2000. The latest Flex version introduced in 2003, incorporates high-resolution color cameras for improved imaging, and is designed to inspect the placement of very small (0201) components on circuit boards. In addition, our Flex product allows for a variety of machine configurations (different number of cameras based on board size and resolution requirements) based on customer needs. We are working on a new enhanced version of the Flex product, called the Flex Ultra, which we introduced in January 2006.

Semiconductor Products

Although we had sold some sensors for semiconductor wafer inspection prior to 1999, the semiconductor product line became a significant part of our business with the acquisition of certain assets of HAMA Laboratories, Inc. in 1999 and was further expanded with the acquisition of Imagenation Corporation in 2000. Currently, our principal semiconductor products are sensors that inspect the presence and orientation of semiconductor wafers in cassettes and FOUPS during the fabrication process. Other products include frame grabber and machine vision subsystems that were developed and sold by Imagenation. All semiconductor products are sold to original equipment manufacturers for incorporation into their workstations and systems. We have also recently introduced WaferSense (ALS), a wireless auto leveling sensor for calibration of semiconductor process tools. We anticipate that a greater proportion of our WaferSense sales will be to end-user customers than with our other semiconductor products. Overall, sales of our semiconductor products constituted 13% of our revenue in 2005, 12% in 2004 and 16% in 2003.

Wafer Mapping and Alignment Sensors. We manufacture and sell laser based reflective sensors that improve the performance of robotic wafer handling equipment. During the fabrication process, semiconductor wafers are stored in slotted cassettes during transport to various fabrication tools. Robotic equipment removes the wafers from the cassettes and inserts them into a fabrication tool. Our wafer mapping sensors inspect for the presence of wafers in the cassettes and determine if the wafer is properly present and located in the cassette. We introduced an improved version of the wafer mapper product, the EXQ mapper, in late 2003, and a new smaller form factor of this product, the EXQS, in 2005.

Frame Grabber Products and Machine Vision Subsystems. Frame grabber products are a machine vision component that captures, digitizes, and stores video images. These products are currently sold into a broad array of applications in a number of different industries, with strategic emphasis on semiconductor customers. We offer both digital and analog versions of frame grabbers under the Imagenation brand.

WaferSense Sensors. Our WaferSense family of sensors is intended to go where wafers go in semiconductor fabrication and provide measurements of critical factors that are currently impossible or extremely difficult to obtain. We introduced our first WaferSense product, the automatic leveling sensor (ALS), a level calibration tool for semiconductor process tools, in late 2004. The WaferSense ALS is a wireless, vacuum-compatible sensor that can be placed in cassettes, FOUPS, on end effectors, aligners, in load locks and process chambers used in semiconductor fabrication to ensure that all stations are level and coplanar. Because the user is not required to break down semiconductor fabrication equipment, or pressurize a vacuum chamber, we believe that WaferSense ALS will save significant time over the manual leveling currently used by customers and increase equipment up-time, through-put and process yield. We anticipate that a greater proportion of our WaferSense sales will be to end-user customers than with our other semiconductor products.

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Markets and Customers

We sell the vast majority of our products into the electronics manufacturing market (87% of total revenues in 2005), particularly the portion servicing manufacturers doing SMT circuit board assembly. The value of automation is high in this market because the products produced have high unit costs and are manufactured at speeds too high for effective human intervention. Moreover, the trend in these industries toward smaller devices with higher circuit densities and smaller circuit paths requires manufacturing and testing equipment capable of extremely accurate alignment and multidimensional measurement such as achieved using non-contact optical sensors. Customers in these industries also employ knowledgeable engineers who are competent to work with computer-related equipment. Our LaserAlign products are sold to OEMs serving this market and the SE 300, SE 300 Ultra and Flex series inspection systems are sold to end-user electronic assembly manufacturers in this market.

We sell our semiconductor products into the semiconductor capital equipment market, for use in the fabrication of semiconductor devices. This market has many of the same characteristics as the SMT electronics assembly market and requires non-contact optical measurement tools that enable the production of more complex, higher density and smaller semiconductor devices. We sell our wafer mapping and alignment sensors to manufacturers of equipment that transport wafers during the semiconductor manufacturing (front-end fabrication) process. Our new WaferSense ALS will be sold directly to semiconductor fabrication facilities for use by process and equipment engineers during the production of semiconductor wafers.

An increasing proportion of our end-user SMT System sales are being originated in the low cost geographies of Asia, and particularly in the People's Republic of China. While there is a limited amount of new worldwide production capacity being added due to excess capacity for circuit board assembly, the new facilities that are being built are primarily in China. Consequently, most capital equipment suppliers are increasing their sales and operational capabilities in China to pursue sales in this market. In response, we opened our Singapore office in 2001 to support SMT

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Systems sales throughout Asia and opened a sales office in China in October 2004. This market is also important to our OEM electronic assembly sensor product lines as our OEM customers are looking to sell their pick-and-place equipment into this market.

We sell our products worldwide to many of the leading manufacturers of electronic circuit board assembly equipment, manufacturers of semiconductor DRAM memory, semiconductor capital equipment manufacturers and end-user electronic assembly manufacturers. Although we maintain sales offices in the UK, Singapore and China, all manufacturing of our products occurs in the United States and all sales originate in the United States.

There has been an increase in export sales from 2003 to 2005 as the result of the majority of new worldwide electronics and semiconductor capacity being added in Asia. In addition, a significant portion of our export sales to Europe are OEM electronic assembly sensors that ultimately are sold by our OEM customer into Asia. The following table sets forth the percentage of total sales revenue represented by total export sales (sales for delivery to countries other than the United States, including sales delivered through distributors) by location during the past three years:

	Year Ended December 31,		
	2005	2004	2003
Asia	51%	46%	53%
Europe	30%	34%	25%
Other (1)	1%	1%	1%

(1) Includes export sales in North America, primarily export sales to Canada, Mexico and Latin America.

See Note 11 to the Company's Consolidated Financial Statements contained in item 8 of this Form 10-K.

All export sales are negotiated, invoiced and paid in U.S. dollars. Accordingly, although changes in exchange rates do not affect revenue and income per unit, they can influence the willingness of customers to purchase units.

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Sales and Marketing

Our electronic assembly sensors are sold to large OEM customers by a direct sales staff located in Minnesota. Our systems products are primarily sold through independent representatives and distributors managed by direct sales personnel located in Minnesota, as well as in the UK, Singapore and China. We have agreements with 13 representatives and distributors in North and South America who focus primarily on SMT Systems products sold to end-users. We make most of our sales to international end-users of systems products through 22 representatives and distributors covering Europe (13) and the Pacific Rim (9).

Our wafer mapping semiconductor products are sold to large OEM customers by a direct sales staff located in Oregon and California. We sell our semiconductor frame grabber products through a direct sales staff located in Portland, Oregon, and through 29 sales representatives throughout the world. These representatives are not under contract, but are authorized to sell frame grabber products and in many cases act as system integrators for our products. We have established a worldwide sales representative organization for WaferSense semiconductor products. We currently have agreements in place or in process with sales representatives in the U.S. (3), Europe (3) and the Pacific Rim (7). Most of these sales representatives will also be authorized to sell wafer mapping semiconductor products.

We market our products through appearances at industry trade shows, advertising in industry journals, articles published in industry and technical journals and on the Internet. In addition, we have strategic relationships with certain key customers that serve as highly visible references.

Backlog

Our products are typically shipped two weeks to two months after the receipt of an order. Product backlog was \$6.9 million at December 31, 2005, compared to \$3.7 million on December 31, 2004, and \$6.6 million on December 31, 2003. Substantially all of the 2005 backlog is deliverable in the first quarter of 2006. On a relatively small portion of system products, revenue is not recognized until final customer acceptance. Although our business is generally not of a seasonal nature, sales may vary seasonally based on the capital procurement practices in the electronics and semiconductor industries. Our scheduled backlog at any time may vary significantly based on the timing of orders from OEM customers. Accordingly, backlog may not be an accurate indicator of performance in the future.

Research and Development

We differentiate our products primarily on the basis of customer benefits afforded by the use of clever and proprietary technology and on our unique ability to combine several different technical disciplines to address industry and customer needs. CyberOptics was founded by research scientists and has retained relationships with academic institutions to ensure that the most current information on technological developments is obtained. In addition, we actively seek ongoing strategic customer relationships with leading product innovators in our served markets and actively investigate the needs of, and seek input from, these customers to identify opportunities to improve manufacturing processes. Our engineers have frequent interactions with our customers to ensure adoption of current technologies. In some instances, we receive funding from these customers through development contracts that provide the customer with an exclusive selling period but allows us to retain technology and distribution rights.

We believe that continued and timely development of new products and enhancements to existing products is essential to maintaining our industry leading position in the market. As a technology based company, we commit substantial resources to research and development efforts, which plays a critical role in maintaining and advancing our position as a leading provider of optical sensors and systems. During 2005 and 2004, research and development efforts were focused on a number of development activities, including a new InPrinter Inspection Camera for DEK International GmbH, development of our new Embedded Process Verification sensor family (EPV®), and continued development of the SE and Flex series inspection systems, including our new SE 300 Ultra solder paste inspection system, and new Flex Ultra automated optical inspection system.

In addition, we have continued to enhance our semiconductor wafer mapping sensors for the semiconductor market. In 2005, we commenced shipment of the EX-QS wafer mapping sensor. We also continued development of our recently introduced WaferSense auto leveling sensor (ALS) products. During 2006, we intend to continue to develop and introduce new semiconductor products, including further enhancements and introductions for our WaferSense family of sensor products.

Research and development expenses were \$7.1 million in 2005, \$7.6 million in 2004 and \$7.2 million in 2003. These amounts represented 17% of revenues in 2005, 13% in 2004 and 20% in 2003. Research and development expenses consist primarily of salaries, project materials, contract labor and other costs associated with ongoing product development and enhancement efforts. Research and development resource utilization is centrally managed based on market opportunities and the status of individual projects.

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Manufacturing

Much of our product manufacturing, which is primarily circuit board manufacturing, lens manufacturing and metal parts production, is contracted with outside suppliers. Our production personnel inspect incoming parts, assemble sensor heads and calibrate and perform final quality control testing of finished products. Our products are not well suited for the large production runs that would justify the capital investment necessary for complete internal manufacturing. Our electronic assembly sensor products and SMT systems products are assembled in Minneapolis, MN, and our semiconductor products are assembled in Portland, OR.

A variety of components used in our products are available only from single sources and involve relatively long order cycles, in some cases over one year. Although we have located sources for substitute components, use of those alternative components could require substantial rework of the product designs, resulting in periods during which we could not satisfy customer orders. Further, although we believe we have identified alternative assembly contractors for most of our subassemblies, an actual change in such contractors would likely require a period of training and testing. Accordingly, an interruption in a supply relationship or the production capacity of one or more of such contractors could result in the inability to deliver one or more products for a period of several months. To help prevent delays in the shipment of our products, we maintain in inventory, or on scheduled delivery from suppliers, what we believe to be a sufficient amount of certain components based on

forecasted demand (forecast extends a minimum of 6 months).

Competition

Although we believe that our products offer unique capabilities, competitors offer technologies and systems that perform some of the visual inspection and alignment functions performed by our products. We face competition from a number of companies in the machine vision, image processing and inspection systems market, some of which are larger and have greater financial resources.

Our electronic assembly sensor products face competition in the market for alignment and inspection on OEM component placement machines primarily from manufacturers of vision (camera and software based) systems. Potential competitors in these markets include Cognex Corporation, Electro Scientific Industries, Inc. and ICOS Vision Systems, NV (Belgium). Competition in this market is based on our ability to custom design products with stringent physical form requirements, speed, flexibility, cost and ease of control. In addition, our products compete with systems developed by OEMs using their own design staff for incorporation into their products. Our electronic assembly sensor products have historically competed favorably on the basis of these factors, and particularly on the basis of speed and product cost. Nevertheless, advances in terms of speed by vision systems have reduced some of the advantages of our products in some configurations. We have introduced newer configurations adapted by several customers that we believe allow our sensors, and the component placement machines in which they are incorporated, to compete favorably based on the speed and accuracy of their performance, and their price. In addition, we are expanding our focus to incorporate additional inspection capabilities into our sensors, including our embedded process verification (EPV), which could give us a competitive advantage in this market.

The primary competition for sales of our SE 300 products has been GSI Lumonics, Inc. (SVS division), Agilent Technologies, Inc. and Orbotech, Ltd. (Israel). More recently Asian based companies such as Koh Young Technology (Korea), CKD Corporation (Japan) and Test Research, Inc. (Taiwan) have introduced three dimensional inspection systems that provide less performance than our SE 300 products, but are increasingly competing for SE 300 product sales in the Pacific Rim. We believe that a few of these competing systems have a lower cost position than our SE 300 products. In addition, some manufacturers of screen printing equipment provide optional 2-D solder paste inspection, and other machine vision companies (AOI companies) have started offering 2-D and occasionally 3-D solder paste inspection products. Although we believe our SE 300 products compete favorably against these competitive products on the basis of performance and reliability, the introduction of lower cost competitive models has required us to decrease the price of our SE 300 products in some markets.

Our AOI inspection system products (Flex Products) face competition from a large number of AOI companies, the most significant being Agilent (formerly MVT), Orbotech, Ltd. (Israel), Viscom (Germany), Saki Corporation (Japan) and Omron, Ltd. (Japan). We believe that the technology used in the Flex series is differentiated from the competition and that it will compete effectively in this market based on measurement accuracy, cost, ease of use and the low rate of false calls.

Our semiconductor products face competition in the wafer mapping and alignment market primarily from manufacturers of through-beam sensors developed by our customers using inexpensive sensors from general industrial market suppliers like Banner Engineering Corporation, Omron, Ltd (Japan) and Keyence, Ltd (Japan). We believe that our sensors compete favorably in this market based on performance and the unique advantages of the reflective mode of operations.

Although we believe our current products offer several advantages in terms of price and suitability for specific applications and although we have attempted to protect the proprietary nature of such products, it is possible that any of our products could be duplicated by other companies in the same general market.

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Employees

As of December 31, 2005, we had 168 full-time and 2 part-time employees worldwide, including 35 in sales, marketing and customer support, 71 in manufacturing, purchasing and production engineering, 46 in research and development and 18 in finance, administration and information services. Of these employees, 124 are located at our corporate headquarters in Minneapolis and 46 are located in other offices (3 in the UK, 31 in Oregon, 6 in Singapore and 6 in China). All of our employees located in Oregon work in our Semiconductor business. To date, we have been successful in attracting and retaining qualified technical personnel, although there can be no assurance that this success will continue. None of our employees are covered by collective bargaining agreements or are members of a union.

Proprietary Protection

We rely on the technical expertise and know-how of our personnel and trade secret protection, as well as on patents, to maintain our competitive position. We attempt to protect intellectual property by restricting access to proprietary methods by a combination of technical and internal security measures. In addition, we make use of non-disclosure agreements with customers, consultants, suppliers and employees. Nevertheless, there can be no assurance that any of the above measures will be adequate to protect our proprietary technology.

We hold 76 patents (56 U.S. and 20 foreign) on a number of technologies, including those used in the LaserAlign systems and other products. Some of the patents relate to equipment such as pick-and-place machines, into which our sensor products are integrated. In addition, the Company has 96 pending patents (24 U.S. and 72 foreign). We protect the proprietary nature of our software primarily through copyright and license agreements, but also through close integration with our hardware offerings. We utilize 15 registered trademarks, 3 of which are foreign. We also have 12 domain names and several common law trademarks. It is our policy to protect the proprietary nature of our new product developments whenever they are likely to become significant sources of revenue. No guarantee can be given that we will be able to obtain patent or other protection for other products.

As the number of our products increases and the functionality of those products expands, we may become increasingly subject to attempts to duplicate our proprietary technology and to infringement claims. In addition, although we do not believe that any of our products infringe the rights of others, there can be no assurance that third parties will not assert infringement claims in the future or that any such assertion will not require us to enter into a royalty arrangement or result in litigation.

Government Regulation

Many of our products contain lasers. Products containing lasers are classified as either Class I, Class II or Class IIIb Laser Products under applicable rules and regulations of the Center for Devices and Radiological Health (CDRH) of the Food and Drug Administration. Such regulations generally require a self-certification procedure pursuant to which a manufacturer must file with the CDRH with respect to each product incorporating a laser device, periodic reporting of sales and purchases and compliance with product labeling standards. Our lasers are generally not harmful to human tissue, but could result in injury if directed into the eyes of an individual or otherwise misused. We are not aware of any incident involving injury or a claim of injury from our laser devices and believe that our sensors and sensor systems comply with all applicable laws for the manufacture of laser devices.

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ITEM 1A. RISK FACTORS

Our operations are subject to a number of risks and uncertainties that may effect our financial results, our accounting, and the accuracy of the forward making statements we make in this Form 10-K. We make statements regarding anticipated product introductions, changes in markets, customers and customer order rates, expenditures in research and development, growth in revenue, taxation levels, the effects of pricing, and the ability to continue to price foreign transactions in U.S. currency, all of which represent our expectations and beliefs about future events. Our actual results may vary from these expectations because of a number of factors that affect our business, the most important of which include the following:

The market for capital equipment for the electronics industry in which we operate is cyclical and we cannot predict with precision when market downturns will occur. We operate in a very cyclical market the electronics capital equipment market. We have been unable to predict with accuracy the timing or magnitude of periodic downturns in this market. These downturns, particularly the severe downturn in electronics production markets from 2001 through 2003, have severely affected our operations and generated several years of unprofitable operations. We may be unable to foresee additional changes in these markets before they affect our operations in the future.

World events beyond our control may effect our operations. Our operations and markets could be negatively affected by world events that effect economies and commerce in countries, such as China, Singapore and Japan, in which we do business. Natural disasters, such as the SARS outbreak, have affected travel patterns and accessibility in these countries in the past and other natural occurrences, such as a bird flu outbreak, could affect the business we do in these countries in the future. Further, these countries may be affected by economic forces that are different from the forces that affect the United States and change the amount of business we conduct.

We are dependent upon two customers for a significant amount of our revenue. We have been dependent on two original equipment manufacturer customers for a large portion of our revenue (44% in 2005, 50% in 2004 and 41% in 2003). Our operations were significantly negatively affected by reduced order rates from these two customers during 2001, 2002 and the first half of 2003, and were favorably impacted by increased order rates in the last half of 2003 and the first three quarters of 2004. Order rates for these customers continued to sequentially decline through the second quarter of 2005, and then started to sequentially increase in the third and fourth quarters of 2005. In the third quarter, we added a third original equipment manufacturer customer. If these customers are unsuccessful selling the products into which our sensors are incorporated, design their products to function without our sensors, purchase sensors from other suppliers, or otherwise terminate their relationships with us, our results of operations would be significantly negatively affected.

We are dependent upon a single product line in our systems business for over a quarter of our revenue. During 2005, approximately 25% of our total revenue was generated by sales of a single SMT Systems product line, the SE 300, and SE 300 Ultra. Sales of these products have been subject to increasing competition in the Asian markets. If we are not successful in continuing to sell and differentiate this product line relative to our competition, our results of operations would be negatively affected.

We generate more than three quarters of our revenue (approximately 81% in 2005) from export sales that are subject to risks of international operations. Our export sales are subject to many of the risks of international operations including:

- currency controls and fluctuations in currency exchange rates;
- changes in local market business requirements and increased cost and development time required to modify and translate our products for local markets;
- inability to recruit qualified personnel in a specific country or region;
- difficulty in establishing and maintaining relationships with local vendors;
- differing foreign technical standards;
- differing regulatory requirements;
- export restrictions and controls, tariffs and other trade barriers;
- difficulties in staffing and managing international operations;
- reduced protection for intellectual property rights;
- changes in political and economic conditions;
- seasonal reductions in business activity;
- potentially adverse tax assessments; and
- terrorism, disease, or other events that may affect local economies and access.

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Because we price our products in US dollars, our products may have difficulty competing in periods of increasing strength of the dollar. All of our international export sales are negotiated, invoiced and paid in U.S. dollars, and accordingly, currency fluctuations do not affect our revenue and income per unit. However, significant fluctuations in the value of the U.S. dollar relative to other currencies could have an impact on the price competitiveness of our products relative to foreign suppliers, which could impact the willingness of customers to purchase our products and have an impact on our results of operations.

Our products could become obsolete. Our current products, as well as the products we have under development, are designed to operate with the technology we believe currently exists or may exist for electronic components and printed circuit boards. The technology for these components changes rapidly and, because it takes considerable time to develop new products, we must anticipate technological developments in order to effectively compete. Further, because we do not have unlimited development resources, we might choose to forgo the pursuit of what becomes a leading technology and devote our resources to technology that is less successful. If we incorrectly anticipate technology developments, or have inadequate resources to develop our products to deal with changes in technology, our products could become obsolete.

We compete in the electronics assembly sensor market with larger companies. Our electronic assembly sensor products compete with products made by larger machine vision companies, other optical sensor companies, and by solutions internally developed by our customers. Advances in machine vision technology in recent years have eliminated some, but not all, of the features that have differentiated our products from some of these competitors.

The market for surface mount capital equipment has become very price competitive. The electronics capital equipment market for surface mount technologies is becoming more mature, resulting in increased price pressure on suppliers of equipment. Consequently, our electronic assembly system and sensor products have become subject to increased levels of price competition and competition from other suppliers and technologies, including suppliers in Asia who have specifically designed their products to compete favorably against our products.

Our systems products carry lower margins. We use a different distribution network to sell our end-user systems products, such as the SE 300, and generate lower margins from these products, than the distribution system and margins from our electronic assembly sensor and semiconductor products. To the extent our end-user systems constitute a larger portion of our business, our profitability may be affected.

Competitors in Asia may be able to compete favorable with us based on lower production costs. We compete with large multinational systems companies in sales of end-user systems products, many of which are able to take advantage of greater financial resources and larger sales distribution networks. We also compete with new Asian based suppliers of end-user systems products, many of which have lower overall production costs and are willing to offer their products at lower selling prices to customers.

We are dependent upon outside suppliers for components of our products, and delays in or unavailability of those components would adversely effect our results. We use outside contractors to manufacture the components used in many of our products and some of the components we order require significant lead times that could affect our ability to sell our products if not available. In addition, if these components do not meet stringent quality requirements or become subject to obsolescence, there could be delays in product availability, and we could be required to make significant investments in designing replacement components.

Our operations could be effected by lead-free regulations. New regulations have been enacted in various countries requiring the reduction of hazardous substances in electronics products and capital equipment in future years. New regulations are also increasing the obligations of manufacturers of electronics products and capital equipment to ensure proper disposal of their products when they are no longer being used by the customer. When effective, these regulations will impact production processes of our customers and require us to incorporate lead-free components into our products. If the production processes or our customers are interrupted, or we are not able to complete the transition to lead-free components in our products by the effective date of these regulations, our results of operations could be negatively affected. In addition the new regulations requiring us to ensure proper disposal of our products will increase our costs, and our results of operations could be negatively affected.

Our results are affected by the timing and success of product introductions. We plan to continue to introduce new products during fiscal 2006 and beyond. If those introductions are delayed, our revenue and profitability could be negatively affected. For example, we have devoted and continue to devote significant resources to complete development and commence sale of our embedded process verification (EPV) products. The introduction of these products has been delayed because of economic conditions affecting our customers, required adaptations for OEM requirements and other issues and these products have yet to generate substantial commercial sales.

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The accuracy of our financial reporting is dependent on continued maintenance of adequate internal controls. Our ability to capture, process and report transactions in a timely and accurate manner in compliance with accounting principles generally accepted in the United States is dependant upon the operation of our internal controls over financial reporting. Although we believe our controls, policies, practices and systems are adequate to ensure the integrity of our financial reporting, unanticipated and unauthorized actions of employees (both domestic and internationally), temporary lapses in internal controls due to shortfalls in transition planning and oversight, or resource constraints could lead to improprieties and undetected errors that could impact our financial condition or results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

We lease a 70,000 square foot mixed office and warehouse facility built to our specifications in Golden Valley, Minnesota, which functions as our corporate headquarters and primary manufacturing facility. The lease for this space is set to expire in May 2006. We are presently negotiating a renewal of our lease. As of December 31, 2005, we also have operating leases in Oregon (for our semiconductor business), Singapore, Massachusetts, the United Kingdom, and Shanghai China, which expire in May 2007, May 2006, August 2006, February, 2006 and August 2006, respectively.

ITEM 3. LEGAL PROCEEDINGS

We are not currently subject to any material pending or threatened legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted during the fourth quarter of 2005.

Table of Contents**PART II.**

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND
ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the Nasdaq National Market. The following table sets forth, for the fiscal periods indicated, the high and low quotations for our common stock as reported by the Nasdaq National Market. These prices do not reflect adjustments for retail markups, markdowns or commissions.

Quarter	2005		2004	
	High	Low	High	Low
First	\$15.36	\$11.76	\$19.67	\$11.34
Second	\$14.17	\$10.31	\$26.63	\$17.51
Third	\$15.36	\$12.83	\$26.24	\$14.55
Fourth	\$14.74	\$12.26	\$17.17	\$10.28

As of February 28, 2006, there were approximately 216 holders of record of common stock and approximately 3,010 beneficial holders. We have never paid a dividend on common stock. Dividends are payable at the discretion of the Board of Directors out of funds legally available therefore. Our board has no current intention of paying dividends.

Company Repurchase of Equity Securities

Period

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND

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	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
October 1, 2005 to October 31, 2005				479,500
November 1, 2005 to November 30, 2005				479,500
December 1, 2005 to December 31, 2005	17,700	\$ 12.4863	17,700	461,800
Total	17,700	\$ 12.4863	17,700	461,800

- (1) Prior to October 1, 2005, the Company had repurchased an aggregate of 20,500 shares of its common stock pursuant to the repurchase program that it publicly announced on May 7, 2005 providing for the repurchase of 500,000 shares, and with the repurchases of 17,700 shares in the fourth quarter, had repurchased an aggregate of 38,200 shares under that authorization. On May 25, 2005, the Company also announced that it had adopted a 10b5-1 plan to facilitate the purchase of the shares during periods it might otherwise be prevented by insider trading laws from making such repurchases. Shares were purchased in open market transactions.

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ITEM 6. SELECTED FINANCIAL DATA

Five-Year Financial Summary

CyberOptics Corporation

(In thousands, except per share information)

Year Ended December 31	2005 (1)	2004	2003 (2)	2002 (3)	2001 (4)
Revenues	\$ 42,179	\$ 58,037	\$ 35,636	\$ 24,634	\$ 38,446
Income (loss) from operations	\$ 3,104	\$ 12,325	\$ (2,814)	\$ (13,908)	\$ (8,594)
Net income (loss)	\$ 7,150	\$ 10,626	\$ (2,637)	\$ (13,555)	\$ (4,164)
Net income (loss) per share:					
Basic	\$ 0.80	\$ 1.23	\$ (0.32)	\$ (1.66)	\$ (0.52)
Diluted	\$ 0.79	\$ 1.18	\$ (0.32)	\$ (1.66)	\$ (0.52)
Cash and marketable securities	\$ 41,140	\$ 40,284	\$ 24,822	\$ 20,818	\$ 28,560
Working capital	48,515	38,921	26,963	25,268	33,492
Total assets	73,027	65,096	47,926	48,274	61,181
Stockholders' equity	66,190	57,951	41,752	44,062	57,038

- (1) 2005 results include a \$3.7 million non-cash income tax benefit related to a reduction in the valuation allowance for deferred income taxes in the fourth quarter of 2005.

(2)

ITEM 6. SELECTED FINANCIAL DATA

2003 results include a \$1.2 million charge for workforce reductions, leased facility consolidation and other restructuring charges and a \$632,000 charge for accelerated amortization of intangible assets. In addition, 2003 includes a \$645,000 gain from a technology transfer and license.

- (3) 2002 results include an increase in the valuation allowance for deferred income taxes of approximately \$4.3 million. In addition, 2002 results include a pre-tax charge of \$1.6 million for workforce reduction costs and other restructuring charges.
- (4) 2001 results include a pre-tax charge of \$419,000 for workforce reduction costs.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General Overview:

Our products are sold primarily into the electronics assembly, semiconductor DRAM memory, and semiconductor fabrication capital equipment markets, where we sell products both to original equipment manufacturers of production equipment and to end-user customers that produce circuit boards and semiconductor wafers and devices. Historically these markets have been very cyclical, with periods of rapid growth as worldwide capacity is added to support increased consumer demand for electronic products, and new capital equipment is purchased as a result of technology changes in electronics components, such as miniaturization, and changing production requirements. These periods of growth have historically been followed by periods of excess capacity and reduced capital spending.

Our operating results declined in 2005 in response to downturns in both the electronic assembly and semiconductor capital equipment markets that began late in the third quarter of 2004 and continued through the second quarter of 2005. Although the economies in the countries where most of our products are sold continued to be strong, the semiconductor market weakened, and with it, the circuit board production market. While this downturn was not as severe as the downturn experienced from 2001 to early 2003, it resulted in a significant decline in operating results over our exceptionally strong results in 2004. Consolidated revenues for 2005 declined 27% from 2004 to \$42.2 million. Operating results for 2005 benefited from a lower cost structure implemented during 2001, 2002 and 2003. In response to reduced revenues and operating losses, we took aggressive cost reduction actions, including reducing our worldwide employment by over 50% from 2001 peaks, and closing or downsizing facilities. As a result, 2005 operating profits were \$3.1 million despite lower revenues compared to 2004.

Order rates during the fourth quarter of 2005 improved significantly over the rates experienced in the first three quarters of 2005, to levels not experienced since mid 2004. Revenues in the fourth quarter of 2005 increased 17% compared to the third quarter of 2005 and increased 8% compared to the fourth quarter of 2004. Order rates in the first month of 2006 were strong, and although we cannot predict with precision the trends in markets we serve, we expect continued strength in our markets, at least for the early months of 2006.

As a result of our lower cost structure enabling us to generate profits during our recent cyclical downturns and the recent improvement in order rates during the fourth quarter, we reduced the valuation allowance for deferred income taxes that had been established in the third quarter of 2002. The reduction in the valuation allowance resulted in a non-cash income tax benefit in the fourth quarter of \$3.7 million. See Note 6 of this Form 10-K for a further discussion of the accounting treatment for income taxes.

Our balance sheet is also well positioned as the result of improved operating results and effective management of working capital and other assets. We have no debt and our cash and marketable securities are \$41.1 million at December 31, 2005 compared to \$40.3 million at December 31, 2004.

During the fourth quarter of 2005, we reorganized our business into two operating segments, the Electronic Assembly and Semiconductor segments, in order to increase focus and management attention on growth opportunities in our markets. The Electronic Assembly segment designs, manufactures and sells optical process control sensors and inspection systems for the electronics assembly equipment market. The Semiconductor segment designs, manufactures and sells optical and other process control sensors and related equipment for the semiconductor capital equipment market.

Table of Contents**Results of Operations for the Three Years Ended December 31, 2005:****Revenues**

Our revenues decreased by 27% to \$42.2 million in 2005 from \$58.0 million in 2004, and increased 63% in 2004 from \$35.6 million in 2003. The following table sets forth, for the years indicated, revenues by product line (in thousands):

	2005	2004	2003
Electronic Assembly			
OEM Sensors	\$ 21,623	\$ 31,275	\$ 16,122
SMT Systems	15,115	19,744	13,964
Total Electronic Assembly	36,738	51,019	30,086
Semiconductor	5,441	7,018	5,550
Total	\$ 42,179	\$ 58,037	\$ 35,636

Electronic Assembly

Revenues from our electronic assembly sensors decreased \$9.7 million or 31% during 2005 compared to 2004, and increased by \$15.2 million or 94% during 2004 compared to 2003. During 2005, revenue from electronic assembly sensors were negatively impacted by a downturn in our SMT electronic assembly market, which began in the fourth quarter of 2004, and continued through the second quarter of 2005. Sensor revenues were sequentially higher in the third and fourth quarters of 2005, but had not yet returned to the peak levels of 2004. In addition, 2005 sensor revenue was favorably impacted by the introduction of a new InPrinter Inspection camera for DEK International GmbH. During 2004, sensor revenues were positively impacted by improved market conditions in the worldwide market for SMT capital equipment and by the introduction of two new sensors for one of our large customers. These sensors were designed for the latest generation pick-and-place machine of this customer, which was introduced during 2003 and resulted in a higher content of our products per machine than in the previous version. During 2003, revenues began to improve during the second half of the year due to improved market conditions and the initial introduction of the previously discussed new sensors. Prior to 2003, revenues were negatively impacted by the depressed market conditions in the worldwide market for SMT capital equipment. This slowdown began in the first half of 2001 and continued throughout 2002 and early 2003.

Revenues from our SMT systems products decreased \$4.6 million or 23% during 2005 compared to 2004 and increased \$5.8 million or 41% during 2004 compared to 2003. During 2005, revenue from our SMT system products were negatively impacted by a downturn in our SMT electronic assembly market, which began in the fourth quarter of 2004, and continued through the second quarter of 2005. Partially offsetting the negative impact from the market downturn, was the introduction and positive market acceptance of our next generation solder paste inspection system, the SE 300 Ultra, and increased sales of our Flex series AOI systems, which increased approximately \$.5 million compared to 2004. During 2004 and 2003, revenues from SMT systems, primarily our SE 300 solder paste inspection system, were positively impacted by improved market conditions in the SMT capital equipment markets and by success in selling systems to many of the large manufacturers of circuit boards in Asia (particularly China). A large portion of the worldwide production capacity for printed circuit boards is being added in Asia, and we have been successful in selling inspection systems to new and existing customers in that region through our expanded distribution capability (opened Singapore sales office in 2001 and a sales office in China in 2004). In addition, 2004 revenues from our Flex series AOI systems increased \$1.5 million compared to 2003 levels. We believe that increased use of outsourcing for circuit board assembly, production difficulties associated with smaller component sizes, increased production speeds and increased cost pressure on companies manufacturing circuit boards has caused increased demand for our inspection equipment.

International revenue from electronic assembly sensors and SMT systems totaled \$32.8 million in 2005, \$45.3 million in 2004 and \$26.8 million in 2003, comprising approximately 89% of electronic assembly revenue in 2005, 2004, and 2003. The international markets of China and the rest of Asia, Japan and Europe account for a significant portion of the production capability of capital equipment for the manufacture of electronics, the primary market for our electronic assembly sensor and SMT system product lines. An increasing proportion of our sales have been to international customers as manufacturing of electronic components has migrated offshore, particularly to China.

Table of Contents***Semiconductor***

Revenues from semiconductor products decreased \$1.6 million or 22% in 2005 compared to 2004, following an increase of \$1.5 million or 26% in 2004 compared to 2003. The decrease in 2005 was primarily due to lower revenues from wafer mapping sensors as a result of depressed market conditions in the semiconductor fabrication capital equipment market for much of 2005. Frame grabber revenues decreased slightly in 2005 compared to 2004, as the result of depressed conditions in the general industrial capital equipment markets. The increase in 2004 was primarily due to higher revenues from wafer mapping sensors as a result of improved market conditions in the semiconductor fabrication capital equipment market for much of 2004. Frame grabber revenues increased slightly in 2004 compared to 2003, as the result of improved conditions in the general industrial capital equipment markets.

Our wafer mapping and frame grabber products are relatively mature. We anticipate that future growth in our semiconductor revenues, exclusive of changes related to capital procurement cycles, will come from our new WaferSense product line. WaferSense is a family of wireless, waferlike precision measurement tools for in-situ setup, calibration and process optimization in semiconductor processing equipment. We are currently working on several new additions to the WaferSense product line.

International revenue from semiconductor products totaled \$1.6 million or 29% of total semiconductor revenue in 2005, \$1.5 million or 22% of total semiconductor revenue in 2004, and \$1.4 million or 25% of total semiconductor revenue, in 2003. The level of international revenue as a percentage of total semiconductor revenue is due to fluctuations in the level of wafer mapper sales. Our wafer mapping sensors do not generate significant international revenue. The increase in international revenue as a percentage of total semiconductor revenue for 2005, compared to 2004, is due to lower levels of wafer mapper sales. The decrease in international revenue as a percentage of total semiconductor revenue for 2004, compared to 2003, is due to higher levels of wafer mapper sales.

Gross Margin

Our gross margin as a percentage of sales for both our Electronic Assembly and Semiconductor products are somewhat dependent on the level of revenues and resulting production levels over which to spread fixed manufacturing overhead costs that do not vary with activity levels. In addition, with higher production volumes manufacturing processes become more efficient and we are able to negotiate lower material costs from our suppliers as the result of volume discounts which reduces the overall cost of producing products for sale. The mix of products sold can also have an impact on Electronic Assembly and Semiconductor margins.

Electronic Assembly

Gross margin as a percentage of electronic assembly sales were 53% in 2005, 57% in 2004 and 49% in 2003. The decrease in gross margin as a percentage of sales in 2005, compared to 2004, was due in part, to pricing pressures from increased competition for sales of our solder paste inspection machines, reducing electronic assembly gross margins as a percentage of sales by approximately two percentage points. The remaining decrease in gross margin as a percentage of sales in 2005 was due to product mix, with a higher percentage of our sensor and system sales coming from lower margin products, and the lower level of production volumes, which reduced manufacturing efficiency when compared to 2004. With respect to our systems products, and particularly our solder paste inspection machines, we anticipate that pricing pressures will continue in 2006 due to additional competition in the marketplace for solder paste inspection.

The increase in gross margin as a percentage of sales in 2004 compared to 2003 resulted from increased production volume, a change in revenue mix with higher levels of higher margin OEM sensor revenues, and the impact of cost reduction measures implemented during 2001 to 2003. Revenue and production volumes were 70% higher in 2004 compared to 2003, resulting in improved manufacturing efficiency. Further, our OEM sensor products carry higher gross margins as a percentage of revenue than end-user systems products, and our sensor products constituted a growing proportion of our Electronic Assembly revenue in 2004 and 2003.

Semiconductor

Gross margin as a percentage of sales were 68% in 2005, 74% in 2004 and 71% in 2003. Similar to the electronic assembly segment, gross margin as a percentage of sales for the semiconductor segment is dependent on revenue mix and the level of production volume over which to spread fixed manufacturing overhead costs. Gross margins decreased as a percentage of revenue in 2005 from 2004 due to decreased volume, and a change in revenue mix, with lower sales of higher margin wafer mappers. The increase in gross margin as a percentage of revenue in 2004, compared to 2003, was due to increased volume, a change in our revenue mix, with higher levels of wafer mapper sales, and the impact of cost

reduction measures implemented during 2001 to 2003. We currently expect gross margins to decrease slightly as a percentage of revenue in 2006, from 2005 levels, due to anticipated changes in revenue mix, and new product introductions, which are expected to carry lower gross margins than our existing products.

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Operating Expenses

We believe continued investment in research and development of new products, coupled with continued investment and development of our sales channels, is critical to future growth and profitability. We maintain research and development and sales and marketing expenses at relatively high levels, even during periods of downturn in our electronic assembly and semiconductor capital equipment markets, as we continue to fund development of important new products, and continue to invest in our sales channels and develop new sales territories.

We are currently expecting research and development, and selling, general and administrative expenses to be higher in 2006, compared to 2005, as we continue new product development efforts, and continue development of our sales channels and new sales territories. Our research and development and other operating costs will increase for stock compensation expenses due to our required adoption of SFAS No. 123(R) *Share Based Payment*. In addition, we are currently considering additional research and development projects, and may elect to increase expenditures based on an assessment of the future revenue and profit potential of these projects. Further, we expect sales commissions and incentive compensation costs to be higher in 2006 compared to 2005, due to anticipated improvements in revenue and profit levels.

Fluctuations in the level of research and development and selling, general and administrative expenses as a percentage of revenue for both the Electronic Assembly and Semiconductor segments are primarily due to fluctuations in the level of revenue in 2005, 2004 and 2003.

Electronic Assembly

Research and development expenses were \$5.4 million or 15% of revenue in 2005, \$5.8 million or 11% of revenue in 2004 and \$5.5 million or 18% of revenue in 2003. The 6% decrease in research and development expenses in 2005 compared to 2004, was principally due to a \$300,000 decrease in company wide incentive compensation costs in 2005, resulting from lower levels of revenue and profits. Likewise, a \$300,000 increase in company wide incentive compensation contributed to the 5% increase in research and development expenses in 2004 compared to 2003.

During 2005 we completed development of our new SE 300 Ultra solder paste inspection system, and our new InPrinter Inspection camera for DEK International GmbH. We also started development of an enhanced version of our Flex series automated optical inspection system. During 2004 and 2003, research and development efforts were primarily focused on initial development activities for several new sensor products, including development activities for the new Embedded Process Verification sensor family (EPV®), continued development of the SE and Flex series inspection systems, next generation LaserAlign products, and board alignment cameras.

Selling, general and administrative expenses were \$10.1 million or 27% of revenue in 2005, \$11.1 million or 22% of revenue in 2004, and \$10.0 million or 33% of revenue in 2003. The 9% decrease in selling, general and administrative expenses in 2005 compared to 2004, was principally due to a \$1.4 million reduction in sales commissions and company wide incentive compensation costs associated with lower levels of revenue and profits in 2005, partially offset by increased costs for our new sales office in China that opened in 2004. The 11% increase in selling, general and administrative expenses in 2004 compared to 2003, is due to additional investment in sales and marketing, primarily in Asia, increases in other costs associated with supporting a growing end-user systems revenue base and a \$500,000 increase in company wide incentive compensation costs associated with higher revenue and profit levels. Increased corporate governance costs, including costs associated with implementing an internal control framework in accordance with section 404 of the Sarbanes Oxley Act of 2002 had a significant impact on increased selling, general and administrative expenses in 2004 compared to 2003.

Semiconductor

Research and development expenses were \$1.7 million or 31% of revenue in 2005, \$1.9 million or 27% of revenue in 2004 and \$1.7 million or 30% of revenue in 2003. A \$100,000 decrease in incentive compensation costs, resulting from lower levels of revenue and profit in 2005, contributed to the 11% decrease in research and development expenses in 2005 compared to 2004. Likewise, a \$100,000 increase in incentive compensation costs in 2004 contributed to the 11% increase in research and development expenses in 2004 compared to 2003.

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During 2005 and 2004, research and development efforts were primarily focused on enhancements to the semiconductor wafer mapping sensor family and development of new products for the semiconductor market, including development and enhancements to the WaferSense auto leveling sensor (ALS) first introduced in late 2004, with subsequent new product introductions in 2005.

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Selling, general and administrative expenses were \$2.0 million or 37% of revenue in 2005, \$2.0 million or 29% of revenue in 2004 and \$1.8 million or 32% of revenue in 2003. Expenses in 2005 were flat compared to 2004, as a \$200,000 reduction in costs for sales commissions and company wide incentive compensation programs resulting from lower revenue and profit levels in 2005 were offset by higher costs for additional management and marketing employees. The increase in 2004 expenses compared to 2003 is due to a \$200,000 increase in sales commissions and incentive compensation costs associated with higher revenue and profit levels in 2004.

Restructuring and Severance Costs

During 2001 to 2003, we implemented a series of workforce reductions, closed our facility in California, downsized facilities in the UK and Minneapolis and made other reductions in discretionary spending designed to reduce our cost structure in light of declining revenues during those periods caused by the depressed capital equipment markets for suppliers to electronics manufacturing.

Changes to the consolidated restructuring liability accounts were as follows (in thousands):

	Employee Termination Benefits	Lease Commitment Costs	Other	Total
Restructuring liability, December 31, 2002	\$ 148	\$ 188	\$ 16	\$ 352
Initial expense and accrual	541	694	7	1,242
Cash payments	(509)	(510)	(23)	(1,042)
Restructuring liability, December 31, 2003	180	372		552
Change in estimate		169		169
Cash payments	(180)	(236)		(416)
Restructuring liability, December 31, 2004		305		305
Cash payments		(221)		(221)
Restructuring liability, December 31, 2005	\$	\$ 84	\$	\$ 84

Electronic Assembly

In September 2003, we incurred approximately \$452,000 of severance and costs associated with restructuring measures. Cost reduction measures included workforce reductions associated with downsizing direct sales and marketing resources in North America and Europe, the consolidation of UK R&D operations into our Minneapolis headquarters and other general cost reduction measures. Severance costs were associated with a planned workforce reduction of 19 people. Of these costs, approximately \$272,000 was paid as of December 31, 2003. Severance and associated costs of \$180,000 were accrued as of December 31, 2003, and paid as of September 30, 2004.

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In December 2003, we completed the buy-out of our UK facility lease effective in the first quarter of 2004. Following this buyout, we signed a new lease for less space in the same facility. The cost of the buy-out, paid in December 2003, was approximately \$219,000. In addition, during December 2003, we permanently vacated approximately 18,000 square feet of our primary Minneapolis facility and recorded a restructure charge of approximately \$390,000 for future lease payments (reduced for estimated sub-lease income of approximately \$201,000) and related costs.

During 2004, we recorded restructuring charges of \$169,000. These charges reflected our change in estimate relative to the amount of sub-lease income we will receive from space vacated during the corporate restructuring in December 2003. Based on our unsuccessful attempts to secure a sub-lease tenant for this space, and given that our lease term ends in May 2006, we determined it was appropriate to record an additional charge assuming that no sub-lease income would be received on the property vacated during 2003.

Semiconductor

In January 2003, we incurred approximately \$170,000 of severance costs and facility closure costs associated with further consolidation of our semiconductor product group from Redwood City, California to Portland, Oregon. Severance costs were associated with a workforce reduction of 5 people. Substantially all of these costs were paid as of March 31, 2003.

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In September 2003, we incurred approximately \$11,000 of severance costs associated with the termination of one employee, which was paid as of December 31, 2003.

Gain on Technology Transfer and License

In March 2003, our Electronic Assembly segment transferred the rights and technology necessary to manufacture our Digital Range Sensors (DRS) to the Optical Gaging Products (OGP) Division of Quality Vision International, Inc. (QVI). In addition, we granted QVI a non-exclusive license to the intellectual property associated with this product line and sold a portion of our inventory as part of this transaction. QVI had been the primary customer for DRS sensors prior to this agreement as part of a separate 1999 agreement. The agreement called for QVI to pay \$750,000 as a one-time fee for the purchase of fixtures, a technology transfer fee and a non-refundable royalty payment. In addition, we sold QVI raw material inventories associated with the product line. The gain was determined as the difference between the proceeds received and our carrying value of product line inventory and fixed assets prior to the sale. As a result of this transaction, we recorded a \$645,000 gain in the three-month period ended March 31, 2003.

Amortization of Intangible Assets

Amortization of acquired intangible assets related to our Electronic Assembly segment was approximately \$110,000 in 2005, 2004 and 2003. We expect amortization expense for acquired intangible assets related to our Electronic Assembly segment to be \$110,000 in 2006.

Amortization of acquired intangible assets related to our Semiconductor segment was \$719,000 in 2005, \$798,000 in 2004 and \$1,644,000 in 2003. The decrease in Semiconductor related amortization in 2005 was due to certain acquired intangible assets becoming fully amortized during 2004. The decrease in Semiconductor related amortization in 2004, compared to 2003, resulted from a \$632,000 charge in the third quarter of 2003 to accelerate the amortization of certain acquired intangible assets that were determined to be non-strategic. These general-purpose product lines from our acquisition of HAMA, Inc. in 1999 were discontinued during 2004, and consequently, amortization of the developed technology was accelerated. We expect amortization expense for acquired intangible assets related to our Semiconductor segment to be \$482,000 in 2006.

Income Taxes

We currently have significant deferred tax assets as a result of foreign net operating loss carryforwards, U.S. tax credit carryforwards and temporary differences between taxable income on our tax returns and income before income taxes under U.S. generally accepted accounting principals. A deferred tax asset generally represents future tax benefits to be received when these carryforwards can be applied against future taxable income or when expenses previously reported in our financial statements become deductible for income tax purposes. We assess the realizability of our deferred tax assets and the need for a valuation allowance based on Statement of Financial Accounting Standards No. 109.

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In the third quarter of fiscal 2002, we recorded a full valuation allowance against our deferred tax assets. Our decision to record the valuation allowance was based on the cumulative losses we had incurred over the three years prior to that date, the fact that we were continuing to generate operating losses and that we fully utilized our loss carryback benefit in 2002. From the third quarter of fiscal 2002 through the third quarter of 2005, we continued to provide a full valuation allowance against all future tax benefits produced by our operating results.

During the fourth quarter of 2005, we reduced the valuation allowance on our deferred tax assets, initially established in the third quarter of 2002, resulting in a non-cash income tax benefit of \$3.7 million. Our tax benefit for 2005, including reversal of the valuation allowance, was equal to \$3.1 million. We considered a number of factors in our decision to reduce the valuation allowance on deferred tax assets, including our anticipated level of profitability in the future, our history of recent profitability and cumulative profitability since inception, and utilization of our available U.S. based net operating loss carryforwards. After considering these factors, we concluded that a reduction in the valuation allowance was appropriate. Accordingly, the benefit we will derive in future accounting periods from carryforwards and deductible temporary differences has been reflected as a deferred tax asset on our balance sheet. Due to the reduction of the valuation allowance, we expect to be taxed at a more normalized rate, approximating an effective rate of 36%, starting with the first quarter of 2006.

During 2004, we recorded an income tax provision of approximately \$2.0 million resulting in an effective income tax rate of approximately 16%. Income earned in 2004 resulted in full utilization of our remaining U.S. federal tax operating loss carryforwards. Because we maintained a valuation allowance on deferred tax assets in 2004 our cash taxes due and payable for the year were recorded as an expense, resulting in the effective rate of 16%.

We recorded a tax provision of \$214,000 in 2003 resulting from tax on income generated by our foreign subsidiaries. There was no tax benefit recorded on U.S. based operating losses in 2003 as the result of establishing a valuation allowance against deferred tax assets in 2002.

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Interest Income and Other

Interest income and other primarily includes interest earned on investments and losses associated with foreign currency translation. Interest income and other increased during 2005 as the result of additional invested funds, higher interest rates and lower translation losses. Interest income and other increased during 2004 as the result of additional invested funds, partially offset by increased translation losses.

Liquidity and Capital Resources

Our cash and cash equivalents decreased by \$5.8 million during 2005 primarily because of the purchase of \$6.7 million of marketable securities, net of maturities, and the purchase of \$1.2 million of capital assets, partially offset by \$1.6 million of cash generated from operating activities and \$0.4 million of cash generated from financing activities. Our cash and cash equivalents fluctuate in part because of maturities of marketable securities, and investment of cash balances in marketable securities, or from other sources of cash, in addition to marketable securities. Accordingly, we believe the combined balances of cash and marketable securities provide a more reliable indication of our available liquidity. Our combined balances of cash and marketable securities increased \$0.8 million to \$41.1 million as of December 31, 2005 from \$40.3 million as of December 31, 2004.

We generated \$1.6 million of cash from operations during 2005. Cash generated from operations primarily included net income of \$7.1 million, which included net non-cash expenses for depreciation and amortization, provisions for inventory obsolescence and doubtful accounts of \$2.2 million, tax benefits from the exercise of stock options of \$98,000 and increases in accounts payable of \$1.1 million. This cash generated was adjusted by \$3.7 million related to the non-cash deferred tax provision and offset by an increase in accounts receivable of \$2.4 million, increases in inventory of \$777,000 and increases in other assets of \$123,000, as well as, reductions in accrued expenses of \$1.9 million. Increases in accounts payable are the result of increased inventory purchases. The increase in deferred taxes resulted from the reversal of the valuation allowance established in 2002. Increases in accounts receivable are due to higher revenue levels in the fourth quarter of 2005, compared to 2004, and proportionately more system sales through distributors, which increases the timing of receivable collections. Increases in inventory are the result of purchases to support higher order rates and backlog at the end of 2005, compared to 2004. Decreases in accrued expenses are primarily due to payment of 2004 incentive compensation accruals in 2005.

We generated \$11.7 million of cash from operations during 2004. Cash generated from operations primarily included net income of \$10.6 million, which included \$2.6 million of net non-cash expenses for depreciation and amortization, provision for inventory obsolescence, foreign deferred taxes and other non-cash items, tax benefits from the exercise of stock options of \$678,000, reduced accounts receivable of \$326,000, advance customer payments of \$429,000 and increased accrued expenses of \$2.1 million. This cash generated more than offset investments in

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inventory of \$3.1 million and other assets of \$388,000, as well as, reductions in accounts payable of \$1.6 million. Increased accrued expenses are primarily due to increased incentive and warranty accruals during 2004. Investments in inventory are the result of significantly reduced revenues and order rates during the fourth quarter of 2004, which caused build-up in inventory as we aligned production rates with customer order rates. Reduced accounts payable are the result of lower levels of inventory purchases during the fourth quarter as we attempted to bring inventory levels down.

We used \$7.9 million of cash for investing activities during 2005 compared to \$2.8 million in 2004. Changes in the level of investments in marketable securities, resulting from the purchases and maturities of those securities, used \$6.7 million of cash in 2005 and \$1.6 million of cash in 2004. We used approximately \$1.2 million of cash in 2005 and \$681,000 of cash in 2004 for the purchase of fixed assets and capitalized patent costs and \$500,000 of cash in 2004 for the acquisition of a patent license.

We generated approximately \$433,000 of cash from financing activities during 2005 compared to \$5.1 million in 2004. Cash generated from stock option exercises and issuance of common stock under the Employee Stock Purchase Plan was \$0.9 million in 2005 compared to \$5.1 million in 2004. During 2005, \$473,000 of cash was used to repurchase common stock.

At December 31, 2005, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of establishing off-balance sheet arrangements or other contractually narrow or limited purposes. We do not believe we are exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

We had no material commitments for expenditures as of December 31, 2005. While there were no material commitments, we evaluate investment opportunities that come to our attention and could make a significant commitment in the future. Our cash and equivalents and investments totaled \$41.1 million at December 31, 2005. We believe that on-hand cash, cash equivalents and marketable securities, coupled with anticipated future cash flow from operations, will be adequate to fund our cash flow needs for the foreseeable future, including contractual obligations discussed below.

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The following summarizes our contractual obligations at December 31, 2005, and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

December 31 (in 000 s)	Total	Less Than 1 Year	1 - 3 Years	After 3 Years
Contractual Obligations:				
Borrowings	\$	\$	\$	\$
Non-cancelable operating lease obligations	600	556	44	
Purchase obligations	5,809	5,792	17	
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total contractual cash obligations	\$ 6,409	\$ 6,348	\$ 61	\$
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

We lease a 70,000 square foot mixed office and warehouse facility built to our specifications in Golden Valley, Minnesota, which functions as our corporate headquarters and primary manufacturing facility. The lease for this space is set to expire in May 2006. We are presently negotiating a renewal of our lease.

Purchase obligations are defined as agreements to purchase goods or services that are enforceable and legally binding. Included in the purchase obligations category above are obligations related to purchase orders for inventory purchases under our standard terms and conditions and under negotiated agreements with vendors and utilities. We expect to receive consideration (products or services) for these purchase obligations. The purchase obligation amounts do not represent all anticipated purchases in the future, but represent only those items for which we are contractually obligated. The majority of our products and services are purchased as needed, with no contractual commitment. Consequently, these amounts will not provide a reliable indicator of our expected future cash outflows on a stand-alone basis.

Related Party Transactions

On April 30, 2002, we loaned \$1.5 million to Avanti Optics Corporation (Avanti), a company founded by Steven K. Case, our Chairman, founder and a significant shareholder of CyberOptics. Erwin Kelen, one of our directors, also served as director of Avanti, was a shareholder in Avanti, and was a representative of one of the principal venture capital investors in Avanti. We held approximately 12% of the outstanding capital stock of Avanti prior to the loan, which we had acquired in consideration of the contribution of \$190,000 cash and intellectual property to Avanti when Avanti was formed. The loan transaction was approved by our Board of Directors without the participation of Dr. Case or Mr. Kelen and only after a determination that the loan was in our best interests.

The loan was represented by a convertible promissory note that bore interest at 3% above the prime rate of interest and was repayable on April 30, 2003, or upon an earlier event of default. The loan was secured by all of the intellectual property of Avanti (consisting primarily of rights in United States patents and patent applications in the area of photonics component manufacture), and provided us with the exclusive rights to manufacture and distribute manual and semi-automated equipment for the assembly of surface mountable optical components that were under development by Avanti. During 2002, we reduced the carrying value of the term loan by \$1,450,000 to reflect our equity in the cumulative losses of Avanti and to reduce our investment to reflect its net realizable value as of December 31, 2002. In December 2002, we were notified that, as a result of not being able to raise additional third party funding, Avanti decided to cease operations and liquidate its remaining assets. In February 2003, Avanti's Board of Directors and its significant shareholders passed a resolution to cease business operations. Consequently, all of the Avanti intellectual property rights were transferred to us under the terms of the loan. At December 31, 2003, there is no remaining carrying value for the loan.

Inflation and Foreign Currency Translation

Changes in our revenues have resulted primarily because of changes in the level of unit shipments and the relative strength of the worldwide electronics and semiconductor fabrication capital equipment markets. We believe that inflation has not had a significant effect on our operations. All of our international export sales are negotiated, invoiced and paid in U.S. dollars. Accordingly, although currency fluctuations do not significantly affect our revenue and income per unit, they can influence the price competitiveness of our products and the willingness of existing and potential customers to purchase units.

We have sales offices located in the UK and Singapore, and opened a sales office in China during 2004. We do not believe that currency fluctuations will have a material impact on our consolidated financial statements.

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Recent Accounting Developments

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), Share-Based Payment, which is a revision of SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. Originally, SFAS No. 123(R) was effective for all stock-based awards granted beginning with the first interim period after June 15, 2005. On April 14, 2005, the Securities and Exchange Commission (SEC) approved a new rule that changed the effective date of SFAS No. 123(R) for public companies to annual, rather than interim periods that begin after June 15, 2005. The standard may be adopted under either the modified prospective method or alternative methods, which allow for restatement of prior interim periods or prior years. We adopted the provisions of SFAS No. 123(R) on January 1, 2006 using the modified prospective method. We presently estimate that the adoption of SFAS No. 123(R) will increase pre-tax expenses for the first quarter ending March 31, 2006 by approximately \$250,000. The level of expenses in subsequent periods will be impacted by the number of future stock option grants, forfeiture rates and fluctuations in our stock price and volatility levels.

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151 (SFAS 151), Inventory Cost and amendment of ARB No. 43. SFAS 151 requires idle facility expenses, freight, handling costs, and wasted material spoilage costs to be recognized as current-period charges. It also requires that allocations of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005, and we adopted the provisions of SFAS No. 151 on January 1, 2006. We do not believe that adoption of SFAS No. 151 will impact our operating results in 2006. SFAS No. 151 could impact our results in the future, during a severe market downturn, if utilization of our fixed production capacity falls below our normal capacity level.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate these estimates, including those related to bad debts, warranty obligations, inventory valuation, intangible assets, income taxes, and restructuring costs. We base these estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our actual results may differ from these estimates under different assumptions or conditions. The estimates and judgments that we believe have the most effect on our reported financial position and results of operations are as follows:

Allowance for Doubtful Accounts. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. In making the determination of the appropriate allowance for doubtful accounts, we consider specific accounts, historical write-offs, changes in customer relationships and credit worthiness and concentrations of credit risk. Specific accounts receivable are written-off once a determination is made that the account is uncollectible. 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. The allowance for doubtful accounts is \$286,000 as of December 31, 2005.

Allowance for Warranty Expenses. We provide for the estimated cost of product warranties at the time revenue is recognized. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of component suppliers, warranty obligations are affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability would be required. The allowance for warranties is \$558,000 at December 31, 2005.

Reserve for Inventory Obsolescence. 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. If actual market conditions are less favorable than those projected, or if in the future we decide to discontinue sales and marketing of any of our products, additional inventory write-downs may be required. At December 31, 2005, we had a reserve for obsolete and excess inventory of \$802,000.

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Valuation of Intangible and Long-Lived Assets. We assess the impairment of identifiable intangible assets, long lived assets and related goodwill whenever events or changes in circumstances indicate the carrying value may not be recoverable. Factors we consider important, which could trigger an impairment review include the following:

- significant under-performance relative to expected historical or projected future operating results.
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business.
- significant negative industry or economic trends.
- significant decline in our stock price for a sustained period; and our market capitalization relative to net book value.
- for intangible assets and long-lived assets, if the carrying value of the asset exceeds the undiscounted cash flows from such asset.

When we determine that the carrying value of intangibles, long-lived assets and related goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any potential impairment based on a projected discounted cash flow method using a discount rate that we believe is commensurate with the risk inherent in our current business model. Annually, we also test for impairment of goodwill for each of our reporting units by estimating their fair value, utilizing a discounted cash flow methodology to determine a reasonable valuation. The evaluation of asset impairment requires us to make assumptions about future cash flows over the life of the asset being evaluated. These assumptions require significant judgment and actual results may differ from assumed or estimated amounts.

Deferred Tax Assets. We currently have significant deferred tax assets as a result of foreign net operating loss carryforwards, tax credit carryforwards and temporary differences between taxable income on our tax returns and income before income taxes under U.S. generally accepted accounting principals. A deferred tax asset generally represents future tax benefits to be received when these carryforwards can be applied against future taxable income or when expenses previously reported in our financial statements become deductible for income tax purposes. We assess the realizability of our deferred tax assets and the need for a valuation allowance based on Statement of Financial

Accounting Standards No. 109.

In the third quarter of fiscal 2002, we recorded a full valuation allowance against our deferred tax assets. Our decision to record the valuation allowance was based on the cumulative losses we had incurred over the three years prior to that date, the fact that we were continuing to generate operating losses and that we fully utilized our loss carryback benefit in 2002. From the third quarter of 2002 through the third quarter of 2005, we continued to provide a full valuation allowance against all future tax benefits produced by our operating results.

During the fourth quarter of 2005, we reduced the valuation allowance on our deferred tax assets initially established in the third quarter of 2002, resulting in a non-cash income tax benefit of \$3.7 million. We considered a number of factors in our decision to reduce the valuation allowance on deferred tax assets, including our anticipated level of profitability in the future, our history of recent profitability and cumulative profitability since inception, and utilization of our available U.S. based net operating loss carryforwards. After considering these factors, we concluded that a reduction in the valuation allowance was appropriate. Accordingly the benefit we will derive in future accounting periods from deductible temporary differences has been reflected as a deferred tax asset on our balance sheet.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We invest excess funds not required for current operations in marketable securities. The investment policy for these marketable securities is approved annually by the Board of Directors and administered by management. A third party, approved by our Board of Directors, manages the portfolio at the direction of our management. The investment policy dictates that marketable securities consist of U.S. Government or U.S. Government agency securities or certain approved corporate instruments with maturities of three years or less and an average portfolio maturity of not more than 18 months. As of December 31, 2005 our portfolio of marketable securities had an average term to maturity of less than one year. All marketable securities are classified as available for sale and carried at fair value. We estimate that a hypothetical 1% increase in market interest rates would decrease the market value of our marketable securities by approximately \$175,000. If such a rate increase occurred, our net income would only be impacted if securities were sold prior to maturity.

We enter into foreign currency swap agreements to hedge short term inter-company financing transactions with our subsidiary in the United Kingdom. These currency swap agreements are structured to mature near the last day of each quarter, and are designated as cash flow hedges. At December 31, 2005, the Company had one open swap agreement that was purchased on December 30, 2005. As a result, there were no unrealized gains or losses as of December 31, 2005. During the year ended December 31, 2005, we recognized a net gain of approximately \$219,000 from settlement of foreign currency swap agreements that offset the approximately \$351,000 translation loss on the underlying inter-company balance.

Our foreign currency swap agreements contain credit risk to the extent that our bank counter-parties may be unable to meet the terms of the agreements. The Company minimizes such risk by limiting its counter-parties to major financial institutions. We do not expect material losses as a result of defaults by other parties.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**CONSOLIDATED BALANCE SHEETS
CYBEROPTICS CORPORATION**

(In thousands, except share information)	December 31,	
	2005	2004
ASSETS		
Cash and cash equivalents	\$ 19,592	\$ 25,416
Marketable securities	15,607	5,537
Accounts receivable, less allowance for doubtful accounts of \$286 and \$345 in 2005 and 2004, respectively	9,775	7,424
Inventories	7,512	7,178
Other current assets	924	511
Deferred tax assets	1,942	
Total current assets	55,352	46,066
Marketable securities	5,941	9,331
Equipment and leasehold improvements, net	1,378	993
Intangible and other assets, net	1,737	2,587
Goodwill	4,856	6,119
Deferred tax assets	3,763	
Total assets	\$ 73,027	\$ 65,096
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	\$ 2,633	\$ 1,543
Advance customer payments		