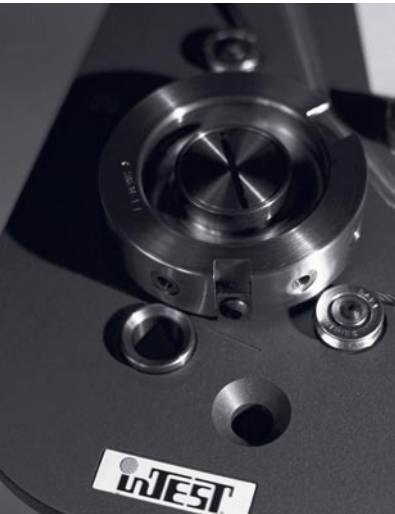




2005 Annual Report

Optimizing for the Future



## Company Profile

inTEST Corporation (Nasdaq: INTT) is an independent designer, manufacturer and marketer of ATE (Automatic Test Equipment) interface solutions and temperature management products used by semiconductor manufacturers to perform final testing of integrated circuits (ICs) and electronic assemblies. Our high-performance products are designed to enable semiconductor manufacturers to improve the speed, reliability, efficiency and profitability of IC test processes. Specific products include test head manipulators and docking hardware products, temperature management systems and customized interface solutions. We have established strong relationships with semiconductor manufacturers and ATE manufacturers globally, which we support through a network of local offices. Our largest customers include Texas Instruments Inc., Sony Corp., Teradyne, Inc., Cascade Microtech Inc., Bosch, Credence Systems Corp., LTX Corporation, STMicroelectronics N.V., Agilent Technologies Inc. and Agere Systems, Inc.

Headquartered in Cherry Hill, New Jersey, inTEST has approximately 200 highly skilled and trained technical personnel. We have manufacturing facilities in New Jersey, Massachusetts, California, Germany and Singapore. We also have sales, service and support offices in Japan, the U.K. and Germany, with additional support personnel in Arizona and Texas.



## Selected Financial Data

The following table contains certain selected consolidated financial data of inTEST and is qualified by the more detailed Consolidated Financial Statements and Notes thereto included elsewhere in this Annual Report to Stockholders and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the other financial information included in this Annual Report to Stockholders.

Years Ended December 31,  
(in thousands, except per share data)

	2005	2004	2003	2002	2001
<b>Condensed Consolidated Statement of Operations Data:</b>					
Net revenues	\$53,359	\$71,211	\$48,028	\$47,127	\$51,627
Gross margin	19,726	28,790	18,849	18,239	12,711
Operating income (loss)	(3,562)	1,666	(3,834)	(1,806)	(14,689)
Net earnings (loss)	(3,620)	1,270	(5,451)	(283)	(11,329)
Net earnings (loss) per common share:					
Basic	\$ (0.41)	\$ 0.15	\$ (0.65)	\$ (0.03)	\$ (1.37)
Diluted	\$ (0.41)	\$ 0.14	\$ (0.65)	\$ (0.03)	\$ (1.37)
Weighted average common shares outstanding:					
Basic	8,807	8,480	8,332	8,317	8,279
Diluted	8,807	8,804	8,332	8,317	8,279

As of December 31,  
(in thousands)

	2005	2004	2003	2002	2001
<b>Condensed Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 7,295	\$ 7,686	\$ 5,116	\$ 8,145	\$ 7,281
Working capital	16,195	18,428	15,670	19,765	20,146
Total assets	30,869	33,167	29,977	32,582	31,594
Long-term debt, net of current portion	23	47	117	210	296
Total stockholders' equity	22,806	26,118	22,591	27,357	27,204



## Dear Stockholders

### 2005 in Review

We entered 2005 with the market still in the doldrums after collapsing in the last quarter of 2004. This has been attributed to an over-supply of semiconductors in the end markets. Industry prognosticators predicted that the situation would correct itself by mid-2005. Indeed, we experienced a very weak first quarter 2005 with revenues slightly below the previous quarter. The second quarter showed a slight improvement, followed by a steep increase in revenues in the third quarter. In fact, our customers actually pulled orders planned for the fourth quarter into the third quarter. The fourth quarter saw some softening after the hectic pace of the third quarter.

We returned to profitability during the second half of 2005, although we were unable to recover enough to turn a profit for the full year due to the extremely weak first-half sales as well as charges of \$572,000 associated with our restructuring. We have completed significant restructuring initiatives during 2004 and 2005, and we will continue to monitor and optimize our operations to better weather the ups and downs of the industry in the future.

### Our Operating Segments

The Manipulator and Docking Hardware segment (M&D) introduced several new manipulator designs in 2005 aimed at minimizing required floor space and reducing cost. The development and introduction of manipulators will continue in 2006 with the emphasis on compactness and ease of use. Concurrently, the M&D division will continue the drive to maintain our standing as one of the leading suppliers of advanced docking solutions to the industry.

The Silicon Valley operation is responsible for our tester interface products. Although this business was depressed in 2005, it is back on a strong footing with very encouraging bookings and sales in the first quarter of 2006. This is a direct result of the advancements in interface technology we developed and brought to market over the past year. This year will see continued introductions of products based upon our proprietary Transpar Signal Module technology as well as the planned introduction of a new interconnect technology.

Temptronic, our thermal products segment, introduced evolutionary new products in 2005 that provide improved performance parameters



*We will, as in the past, pursue growth through existing business development as well as through mergers or acquisitions. The goal of our growth initiatives will always be the improvement of shareholder value.*

as well as lowered manufacturing costs. This segment has also made significant penetration into non-semiconductor markets that effectively expands their total available market. So far, new markets entered include medical, automotive, telecom and aerospace. Today these markets represent approximately 30% of Temptronic's revenue, up from 10% the previous year. 2006 will see a sustained effort at diversification of the market base as well as ongoing work at simplifying, improving and down-costing all products.

#### **The Future**

We are in the business of technology. In this business, one either moves the technological barriers forward or dies. Over the past two years, we have taken significant restructuring actions. Although costly to implement, I believe these actions have positioned us to be much more competitive in today's business environment. We have retained our key personnel and are vigorously pushing our product segments' technologies forward. An indication of our technological advancement is the fact that during 2005 we had 7 new patents issued, bringing our total intellectual property portfolio to 38

active patents and 23 pending patent applications. We are committed to becoming the preferred supplier in our industry by being recognized as designers and manufacturers of the most advanced and highest quality products available.

We will, as in the past, pursue growth through existing business development as well as through mergers or acquisitions. The goal of our growth initiatives will always be the improvement of shareholder value.

We will continue to adhere to the highest ethical standards in our relationships with employees, customers, shareholders and the public at large. And, we will make every effort to both exceed customers' expectations while enhancing shareholder value.

Thank you for your support.

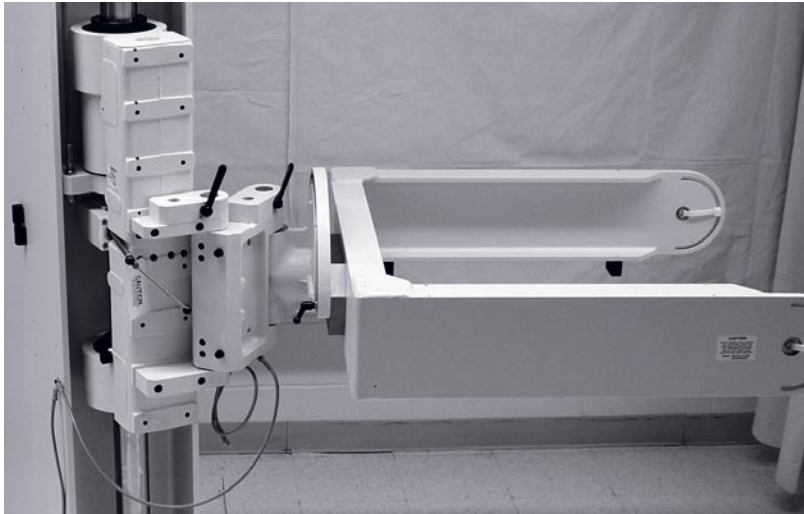
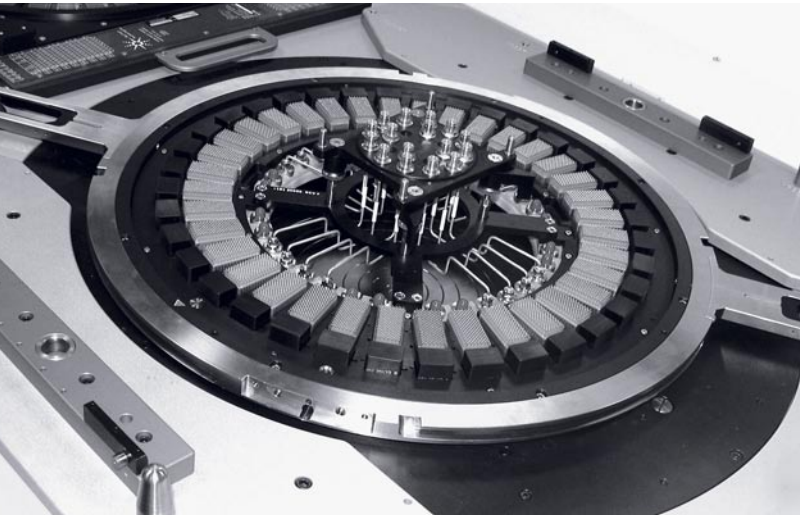
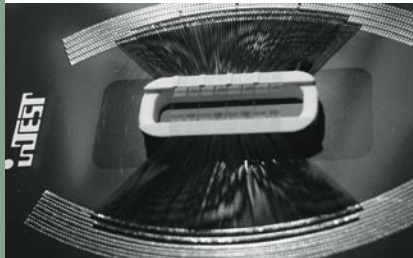
Sincerely,

**Robert E. Matthiessen**

President & CEO

May 31, 2006

*We are committed to becoming the preferred supplier to our industry by being recognized as the designers and manufacturers of the most advanced and highest quality products available. We will make every effort to exceed customers' expectations while enhancing shareholder value.*



# Management's Discussion and Analysis

## of Financial Condition and Results of Operations

### OVERVIEW

Our business and results of operations are substantially dependent upon the demand for ATE by semiconductor manufacturers and companies that specialize in the testing of ICs. Demand for ATE is driven by semiconductor manufacturers that are opening new, or expanding existing, semiconductor fabrication facilities or upgrading existing equipment, which in turn is dependent upon the current and anticipated market demand for semiconductors and products incorporating semiconductors. In the past, the semiconductor industry has been highly cyclical with recurring periods of oversupply, which often have a severe impact on the semiconductor industry's demand for ATE, including the products we manufacture. This can cause wide fluctuations in both our orders and net revenues and, depending on our ability to react quickly to these shifts in demand, can significantly impact our results of operations. These industry cycles are difficult to predict. Because the industry cycles are generally characterized by sequential quarterly growth or declines in orders and net revenues throughout the cycle, year over year comparisons of operating results may not always be as meaningful as comparisons of periods at similar points in either up or down cycles. In addition, during both downward and upward cycles in our industry, while the general trend over several quarters tends to be one of either growth or decline, in any given quarter, the trend in both our orders and net revenues can be erratic. This can occur, for example, when orders are pulled in, pushed out or canceled by a significant customer or when customer forecasts and general business conditions fluctuate during a quarter.

### NET REVENUES AND BOOKINGS

The following table sets forth, for the periods indicated, a breakdown of the net revenues from unaffiliated customers both by product segment and geographic area (based on the location of the selling entity).

(\$ in thousands)	Years Ended December 31,		
	2005	2004	2003
<i>Net revenues from unaffiliated customers:</i>			
Manipulator/Docking			
Hardware	\$28,838	\$38,414	\$24,364
Temperature Management	19,967	22,581	16,780
Tester Interface	6,778	13,516	11,132
Intersegment sales	(2,224)	(3,300)	(4,248)
	<b>\$53,359</b>	<b>\$71,211</b>	<b>\$48,028</b>
<i>Intersegment sales:</i>			
Manipulator/Docking			
Hardware	\$ 1	\$ 53	\$ 10
Temperature Management	1,863	1,599	1,317
Tester Interface	360	1,648	2,921
	<b>\$ 2,224</b>	<b>\$ 3,300</b>	<b>\$ 4,248</b>
U.S.	\$36,894	\$54,123	\$36,762
Europe	6,050	7,343	4,584
Asia-Pacific	10,415	9,745	6,682
	<b>\$53,359</b>	<b>\$71,211</b>	<b>\$48,028</b>

During the first half of 2003, the ATE industry entered a period of expansion that continued throughout the balance of that year and into the first half of 2004. However, late in the third quarter of 2004, there was a significant weakening in the level of our orders in both our manipulator/docking hardware and tester interface product segments as several customers of these two segments either postponed scheduled shipments or canceled orders. This decline in demand continued throughout the balance of 2004 and into the first quarter of 2005 and eventually impacted our temperature management product segment as well. While the trends in orders and net revenues have improved during 2005, demand has not yet returned to the level we experienced in the third quarter of 2004 which we now believe to be the peak of the last up cycle in the ATE industry. The result is that our consolidated net revenues declined \$17.9 million or 25% during 2005 as compared to 2004. The net revenues (net of intersegment sales) of our manipulator/docking hardware, temperature management and tester interface product segments declined 25%, 14% and 46% during 2005 as compared to 2004, respectively.

# Management's Discussion and Analysis

of Financial Condition and Results of Operations *(continued)*

The larger percentage decline in the net revenues of our tester interface segment also reflects increased competition during 2005. This led to significant downward pressure on pricing and, in some cases, we chose not to bid on business rather than sell at prices where we would not be assured of positive margins. Instead, this segment focused on new product development areas during 2005.

The smaller percentage decline in the sales of our temperature management segment also reflects the fact that these products are used in less cyclical non-production environments, such as research and development laboratories, as well as in industries outside semiconductor test.

Total orders for the year ended December 31, 2005 decreased to \$53.6 million on a consolidated basis as compared to \$63.5 million for 2004. The low point for our orders in the last eight quarters was the fourth quarter of 2004 where our orders totaled \$9.3 million. During the first three quarters of 2005, we experienced sequential growth in our orders with orders for the first, second and third quarters of 2005 totaling \$11.4 million, \$12.2 million and \$16.7 million, respectively. During the fourth quarter of 2005, our orders declined to \$13.2 million. We had anticipated this decline as we attributed a portion of the increase in the third quarter to certain customers' programs being accelerated, which resulted in demand being pulled into the third quarter of 2005 from the fourth quarter of 2005.

## BACKLOG

At December 31, 2005, our backlog of unfilled orders for all products was approximately \$6.0 million compared with approximately \$5.8 million at December 31, 2004. Our backlog includes customer orders which we have accepted, substantially all of which we expect to deliver in 2006. While backlog is calculated on the basis of firm purchase orders, a customer may cancel an order or accelerate or postpone currently scheduled delivery dates. Our backlog may be affected by the tendency of customers to rely on short lead times available from suppliers, including us, in periods of depressed demand. In periods of increased demand, there is a tendency towards longer lead times that has the effect of increasing backlog. As a result, our backlog at a particular date is not necessarily indicative of sales for any future period.

## COST CONTAINMENT AND ORGANIZATIONAL CHANGES

In response to the sudden downturn in the second half of 2004, we began the process of restructuring our operations with the goal of significantly reducing our fixed operating costs to position ourselves to more effectively meet the needs and expectations of the cyclical ATE market. In November 2004, we announced organizational changes and cost structure adjustments (the "2004 Workforce Reduction") that gave our divisional general managers increased responsibility for marketing, sales and service, thus allowing for the reduction of corresponding central corporate staff. In March 2005, we announced our intention to close our U.K. manufacturing operation (the "U.K. Operation Closure"). In late July 2005, we made certain cost structure adjustments at our facility in San Jose, California (the "California Workforce Reduction").

As a part of the 2004 Workforce Reduction, we eliminated four executive-level positions, reduced approximately 18% of our domestic personnel, and made certain salary and benefit adjustments. During the fourth quarter of 2004, we incurred severance costs of approximately \$527,000 related to these actions. The annualized cost benefit of these actions was estimated to be approximately \$4.5 million, including both permanent headcount reductions and salary and benefit adjustments, based upon our sales levels at the time of the restructuring. During 2005, we restored some of the salary reductions as sales levels increased in our temperature management segment and in our manipulator/docking hardware segment and will restore an additional portion of the salary reductions during the second quarter of 2006 in our manipulator/docking hardware segment. The level of savings we will achieve in future periods will vary if we determine to restore additional portions of the salary and benefit adjustments or if we determine that we need to increase staffing to meet increasing demand.

As a part of the U.K. Operation Closure, we shut down our manufacturing facility and opened a branch office in the U.K. that will provide customer support to this region. During 2005, we incurred \$234,000 in severance and related costs and \$303,000 in lease termination costs related to these actions. The \$205,000 accrual remaining at December 31, 2005 relates primarily to lease termination costs. In accordance with SFAS No. 146, our accrual for lease termination costs includes an estimate of future rental income from a sub-lease arrangement. At December 31, 2005, we had not sub-leased this facility.



If we are unable to sublet this facility as planned, we may incur additional costs related to this facility in future periods. We estimate that the closure of our U.K. manufacturing operation reduced our annual operating expense structure by approximately \$1.4 million, net of the costs associated with the branch office we have opened. We began to see the benefit of these cost reductions during the third quarter of 2005.

During the third quarter of 2005, we reduced staff in our tester interface product segment located in San Jose, California and incurred \$35,000 in severance costs related to this action. The annualized cost benefit of this action is estimated to be \$272,000. We began to see the benefit of these cost reductions during the fourth quarter of 2005.

We believe our recent reorganization and decentralization will make us a more competitive company and position us to adapt more quickly to new market challenges and opportunities through continued research and development as well as strategic merger and acquisition activities. As part of our continuing focus to determine methods to increase our profitability worldwide while operating in the cyclical ATE markets, we intend to continue reviewing and evaluating actions that could better match our operating costs against our anticipated future revenue and product demand as we pursue additional growth opportunities.

## **EXCESS AND OBSOLETE INVENTORY CHARGES**

On a quarterly basis, we review our inventories and record charges for excess and obsolete inventory based upon our established objective excess and obsolete inventory criteria. These criteria identify material that has not been used in a work order during the prior twelve months and the quantity of material on hand that is greater than the average annual usage of that material over the prior three years. In certain cases, additional excess and obsolete inventory charges are recorded based upon current industry conditions, anticipated product life cycles, new product introductions and expected future use of the inventory. The excess and obsolete inventory charges we record establish a new cost basis for the related inventory. See also the section entitled "Critical Accounting Policies."

We incurred charges for excess and obsolete inventory of \$1.0 million, \$1.4 million and \$886,000 for the years ended December 31, 2005, 2004 and 2003, respectively. The level of these charges was based upon a variety of factors including changes in demand for our products and new

product designs. The charges for 2005 included approximately \$173,000 related to the remaining inventory located at our U.K. manufacturing operation which was closed as of June 30, 2005, as previously discussed. The higher level of inventory obsolescence charges during 2004 was primarily the result of customer order cancellations after we had already purchased inventory to fulfill the orders and where that inventory could not be used in other products we manufacture due to its highly customized nature. In addition, we had increases in our reserves for excess quantities related to materials that were purchased based upon forecasted orders which did not materialize. During the fourth quarter of 2004, management made the determination to curtail the practice of purchasing significant amounts of inventory against forecasted orders due to the increased level of uncertainty in our current business outlook. However, in the future, we may determine that it is appropriate to increase the level of such purchases based on a variety of factors, including, but not limited to, general market conditions and the specific delivery requirements of our customers. See also the section entitled "Critical Accounting Policies."

## **PRODUCT WARRANTY CHARGES**

We accrue product warranty charges quarterly, based upon our historical claims experience. In addition, from time to time, we accrue additional amounts based upon known product warranty issues, such as product retrofits. For the years ended December 31, 2005, 2004 and 2003, our product warranty charges were \$549,000, \$2.0 million and \$1.9 million, or 1.0%, 2.8% and 4.0% of net revenues, respectively. The higher levels of product warranty charges in 2004 and 2003 were the result of specific product retrofits and other costs associated with several products we sold to three ATE manufacturers. There were no similar known product retrofit warranty issues for which we needed to record additional specific product warranty accruals in 2005.

The level of our product warranty charges both in absolute dollars and as a percentage of net revenues is affected by a number of factors including the cyclicity of demand in the ATE industry, the prototype nature of much of our business, the complex nature of many of our products and, at our discretion, providing warranty repairs or replacements to customers after the contracted warranty period has expired in order to promote strong customer relations. See also "Critical Accounting Policies."

# Management's Discussion and Analysis

of Financial Condition and Results of Operations *(continued)*

## PRODUCT/CUSTOMER MIX

Our three product segments each have multiple products that we design, manufacture and sell to our customers. The gross margin on each product we offer is impacted by a number of factors including the amount of intellectual property (such as patents) utilized in the product, the number of units ordered by the customer at one time, or the amount of inTEST designed and fabricated material included in our product compared with the amount of third-party designed and fabricated material included in our product. The weight of each of these factors, as well as the current market conditions, determines the ultimate sales price we can obtain for our products and the resulting gross margin.

The mix of products we sell in any period is ultimately determined by our customers' needs. Therefore, the mix of products sold in any given period can change significantly from the prior period. As a result, our consolidated gross margin can be significantly impacted in any given period by a change in the mix of products sold in that period.

We sell our products to both semiconductor manufacturers (end user sales) and to ATE manufacturers (OEM sales) who ultimately resell our equipment with theirs to semiconductor manufacturers. The mix of customers during any given period will affect our gross margin due to differing sales discounts and commissions. For the years ended December 31, 2005, 2004 and 2003, our OEM sales as a percentage of net revenues were 22%, 39% and 41%, respectively.

The impact of an increase in OEM sales as a percentage of net revenues is generally a reduction in our gross margin, as OEM sales historically have had a more significant discount than end user sales. Our current net operating margins on most OEM sales for these product segments, however, are only slightly less than margins on end user sales because of the payment of third party sales commissions on most end user sales. We also expect to continue to experience demands from our OEM customers' supply line management groups to reduce our sales prices to them. This continued price pressure may have the ultimate effect of reducing our gross and operating margins if we cannot further reduce our manufacturing and operating costs.

We believe that purchases of most of our products are typically made from semiconductor manufacturers' capital expenditure budgets. Certain portions of our business, however, are generally less dependent upon the capital expenditure budgets of the end users. For example, purchases of certain related ATE interface products, such as sockets and interface boards, which must be replaced periodically, are typically made from the end users' operating budgets. In addition, purchases of certain of our products, such as docking hardware, for the purpose of upgrading or improving the utilization, performance and efficiency of existing ATE, tend to be counter cyclical to sales of new ATE. Moreover, we believe a portion of our sales of temperature management systems results from the increasing need for temperature testing of circuit boards and specialized components that do not have the design or quantity to be tested in an electronic device handler. In addition, in recent quarters we have begun to market our temperature management systems in industries outside semiconductor test, such as the automotive, aerospace, medical and telecommunications industries. We believe that these industries usually are less cyclical than the ATE industry.

## RISK FACTORS

Please refer to Item 1A "Risk Factors" in our 2005 Annual Report on Form 10-K for a discussion of other important factors that could cause our results to differ materially from our prior results or those expressed or implied by our forward-looking statements.

## RESULTS OF OPERATIONS

All of our products are used by semiconductor manufacturers in conjunction with ATE in the testing of ICs. Consequently, the results of operations for each product segment are generally affected by the same factors. Separate discussions and analyses for each product segment would be repetitive and obscure any unique factors that affected the results of operations of our different product segments. The discussion and analysis that follows, therefore, is presented on a consolidated basis for the Company as a whole and includes discussion of factors unique to each product segment where significant to an understanding of each such business.

The following table sets forth for the periods indicated the principal items included in the "Consolidated Statements of Operations" as a percentage of total net revenues.

	Percentage of Net Revenues		
	Years Ended December 31,		
	2005	2004	2003
Net revenues	100.0%	100.0%	100.0%
Cost of revenues	63.0	59.6	60.8
Gross margin	37.0	40.4	39.2
Selling expense	16.8	17.1	21.1
Engineering and product development expense	11.1	9.1	12.5
General and administrative expense	14.7	11.0	13.6
Restructuring and other charges	1.1	0.9	—
Operating income (loss)	(6.7)	2.3	(8.0)
Other income	0.4	0.0	0.5
Earnings (loss) before income taxes	(6.3)	2.3	(7.5)
Income tax expense	0.5	0.5	3.8
Net earnings (loss)	(6.8)%	1.8%	(11.3)%

#### Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

*Net Revenues.* Net revenues were \$53.4 million for 2005 compared to \$71.2 million for 2004, a decrease of \$17.9 million or 25%. We believe the decrease in our net revenues reflects the aforementioned weaker cyclical demand during 2005 as compared to most of 2004. As previously mentioned, we began to see a decline in demand late in the third quarter of 2004. For 2005, the net revenues (net of intersegment sales) of our manipulator/docking hardware, temperature management and tester interface segments decreased \$9.5 million or 25%, \$2.9 million or 14% and \$5.5 million or 46%, respectively, over the comparable period in 2004. We believe the larger percentage decreases in our manipulator/docking hardware and tester interface segments reflect the decreased production requirements of our customers during 2005, and that the smaller percentage decrease in the sales of our temperature management segment reflects the fact that these products are used in less cyclical non-production environments, such as research and development laboratories, as well as in industries outside of semiconductor test. The larger percentage decline in the net revenues of our tester interface segment also reflects increased competition during 2005. This led to significant downward

pressure on pricing and, in some cases, we chose not to bid on business rather than sell at prices where we would not be assured of positive margins. Instead, this segment focused on new product development areas during 2005.

During 2005, our net revenues from customers in the U.S. and Europe decreased 32% and 18%, respectively, and our net revenues from customers in Asia increased 7% over the comparable period in 2004. The smaller percentage decline for our European customers reflects the fact that sales of temperature management products represent a higher percentage of our total European sales than they do of our domestic sales, and, as previously discussed, sales of our temperature management products have not been as significantly impacted by the weakened demand in the industry. In addition, the lower percentage decline in sales to European customers can also be attributed to the fact that the sales of our Intestlogic operation in Rosenheim, Germany decreased only 5% in 2005 as compared to 2004. We believe this reflects strong customer acceptance of the products manufactured by this subsidiary. The increase for our customers in Asia primarily reflects an increase in sales of third party products by our Japanese subsidiary in 2005 as compared to 2004.

*Gross Margin.* Gross margin was 37% for 2005 as compared to 40% for 2004. The decline in gross margin was primarily the result of our fixed operating costs not being as fully absorbed in 2005 due to the significantly lower net revenue levels as compared to 2004. As a percentage of net revenues, our fixed operating costs were 19% and 16% for 2005 and 2004, respectively. In absolute dollar terms, our fixed operating costs decreased \$1.5 million during 2005 as compared to 2004. This decrease was primarily due to lower salary and benefits expense as a result of the cost containment initiatives we put into place during late 2004 and early 2005. This decrease was partially offset by a reduction in the utilization rates of our internal machine shop operations in both our Cherry Hill, New Jersey and our San Jose, California facilities, as well as an increase in our insurance premiums. Our component material costs were 39% for 2005 as compared to 38% for the comparable period in 2004. We attribute the increase in component material costs primarily to product mix. Our excess and obsolete inventory charges totaled \$1.0 million, or 2% of net revenues, for 2005 as compared to \$1.4 million, or 2% of net revenues, for 2004. Finally, although the absolute dollar value of direct labor decreased by \$485,000 for 2005 as compared to 2004, as a percentage of net revenues, direct labor

# Management's Discussion and Analysis

## of Financial Condition and Results of Operations *(continued)*

remained consistent at 3% for both years due to the significantly lower net revenue levels in 2005 as compared to 2004. We attribute the decrease in the absolute dollar value of direct labor to the aforementioned cost containment initiatives.

*Selling Expense.* Selling expense was \$8.9 million for 2005 compared to \$12.2 million for 2004, a decrease of \$3.3 million or 27%. We attribute the decrease primarily to a \$1.4 million decrease in product warranty costs as well as lower levels of commission expense. The decrease in product warranty costs is due in part to the fact that our warranty costs in 2004 included \$531,000 in charges related to product retrofits and other costs associated with several products we sold to three ATE manufacturers. In addition, during the third quarter of 2004, we recorded charges of approximately \$200,000 as a result of negative trends in our historical claims experience. There were no similar charges in 2005. Commission expense decreased \$717,000, primarily due to the significantly lower net revenue levels. To a lesser extent, decreases in salary and benefits expense, travel expenses, freight and advertising also contributed to the decreased selling expense. The decreases in these expense categories reflect both the aforementioned cost containment initiatives as well as decreased business activity. These decreases were offset somewhat by an increase in marketing costs for our temperature management product segment for a specific program we implemented in 2005 related to our 300mm technology.

*Engineering and Product Development Expense.* Engineering and product development expense was \$5.9 million for 2005 compared to \$6.5 million for 2004, a decrease of \$520,000 or 8%. We attribute the decrease primarily to an \$898,000 reduction in salary and benefits expense. This reduction was primarily the result of the aforementioned cost containment initiatives. To a lesser extent there were also decreases in spending on travel and supplies. These decreases were partially offset by a \$459,000 increase in the use of third party consultants, primarily by our tester interface product segment related to specific product development projects.

*General and Administrative Expense.* General and administrative expense was \$7.8 million in each of 2005 and 2004. There were decreases in travel and information technology costs during 2005 as compared to the same period in 2004, which were offset by higher levels of incentive compensation expense related to grants of restricted stock. During 2004, we implemented a new

company-wide enterprise resource planning system. The implementation process required significant additional travel and use of third party consultants to complete. The system implementation was completed in 2004; therefore, no charges associated with this process were recorded in 2005. In 2004, we began granting restricted stock awards as a form of incentive compensation for certain members of management and directors. The value of the shares granted is expensed over the four year vesting period. The level of expense in 2004 was significantly lower than in 2005 since the first grant of restricted stock was not made until the fourth quarter of 2004.

*Restructuring and Other Charges.* Restructuring and other charges were \$572,000 for 2005 compared to \$627,000 for 2004, a decrease of \$55,000 or 9%. As previously discussed, the restructuring and other charges recorded during 2005 consisted of \$234,000 in severance and related costs and \$303,000 in lease termination costs resulting from the closure of our U.K. manufacturing operation. In addition, we incurred \$35,000 in severance and related costs associated with a workforce reduction at our facility in San Jose, California. The restructuring and other charges in 2004 consisted of severance costs of approximately \$527,000 related to the reorganization of our domestic operations and long-lived asset impairments of \$100,000 related to our U.K. facility.

*Other Income.* Other income was \$178,000 for 2005 compared to \$2,000 for 2004, an increase of \$176,000. The increase in other income was due to the receipt of \$79,000 in interest related to a domestic income tax refund we received during the second quarter of 2005 combined with an \$89,000 decrease in foreign exchange transaction losses during 2005 as compared to 2004.

*Income Tax Expense.* Income tax expense was \$236,000 for 2005 compared to \$398,000 for 2004. Our effective tax rate for 2005 was (7)% compared to 24% in 2004. Our income tax expense recorded during 2005 included a \$243,000 tax benefit related to domestic income tax refunds we received during the second and third quarters of the year. This amount was offset by foreign income tax expense we recorded on the earnings of certain of our foreign operations where we do not have net operating loss carryforwards to offset income tax expense on those earnings. The income tax expense recorded during 2004 represents foreign income tax expense on the earnings of these same operations. We increased our valuation allowance against our net deferred tax assets by \$644,000 and \$213,000 in 2005 and 2004, respectively, due to taxable

losses experienced in our domestic and certain foreign operations and the uncertainty surrounding whether we would be able to generate sufficient taxable income to fully utilize these net operating loss carryforwards before they expire.

#### **Year Ended December 31, 2004 Compared to Year Ended December 31, 2003**

*Net Revenues.* Net revenues were \$71.2 million for 2004 compared to \$48.0 million for 2003, an increase of \$23.2 million or 48%. We believe the increase in our net revenues reflects the aforementioned stronger cyclical demand early in 2004 compared to the weaker demand throughout 2003. In 2004, the net revenues (net of intersegment sales) of our manipulator/docking hardware, temperature management and tester interface segments increased \$14.0 million or 58%, \$5.5 million or 36% and \$3.7 million or 45%, respectively, over the comparable prior period. We believe the increases in all of our product segments reflect the aforementioned increase in demand we experienced for our products throughout the first half of 2004. We believe the larger percentage increases in our manipulator/docking hardware and tester interface segments reflect the increased production requirements of our customers during the first half of 2004. During the year ended December 31, 2004, our net revenues from customers in the U.S., Europe and Asia-Pacific increased 47%, 60% and 46%, respectively, over the comparable prior period. The larger percentage increase for our European customers was primarily the result of the significant appreciation of the Euro against the U.S. dollar during 2004. When adjusted to eliminate the effect of the change in exchange rates, the 2004 growth rate in the net revenues from our European customers was 47%, which is consistent with both the U.S. and Asia-Pacific.

*Gross Margin.* Gross margin was 40% for 2004 as compared to 39% for 2003. The improvement in the gross margin was primarily the result of our fixed operating costs being more fully absorbed by the significantly higher net revenue levels in 2004 compared to 2003. While the absolute dollar amount of our fixed operating costs increased \$1.9 million in 2004 as compared to 2003, the percentage of net revenues which these costs represent decreased from 20% in 2003 to 16% in 2004. We attribute the increase in the absolute dollar amount of our fixed operating costs primarily to higher salary and benefits expense which increased \$1.4 million over the comparable prior period. This increase was due largely

to the hiring of additional staff and the fact that as industry conditions improved during 2004 we began to reinstate certain previously eliminated employee benefits and our program of annual reviews and merit based salary increases. Also contributing to the increase in fixed operating costs, but to a lesser extent, were increases in insurance, third party consultants and facility rental. The increases in both insurance and third party consultants were driven by the increased level of business activity in 2004 compared to 2003.

*Selling Expense.* Selling expense was \$12.2 million for 2004 compared to \$10.1 million for 2003, an increase of \$2.1 million or 20%. We attribute the increase primarily to increased commission expense as well as higher levels of salary and benefits expense in 2004 as compared to 2003. The increase in commission expense of \$1.0 million in our manipulator/docking hardware and temperature management segments was primarily due to the significantly higher net revenue levels. The \$490,000 increase in salary and benefits expense primarily reflects the reinstatement of certain employee benefits as previously discussed. Also contributing to the increase, but to a lesser extent, were increases in travel and freight expense, which were driven by the increased business activity in 2004 compared to 2003.

*Engineering and Product Development Expense.* Engineering and product development expense was \$6.5 million for 2004 compared to \$6.0 million for 2003, an increase of \$465,000 or 8%. We attribute the increase primarily to a \$472,000 increase in salary and benefits expense due largely to hiring additional staff and the reinstatement of certain employee benefits as previously discussed. In addition, we had increased spending on engineering travel in our manipulator/docking hardware segment due to the increased business activity in 2004 compared to 2003. These increases were partially offset by a reduction in fees paid to third party product development consultants in our manipulator/docking hardware and temperature management segments.

*General and Administrative Expense.* General and administrative expense was \$7.8 million for 2004 compared to \$6.5 million for 2003, an increase of \$1.3 million or 20%. We attribute the increase primarily to a \$483,000 increase in salary and benefits expense, which is largely a result of the reinstatement of employee benefits, as previously discussed. Also contributing to the increase was a \$343,000 increase in professional fees, due primarily to increased audit fees, costs associated with our Sarbanes-Oxley

# Management's Discussion and Analysis

of Financial Condition and Results of Operations (continued)

compliance initiatives and increased patent filing activities. To a lesser extent, we attribute the increase to higher levels of administrative travel expense, accruals for profit-based bonuses and an increase in the fees paid to members of our Board of Directors.

*Restructuring and Other Charges.* Restructuring and other charges were \$627,000 for 2004. We had no comparable expenses incurred during 2003. The restructuring and other charges in 2004 consisted of severance costs of approximately \$527,000 related to the reorganization of our domestic operations, as previously discussed, and long-lived asset impairment of \$100,000 related to our U.K. facility.

*Other Income.* Other income was \$2,000 for 2004 compared to \$224,000 for 2003, a decrease of \$222,000 or 99%. The decrease in other income was primarily due to a significant increase in our foreign exchange transaction losses, which increased from \$12,000 in 2003 to \$223,000 in 2004. The increase in foreign exchange losses was due to the volatility throughout 2004 of the U.S. dollar against the major foreign currencies we operate in worldwide.

*Income Tax Expense.* Income tax expense was \$398,000 for 2004 compared to \$1.8 million for 2003. Our effective tax rate for 2004 was 24% compared to 51% in 2003. Our income tax expense for 2004 represented the foreign income tax expense related to the earnings of certain of our foreign operations. During 2004, we increased our valuation allowance against our net deferred tax assets by \$213,000 due to the taxable losses experienced in our domestic and certain foreign operations and the uncertainty surrounding whether we would be able to generate sufficient taxable income to fully utilize these losses before they expire. During 2003, we recorded a 100% valuation allowance against our net deferred tax assets due to our 2003 operating losses which resulted in the realizability of the net deferred tax assets to no longer be considered more likely than not.

## LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operations for the year ended December 31, 2005 was \$398,000 compared to \$4.0 million in 2004. The decrease in cash provided by operations in 2005 was primarily the result of our \$3.6 million net loss in 2005 compared to \$1.3 million of net income generated in 2004. Also contributing to the decrease was a \$3.0 million increase in accounts receivable during 2005. The increase in accounts receivable at December 31, 2005

from December 31, 2004 was due to higher sales levels in the fourth quarter of 2005 compared to reduced level of sales in the fourth quarter of 2004. Inventories decreased \$3.1 million during 2005 as a result of the sales activity during the year and stronger inventory management. Refundable domestic and foreign income taxes decreased \$704,000 from December 31, 2004 to December 31, 2005 as a result of receiving Federal and state refunds during 2005, as previously discussed. Accounts payable increased \$444,000 from December 31, 2004 to December 31, 2005 due to increased purchases during the fourth quarter of 2005 as compared to the same period in 2004. The increase in purchases is a result of higher order levels in late 2005 as compared to the same period in 2004. Other accrued expenses increased \$403,000 primarily as a result of higher levels of accrued professional fees, accrued rent and accrued royalties at December 31, 2005 as compared to December 31, 2004.

Purchases of machinery and equipment were \$1.4 million for the year ended December 31, 2005, consisting of \$594,000 of purchases we paid for directly and \$854,000 of purchases paid for by our landlord. The purchases of property and equipment we paid for directly consisted of \$214,000 primarily for computer hardware, software and quality assurance equipment for our three domestic operations, \$106,000 for additional leasehold improvements and furniture for our tester interface division's new facility in San Jose, California, \$81,000 for demonstration equipment for our temperature management and tester interface divisions and \$48,000 related to the relocation of our machine shop in Cherry Hill, New Jersey. The balance was primarily for machinery and equipment for our foreign locations.

The purchases that were paid for by our landlord, which totaled \$854,000, represent tenant improvements made at our tester interface division's new facility in San Jose, CA, that we occupied during the first quarter of 2005. These tenant improvements were paid for by the landlord based upon the terms of our lease agreement. At the time that we capitalized these assets, we recorded a liability in the same amount for deferred rent which will be amortized on a straight line basis over the lease term and recorded as a reduction of rent expense.

We have no commitments for capital expenditures for 2006, however, depending upon changes in market demand, we will make such purchases as we deem necessary or appropriate.

Net cash provided by financing activities for the year ended December 31, 2005 was \$842,000, which represented the aforementioned \$854,000 in deferred rent resulting from landlord provided tenant improvements, payments made under capital lease obligations of \$106,000 and \$94,000 of proceeds from stock options exercised.

Our total committed contracts that will affect cash over the next five years and beyond are as follows:

Contractual Commitments (\$ in thousands)	Expected Cash Payments by Year						Total
	2006	2007	2008	2009	2010	2011 & Beyond	
Capital lease obligations	\$ 25	\$ 8	\$ 8	\$ 8	\$ 1	\$ —	\$ 50
Operating lease obligations	1,730	1,593	1,571	1,559	1,346	495	8,294
Letters of credit	250	—	—	—	—	—	250
Inventory material purchase commitments	164	383	438	438	110	—	1,533
	\$2,169	\$1,984	\$2,017	\$2,005	\$1,457	\$495	\$10,127

We have a secured credit facility that provides for maximum borrowings of \$250,000. We have not utilized this facility to borrow any funds. Our usage consists of the issuance of letters of credit in the face amount of \$250,000. We pay a quarterly fee of 1.5% per annum on the total amount of the outstanding letters of credit. The terms of the loan agreement require that we maintain a minimum level of \$200,000 of domestic cash. This credit facility expires on September 30, 2006.

We believe that our existing cash balances plus the anticipated cash to be provided from operations will be sufficient to satisfy our cash requirements for the foreseeable future. As previously discussed, during the second half of 2004 we entered a cyclical downturn in our industry and experienced a significant decline in our orders and sales activity that continued into 2005. Although we began to see increases in our orders and sales activity during the second quarter of 2005, we cannot be certain that this positive trend will continue or what the rate of increases or decreases in our quarterly net revenues and bookings will be in future periods. As a result, we may require additional debt or equity financing to meet working capital or capital expenditure needs. We cannot be certain that, if needed, we would be able to raise such additional financing or upon what terms such financing would be available.

## NEW ACCOUNTING PRONOUNCEMENTS

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 151, *Inventory Costs—An Amendment of ARB No. 43, Chapter 4*, ("SFAS No. 151") which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Under SFAS No. 151, such items will be recognized as current-period charges. In addition, the Statement requires that allocation of fixed production

overheads to the costs of manufacturing be based on normal capacity of the production facilities. This Statement will be effective for the Company for inventory costs incurred on or after January 1, 2006. We do not expect the adoption of this standard to have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-2, *Accounting and Disclosure for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* ("FSP FAS 109-2"). The American Jobs Creation Act ("AJCA") introduced a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. During the second quarter of 2005, we completed our evaluation and determined that we would not benefit from the repatriation provisions provided by AJCA. Although AJCA also provides a special tax deduction related to our qualified production activity income, we will not benefit from this provision until our U.S. federal income tax net operating loss carryforwards have been fully utilized. AJCA's transitional rules applicable to the extraterritorial income exclusion regime will apply to us through 2006.

In December 2004, the FASB issued SFAS No. 123R (revised 2004), *Share-Based Payment*, ("SFAS No. 123R") which amends SFAS No. 123 and supersedes Accounting Principles Board ("APB") Opinion No. 25. SFAS No. 123R requires employee share-based equity awards to be accounted for under the fair value method, and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB Opinion No. 25 and allowed under the original provisions of SFAS No. 123. SFAS No. 123R requires the use of an option pricing model for estimating fair value, which is then

# Management's Discussion and Analysis

of Financial Condition and Results of Operations *(continued)*

amortized to expense over the service periods. SFAS 123R will be applicable to us for annual reporting periods that begin after December 15, 2005.

As previously mentioned, we currently apply APB Opinion No. 25 in accounting for our stock compensation plans. Accordingly, no compensation expense was recognized for employee stock options issued with exercise prices equal to the market price on the date of grant. We do not expect the adoption of this standard to have a material impact on our consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections—a Replacement of APB Opinion No. 20 and FASB Statement No. 3* ("SFAS No. 154"). SFAS No. 154 replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for the reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in an accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS No. 154 will be effective for accounting changes and corrections of errors occurring in fiscal years beginning after December 15, 2005.

## CRITICAL ACCOUNTING POLICIES

The preparation of consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to inventories, long-lived assets, goodwill, identifiable intangibles, deferred income tax valuation allowances and product warranty reserves. We base our estimates on historical

experience and on appropriate and customary assumptions that we believe to be 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. Some of these accounting estimates and assumptions are particularly sensitive because of their significance to our consolidated financial statements and because of the possibility that future events affecting them may differ markedly from what had been assumed when the financial statements were prepared.

### **Inventory Valuation**

Inventory is valued at standard cost, which approximates actual cost computed on a first-in, first-out basis, not in excess of market value. On a quarterly basis, we review our inventories and record excess and obsolete inventory charges based upon our established objective excess and obsolete inventory criteria. These criteria identify material that has not been used in a work order during the prior twelve months and the quantity of material on hand that is greater than the average annual usage of that material over the prior three years. In certain cases, additional charges for excess and obsolete inventory are recorded based upon current industry conditions, anticipated product life cycles, new product introductions and expected future use of the inventory. The charges for excess and obsolete inventory that we record establish a new cost basis for the related inventory. In 2005, we recorded an inventory obsolescence charge for excess and obsolete inventory of \$1.0 million.

### **Long-Lived Asset Valuation**

We assess the impairment of identifiable intangibles and long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could indicate impairment include significant underperformance relative to expected historical or projected



future operating results, significant changes in the manner of our use of the asset or the strategy for our overall business and significant negative industry or economic trends. When we determine that the carrying value of intangibles and/or long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, we prepare projections of operations for our product segments where these intangibles and/or long-lived assets are associated. If the carrying value of the intangible assets and/or long-lived assets exceeds the undiscounted cash flows per the projections, then we would record an impairment charge. We measure the impairment based upon the projected discounted cash flows using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. At December 31, 2005 long-lived assets were \$4.0 million and no asset impairments were recorded during 2005.

#### **Goodwill**

At least annually, we review our goodwill for impairment by comparing the fair value of our reporting units to their carrying values. If the result of this analysis indicates that an impairment charge is required, the fair value of the reporting unit is allocated to its identifiable tangible and intangible assets, resulting in an implied valuation of goodwill associated with the reporting unit. We would measure the impairment based on the difference between the implied valuation of the goodwill and its actual carrying value. During 2005, we did not record any impairment charges for goodwill or identifiable intangibles. Goodwill and intangible assets totaled \$2.7 million at December 31, 2005.

#### **Income Taxes**

Deferred tax assets are analyzed to determine if there will be sufficient taxable income in the future in order to realize such assets. We assess all of the positive and negative evidence concerning the realizability of the deferred tax assets, including our historical results of operations

for the recent past and our projections of future results of operations, in which we make subjective determinations of future events. If, after assessing all of the evidence, both positive and negative, a determination is made that the realizability of the deferred tax assets is not more likely than not, we establish a deferred tax valuation allowance for all or a portion of the deferred tax assets depending upon the specific facts. If any of the significant assumptions were changed, materially different results could occur, which could significantly change the amount of the deferred tax valuation allowance established. As of December 31, 2005, due to our history of operating losses, we have a 100% valuation allowance against all deferred tax assets, including net operating loss carryforwards, where we believe it is more likely than not that we will not have sufficient taxable income to utilize these assets before they expire.

#### **Product Warranty Accrual**

In connection with the accrual of warranty costs associated with our products, we make assumptions about the level of product failures that may occur in the future. These assumptions are primarily based upon historical claims experience. Should the rate of future product failures significantly differ from historical levels, our accrued warranty reserves would need to be adjusted, and the amount of the adjustment could be material. At December 31, 2005 accrued warranty was \$935,000 and we incurred product warranty costs of \$549,000 for the year then ended.

# Quantitative and Qualitative Disclosures

## About Market Risk

### FOREIGN CURRENCY RISK

We are subject to the risk of changes in foreign currency exchange rates due to our global operations. We manufacture and sell our products primarily in North America, Europe and Asia. As a result, our financial results could be significantly affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets in which we manufacture and sell our products. Our operating results are primarily exposed to changes in exchange rates between the U.S. dollar and the Euro, the Singapore dollar and/or the Japanese Yen.

As currency exchange rates change, translation of the statements of operations of our international businesses into U.S. dollars affects year-over-year comparability of operating results. We do not hedge operating translation risks because cash flows from international operations are generally reinvested locally. Changes in foreign currency exchange rates are generally reported as a component of stockholders' equity as all of our foreign subsidiaries report in their local currencies. Total other comprehensive income (loss) was (\$812,000), \$571,000 and \$546,000 in 2005, 2004 and 2003, respectively, due to cumulative translation adjustments.

As of December 31, 2005 and 2004, our net current assets (defined as current assets less current liabilities) subject to foreign currency translation risk were \$3.4 million and \$4.1 million, respectively. The potential decrease in net current assets from a hypothetical 10% adverse change in quoted foreign currency exchange rates would be \$339,000 and \$414,000, respectively. The sensitivity analysis presented assumes a parallel shift in foreign currency exchange rates. Exchange rates rarely move in the same direction. This assumption may overstate the impact of changing exchange rates on individual assets and liabilities denominated in a foreign currency.

### INTEREST RATE RISK

As of December 31, 2005, we had cash and cash equivalents of \$7.3 million. We generally place our investments in U.S. Treasury obligations or money market funds backed by such investments. We have not held and do not hold any derivatives related to our interest rate exposure. Due to the average maturity and conservative nature of our investment portfolio, a sudden change in interest rates would not have a material effect on the value of the portfolio. Management estimates that had the average yield of our investments decreased by 100 basis points, our interest income for the year ended December 31, 2005 would have decreased by less than \$67,000. This estimate assumes that the decrease occurred on the first day of 2005 and reduced the yield of each investment by 100 basis points. The impact on our future interest income of future changes in investment yields will depend largely on the gross amount of our cash, cash equivalents and short-term investments. See "Liquidity and Capital Resources" as part of Management's Discussion and Analysis of Financial Condition and Results of Operations.

The Board of Directors and Stockholders  
inTEST Corporation:

We have audited the accompanying consolidated balance sheets of inTEST Corporation and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, comprehensive earnings (loss), stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of inTEST Corporation and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

**KPMG LLP**

Philadelphia, Pennsylvania  
March 31, 2006

# Consolidated Balance Sheets

(In thousands, except share data)

	December 31,	
	2005	2004
<b>ASSETS:</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 7,295	\$ 7,686
Trade accounts and notes receivable, net of allowance for doubtful accounts of \$199 and \$159, respectively	9,443	6,771
Inventories	6,235	9,401
Refundable domestic income taxes	24	728
Prepaid expenses and other current assets	609	844
Total current assets	<u>23,606</u>	<u>25,430</u>
<b>Property and equipment:</b>		
Machinery and equipment	7,641	12,021
Leasehold improvements	3,214	3,154
	<u>10,855</u>	<u>15,175</u>
Less: accumulated depreciation	(6,904)	(10,621)
Net property and equipment	<u>3,951</u>	<u>4,554</u>
Other assets	594	451
Goodwill	2,403	2,318
Intangible assets, net	315	414
Total assets	<u>\$30,869</u>	<u>\$ 33,167</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 2,527	\$ 2,102
Accrued wages and benefits	1,492	1,456
Accrued warranty	935	1,216
Accrued sales commissions	391	501
Accrued restructuring and other charges	205	261
Other accrued expenses	1,272	893
Domestic and foreign income taxes payable	447	467
Capital lease obligations	24	106
Deferred rent	118	—
Total current liabilities	<u>7,411</u>	<u>7,002</u>
Capital lease obligations, net of current portion	23	47
Deferred rent, net of current portion	629	—
Total liabilities	<u>8,063</u>	<u>7,049</u>
Commitments and Contingencies (Notes 8, 11 and 14)		
<b>Stockholders' equity:</b>		
Preferred stock, \$0.01 par value; 5,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, \$0.01 par value; 20,000,000 shares authorized; 9,460,255 and 9,300,164 shares issued, respectively	95	93
Additional paid-in capital	25,099	24,716
Retained earnings	43	3,663
Accumulated other comprehensive income	237	1,049
Deferred stock compensation	(909)	(1,081)
Treasury stock, at cost; 284,577 and 375,648 shares, respectively	(1,759)	(2,322)
Total stockholders' equity	<u>22,806</u>	<u>26,118</u>
Total liabilities and stockholders' equity	<u>\$30,869</u>	<u>\$ 33,167</u>

See accompanying Notes to Consolidated Financial Statements.

## Consolidated Statements of Operations

(In thousands, except share and per share data)

	Years Ended December 31,		
	2005	2004	2003
Net revenues	\$53,359	\$71,211	\$48,028
Cost of revenues	33,633	42,421	29,179
Gross margin	19,726	28,790	18,849
<b>Operating expenses:</b>			
Selling expense	8,928	12,213	10,144
Engineering and product development expense	5,941	6,461	5,996
General and administrative expense	7,847	7,823	6,543
Restructuring and other charges	572	627	—
Total operating expenses	23,288	27,124	22,683
Operating income (loss)	(3,562)	1,666	(3,834)
<b>Other income (expense):</b>			
Interest income	189	89	67
Interest expense	(15)	(13)	(19)
Other	4	(74)	176
Total other income	178	2	224
Earnings (loss) before income taxes	(3,384)	1,668	(3,610)
Income tax expense	236	398	1,841
Net earnings (loss)	\$ (3,620)	\$ 1,270	\$ (5,451)
<b>Net earnings (loss) per common share:</b>			
Basic	\$ (0.41)	\$ 0.15	\$ (0.65)
Diluted	\$ (0.41)	\$ 0.14	\$ (0.65)
<b>Weighted average common shares outstanding:</b>			
Basic	8,806,528	8,479,914	8,332,320
Diluted	8,806,528	8,804,479	8,332,320

See accompanying Notes to Consolidated Financial Statements.

## Consolidated Statements of Comprehensive Earnings (Loss)

(In thousands)

	Years Ended December 31,		
	2005	2004	2003
Net earnings (loss)	\$ (3,620)	\$ 1,270	\$ (5,451)
Foreign currency translation adjustments	(812)	571	546
Comprehensive earnings (loss)	\$ (4,432)	\$ 1,841	\$ (4,905)

See accompanying Notes to Consolidated Financial Statements.

## Consolidated Statements of Stockholders' Equity

(In thousands, except share data)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Deferred Stock Compensation	Treasury Stock	Total Stockholders' Equity
	Shares	Amount						
Balance, January 1, 2003	8,700,005	\$87	\$ 21,816	\$ 7,844	\$ (68)	\$ —	\$(2,322)	\$ 27,357
Net loss	—	—	—	(5,451)	—	—	—	(5,451)
Other comprehensive income	—	—	—	—	546	—	—	546
Stock options exercised	37,500	—	139	—	—	—	—	139
Balance, December 31, 2003	8,737,505	87	21,955	2,393	478	—	(2,322)	22,591
Net earnings	—	—	—	1,270	—	—	—	1,270
Other comprehensive income	—	—	—	—	571	—	—	571
Stock options exercised	232,659	3	904	—	—	—	—	907
Issuance of shares in connection with acquisition of Intestlogic	100,000	1	755	—	—	—	—	756
Deferred stock compensation related to issuance of restricted stock	230,000	2	1,102	—	—	(1,104)	—	—
Amortization of deferred stock compensation	—	—	—	—	—	23	—	23
Balance, December 31, 2004	9,300,164	\$93	\$ 24,716	\$ 3,663	\$1,049	\$(1,081)	\$(2,322)	\$ 26,118
Net loss	—	—	—	(3,620)	—	—	—	(3,620)
Other comprehensive loss	—	—	—	—	(812)	—	—	(812)
Deferred stock compensation related to issuance of restricted stock	35,000	—	129	—	—	(129)	—	—
Amortization of deferred stock compensation	—	—	—	—	—	277	—	277
Elimination of deferred stock compensation related to restricted stock forfeited	(5,000)	—	(24)	—	—	24	—	—
Stock options exercised	30,091	1	93	—	—	—	—	94
Issuance of shares in connection with acquisition of Intestlogic	100,000	1	373	—	—	—	—	374
Issuance of 91,071 shares of treasury stock to satisfy profit sharing liability	—	—	(188)	—	—	—	563	375
<b>Balance, December 31, 2005</b>	<b>9,460,255</b>	<b>\$95</b>	<b>\$25,099</b>	<b>\$ 43</b>	<b>\$ 237</b>	<b>\$ (909)</b>	<b>\$(1,759)</b>	<b>\$22,806</b>

See accompanying Notes to Consolidated Financial Statements.

# Consolidated Statements of Cash Flows

(In thousands)

	Years Ended December 31,		
	2005	2004	2003
<b>Cash Flows from Operating Activities</b>			
Net earnings (loss)	\$(3,620)	\$ 1,270	\$(5,451)
Adjustments to reconcile net earnings (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,873	2,106	2,027
Impairment of long-lived assets	—	100	—
Deferred taxes	—	—	1,440
Foreign exchange loss	134	217	12
Deferred compensation relating to stock options	277	23	—
Issuance of treasury stock to satisfy profit sharing liability	375	—	—
Loss on disposal of fixed assets	15	175	—
Proceeds from sale of demonstration equipment, net of gain	14	83	85
Changes in assets and liabilities:			
Trade accounts and notes receivable	(3,011)	2,505	(2,365)
Inventories	3,056	(1,979)	(229)
Refundable domestic taxes	704	23	948
Other current assets	215	(275)	(53)
Other assets	(61)	248	43
Accounts payable	444	(1,582)	1,086
Accrued wages and benefits	85	584	110
Accrued warranty	(262)	97	538
Accrued sales commissions	(107)	10	96
Accrued restructuring and other charges	(45)	261	—
Other accrued expenses	403	(70)	189
Domestic and foreign income taxes payable	16	169	142
Deferred rent	(107)	—	—
Net cash provided by (used in) operating activities	398	3,965	(1,382)
<b>Cash Flows from Investing Activities</b>			
Purchase of property and equipment	(1,448)	(2,326)	(1,657)
Net cash used in investing activities	(1,448)	(2,326)	(1,657)
<b>Cash Flows from Financing Activities</b>			
Deferred rent resulting from landlord provided tenant improvements	854	—	—
Repayments of capital lease obligations	(106)	(93)	(86)
Proceeds from stock options exercised	94	907	139
Net cash provided by financing activities	842	814	53
Effects of exchange rates on cash	(183)	117	(43)
Net cash provided by (used in) all activities	(391)	2,570	(3,029)
Cash and cash equivalents at beginning of period	7,686	5,116	8,145
Cash and cash equivalents at end of period	\$ 7,295	\$ 7,686	\$ 5,116
<b>Supplemental Disclosure of Non-Cash Investing and Financing Activities:</b>			
Details of acquisition:			
Common stock released from escrow	\$ 374	\$ 756	\$ —
Goodwill resulting from acquisition	(374)	(756)	—
Restricted stock awards granted	\$ 129	\$ 1,104	\$ —
Capital lease additions	\$ —	\$ 36	\$ —
Cash payments (refunds) for:			
Domestic and foreign income taxes	\$ (502)	\$ 228	\$ (692)
Interest	15	13	19

See accompanying Notes to Consolidated Financial Statements.

# Notes to Consolidated Financial Statements

(In thousands, except share and per share data)

## (1) NATURE OF OPERATIONS

We are an independent designer, manufacturer and marketer of manipulator and docking hardware products, temperature management systems and tester interface products that are used by semiconductor manufacturers in conjunction with automatic test equipment ("ATE") in the testing of integrated circuits ("ICs" or "semiconductors").

The consolidated entity is comprised of inTEST Corporation (parent) and our wholly-owned subsidiaries. We manufacture our products in the U.S., Germany and Singapore. Marketing and support activities are conducted worldwide from our facilities in the U.S., the U.K., Germany, Japan and Singapore.

The semiconductor industry in which we operate is characterized by rapid technological change, competitive pricing pressures and cyclical market patterns. This industry is subject to significant economic downturns at various times. Our financial results are affected by a wide variety of factors, including, but not limited to, general economic conditions worldwide or in the markets in which we operate, economic conditions specific to the semiconductor industry, our ability to safeguard patents and intellectual property in a rapidly evolving market, downward pricing pressures from customers, and our reliance on a relatively few number of customers for a significant portion of our sales. In addition, we are exposed to the risk of obsolescence of our inventory depending on the mix of future business and technological changes within the industry. As a result of these or other factors, we may experience significant period-to-period fluctuations in future operating results.

## (2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation and Use of Estimates

The accompanying consolidated financial statements include our accounts and those of our wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated upon consolidation. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the

reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Certain of our accounts, including long-lived assets, goodwill, inventory, deferred income tax valuation allowances and product warranty reserves, are particularly impacted by estimates.

### Reclassification

Certain prior year amounts have been reclassified to be comparable with the current year's presentation.

### Cash and Cash Equivalents

Short-term investments that have maturities of three months or less when purchased are considered to be cash equivalents and are carried at cost, which approximates market value.

### Trade Accounts and Notes Receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. We grant credit to customers and generally require no collateral. To minimize our risk, we perform ongoing credit evaluations of our customers' financial condition. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance based on historical write-off experience and the aging of such receivables, among other factors. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. We do not have any off-balance sheet credit exposure related to our customers. Bad debt expense was \$55, \$38, and \$0 for the years ended December 31, 2005, 2004 and 2003, respectively.

Notes receivable are due from trade customers in Japan and have original maturities of less than six months. The notes are non-interest bearing. Notes receivable were \$164 and \$43 at December 31, 2005 and 2004, respectively. Cash flows from accounts and notes receivable are recorded in operating cash flows.

### Fair Value of Financial Instruments

Our financial instruments, principally accounts and notes receivable and accounts payable, are carried at cost which approximates fair value, due to the short maturities of the accounts. The estimated fair values of our capital lease obligations approximated their carrying value based upon the rates offered to us for similar type arrangements.



## Inventories

Inventory is valued at standard cost, which approximates actual cost computed on a first-in, first-out basis, not in excess of market value. Cash flows from the sale of inventory are recorded in operating cash flows. On a quarterly basis, we review our inventories and record excess and obsolete inventory charges based upon our established objective excess and obsolete inventory criteria. These criteria identify material that has not been used in a work order during the prior twelve months and the quantity of material on hand that is greater than the average annual usage of that material over the prior three years. In certain cases, additional excess and obsolete inventory charges are recorded based upon current industry conditions, anticipated product life cycles, new product introductions and expected future use of the inventory. The charges for excess and obsolete inventory we record establish a new cost basis for the related inventory. We incurred excess and obsolete inventory charges of \$1,044, \$1,397 and \$886 for the years ended December 31, 2005, 2004 and 2003, respectively.

## Property and Equipment

Machinery and equipment are stated at cost. Depreciation is based upon the estimated useful life of the assets using the straight-line method. The estimated useful lives range from two to seven years. Leasehold improvements are recorded at cost and amortized over the shorter of the lease term or the estimated useful life of the asset. Total depreciation expense, including amortization of assets acquired under capital leases, was \$1,824, \$2,058 and \$1,987 for the years ended December 31, 2005, 2004 and 2003, respectively. Expenditures for maintenance and repairs are charged to operations as incurred.

## Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we continually monitor events and changes in circumstances that could indicate carrying amounts of long-lived assets may not be recoverable. When such events or changes in circumstances occur, we assess the recoverability of long-lived assets by determining whether the carrying value of such assets will be recovered through undiscounted expected future cash flows. If the total of the undiscounted future cash flows is less than the carrying amount of those assets,

we recognize an impairment loss based on the excess of the carrying amount over the fair value of the assets.

## Goodwill and Intangibles

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill and other indefinite life intangible assets are no longer subject to amortization. Instead, they are subject to at least an annual assessment for impairment by applying a fair value based test. During 2005 and 2004, we assessed our goodwill for impairment in accordance with the requirements of SFAS No. 142, and no impairments of goodwill were indicated based on these assessments.

Goodwill at both December 31, 2005 and 2004 relates to the manipulator/docking hardware segment. Changes in the amount of the carrying value of goodwill for the year ended December 31, 2005 and 2004 are as follows:

	2005	2004
Balance—Beginning of period	\$2,318	\$1,384
Goodwill recorded during the year	374	756
Impact of foreign currency translation	(289)	178
Balance—End of period	\$2,403	\$2,318

During both 2005 and 2004, we issued 100,000 shares of common stock to the former owner of our Intestlogic subsidiary. These shares were issued pursuant to a provision contained in the amended agreement of sale that established revenue targets in 2005 and 2004 that if met would require the issuance of up to 200,000 shares of common stock. During the quarter ended September 30, 2004, the revenue target for 2004 was achieved and the maximum number of shares to be earned in 2004 was issued. During the third and fourth quarters of 2005, the revenue targets for 2005 were achieved, and the remaining 100,000 shares were issued. In connection with the issuance of these shares, we recorded goodwill of \$374 and \$756 in 2005 and 2004, respectively, which represented the fair market value of the shares issued.

As of December 31, 2005 and 2004, definite life intangibles totaled \$315 and \$414, net of accumulated amortization of \$152 and \$120, respectively. The net book value of these intangibles reflects \$50 of unfavorable impact related to foreign currency during 2005. These definite life intangibles are the result of our acquisition of Intestlogic and are being amortized using the straight-line method over the remaining estimated useful life of seven years. These definite life intangible assets are technology based, include patented

# Notes to Consolidated Financial Statements

(In thousands, except share and per share data) (continued)

technology and are allocated to the manipulator/docking hardware segment. Amortization expense for the years ended December 31, 2005, 2004 and 2003 was \$49, \$48 and \$40, respectively. Estimated annual amortization expense for each of the next five years is \$49.

## Revenue Recognition

We recognize revenue in accordance with Staff Accounting Bulletin No. 104 ("SAB 104"), *Revenue Recognition*. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectibility is reasonably assured. Sales of our products are made through our sales employees, third-party sales representatives and distributors. There are no differences in revenue recognition policies based on the sales channel. We do not provide our customers with rights of return or exchanges. Revenue is generally recognized upon product shipment. Our sales agreements do not typically contain any customer-specific acceptance criteria, other than that the product performs within the agreed upon specifications. We test all products manufactured as part of our quality assurance process to determine that they comply with specifications prior to shipment to a customer. To the extent that any sales agreements contain customer-specific acceptance criteria, revenue recognition is deferred until customer acceptance.

## Product Warranties

We generally provide product warranties and record estimated warranty expense at the time of sale based upon historical claims experience. Warranty expense for the years ended December 31, 2005, 2004 and 2003 was \$549, \$1,982 and \$1,897, respectively. Warranty expense is included in selling expense in the consolidated financial statements.

The following table sets forth the changes in the liability for product warranties for the years ended December 31, 2005 and 2004:

	2005	2004
Balance—Beginning of period	\$1,216	\$ 1,102
Payments made under warranty	(830)	(1,868)
Accruals for product warranty	549	1,982
Balance—End of period	\$ 935	\$ 1,216

## Engineering and Product Development

Engineering and product development costs, which consist primarily of the salary and related benefits costs of our technical staff, as well as product development costs, are expensed as incurred.

## Restructuring and Other Charges

We recognize a liability for restructuring costs at fair value only when the liability is incurred. The three main components of our restructuring plans are related to workforce reductions, the consolidation of excess facilities and asset impairments. Workforce-related charges are accrued when it is determined that a liability has been incurred, which is generally after individuals have been notified of their termination dates and expected severance benefits. Plans to consolidate excess facilities result in charges for lease termination fees and future commitments to pay lease charges, net of estimated future sub-lease income. We recognize charges for consolidation of excess facilities when we have vacated the premises. Assets that may be impaired consist of property, plant and equipment. Asset impairment charges are based on an estimate of the amounts and timing of future cash flows related to the expected future remaining use and ultimate sale or disposal of the asset. These estimates were derived using the guidance of SFAS No. 146, *Accounting for Exit or Disposal Activities*, and SFAS No. 144, *Accounting for the Impairment of Disposal of Long Lived Assets*.

## Foreign Currency

The accounts of our foreign subsidiaries are translated in accordance with SFAS No. 52, *Foreign Currency Translation*, which requires that assets and liabilities of international operations be translated using the exchange rate in effect at the balance sheet date. The results of operations are translated using an average exchange rate for the period. The effects of rate fluctuations in translating assets and liabilities of international operations into U.S. dollars are included in accumulated other comprehensive income (loss) in stockholders' equity. Transaction gains or losses are included in net earnings (loss). For the years ended December 31, 2005, 2004 and 2003, foreign currency transaction losses were \$134, \$223 and \$12.

## Income Taxes

The asset and liability method is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for operating loss and tax credit carryforwards and for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the results of operations in the period that includes the enactment date. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets if it is more likely than not that such assets will not be realized.

## Net Earnings (Loss) Per Common Share

Net earnings (loss) per common share is computed in accordance with SFAS No. 128, *Earnings Per Share*. Basic earnings (loss) per common share is computed by dividing net earnings (loss) by the weighted average number of common shares outstanding during each year. Diluted earnings (loss) per common share is computed by dividing net earnings (loss) by the weighted average number of common shares and common share equivalents outstanding during each year. Common share equivalents represent stock options and unvested shares of restricted stock and are calculated using the treasury stock method. Common share equivalents are excluded from the calculation if their effect is anti-dilutive.

A reconciliation of weighted average common shares outstanding—basic to weighted average common shares outstanding—diluted appears below:

	Years Ended December 31,		
	2005	2004	2003
Weighted average common shares outstanding—basic	8,806,528	8,479,914	8,332,320
Potentially dilutive securities:			
Employee stock options	—	324,565	—
Weighted average common shares outstanding—diluted	8,806,528	8,804,479	8,332,320

For the years ended December 31, 2005, 2004 and 2003, an average of 912,850, 84,291 and 952,682 employee stock options with weighted average exercise prices of \$2.90, \$6.13 and \$3.86, respectively, were excluded from the calculation because their effect was anti-dilutive.

## Stock-Based Compensation

At December 31, 2005, we have certain stock-based employee compensation plans, that are described more fully in Note 13. We account for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), and related Interpretations. No stock-based employee compensation cost is reflected in the statement of operations when options granted under these plans have an exercise price equal to the market value of the underlying common stock on the date of grant. During the fourth quarter of 2004, we began granting shares of restricted stock to certain directors, officers and key employees. We record compensation expense for the restricted stock awards based on the quoted market price of our stock at the grant date and amortize the expense over the vesting period.

The following table illustrates the effect on net earnings (loss) and net earnings (loss) per share if we had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	2005	2004	2003
Net earnings (loss), as reported	\$(3,620)	\$1,270	\$(5,451)
Add: Stock-based employee compensation expense included in reported net earnings (loss), net of related tax effects	277	15	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(564)	(256)	(741)
Pro forma net earnings (loss)	\$(3,907)	\$1,029	\$(6,192)
Net earnings (loss) per share:			
Basic—as reported	\$ (0.41)	\$ 0.15	\$ (0.65)
Basic—pro forma	\$ (0.44)	\$ 0.12	\$ (0.74)
Diluted—as reported	\$ (0.41)	\$ 0.14	\$ (0.65)
Diluted—pro forma	\$ (0.44)	\$ 0.12	\$ (0.74)

# Notes to Consolidated Financial Statements

(In thousands, except share and per share data) (continued)

The fair value for stock options granted in 2005, 2004 and 2003 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2005	2004	2003
Risk-free interest rate	3.89%	3.77%	2.88%
Dividend yield	0.00%	0.00%	0.00%
Expected common stock market price volatility factor	.99	.98	.89
Weighted average expected life of stock options	5 years	5 years	5 years

The per share weighted average fair value of stock options granted in 2005, 2004 and 2003 was \$2.45, \$4.24 and \$2.13, respectively.

On December 14, 2005, the Board of Directors approved the acceleration of the vesting of 42,200 outstanding options with exercise prices ranging from \$2.99 to \$6.75 per share. At the date of the acceleration of vesting, 9,000 of these shares were in-the-money by \$0.38 per share or a total of \$3. These options had been issued to employees during 2001 and 2002 under the 1997 Stock Plan and would otherwise have vested during 2006 and 2007. No compensation expense was required to be recorded in our consolidated financial statements during 2005 related to this action. Upon adoption of SFAS No. 123R, *Share Based Payments*, on January 1, 2006, we would have recorded compensation expense of approximately \$106 during 2006 and 2007 related to these options had we not accelerated their vesting. Of the total options for which we accelerated the vesting, 12,000 are held by two of our executive officers. None of the other accelerated options are held by our executive officers or directors. As a result of this action, as of December 31, 2005, all of our outstanding options are now exercisable. The Board of Directors accelerated the vesting of these options due to their concern that future compensation expense to be recorded in our financial statements upon the vesting of these options would be significantly in excess of the monetary value that would be ultimately realized by the optionees upon exercise of the underlying stock options due to a number of factors, the most significant of which was the volatility of our common stock share price.

## New Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 151, *Inventory Costs—An Amendment of ARB No. 43, Chapter 4*, ("SFAS No. 151")

which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Under SFAS No. 151, such items will be recognized as current-period charges. In addition, the Statement requires that allocation of fixed production overheads to the costs of manufacturing be based on normal capacity of the production facilities. This Statement will be effective for the Company for inventory costs incurred on or after January 1, 2006. We do not expect the adoption of this standard to have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-2, *Accounting and Disclosure for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* ("FSP FAS 109-2"). The American Jobs Creation Act ("AJCA") introduced a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. During the second quarter of 2005, we completed our evaluation and determined that we would not benefit from the repatriation provisions provided by AJCA. Although AJCA also provides a special tax deduction related to our qualified production activity income, we will not benefit from this provision until our U.S. federal income tax net operating loss carryforwards have been fully utilized. AJCA's transitional rules applicable to the extraterritorial income exclusion regime will apply to us through 2006.

In December 2004, the FASB issued SFAS No. 123R (revised 2004), *Share-Based Payment*, ("SFAS No. 123R") which amends SFAS No. 123 and supersedes Accounting Principles Board ("APB") Opinion No. 25. SFAS No. 123R requires employee share-based equity awards to be accounted for under the fair value method, and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB Opinion No. 25 and allowed under the original provisions of SFAS No. 123. SFAS No. 123R requires the use of an option pricing model for estimating fair value, which is then amortized to expense over the service periods. SFAS 123R will be applicable to us for annual reporting periods that begin after December 15, 2005.

As previously mentioned, we currently apply APB Opinion No. 25 in accounting for our stock compensation plans. Accordingly, no compensation expense has been recognized for employee stock options issued with exercise

prices equal to the market price on the date of grant. We do not expect the adoption of this standard to have a material impact on our consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections—a Replacement of APB Opinion No. 20 and FASB Statement No. 3*, (“SFAS No. 154”). SFAS No. 154 replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for the reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in an accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS No. 154 will be effective for accounting changes and corrections of errors occurring in fiscal years beginning after December 15, 2005.

### (3) MAJOR CUSTOMERS

Texas Instruments Inc. accounted for 16%, 16% and 11% of our consolidated net revenues in 2005, 2004 and 2003, respectively. Teradyne Inc. accounted for 11% of our net consolidated revenues in 2004. Agilent Technologies Inc. accounted for 18% of our consolidated net revenues in 2003. While all three of our operating segments sold to these customers, these revenues were primarily generated by our manipulator/docking hardware and tester interface segments. During the years ended December 31, 2005, 2004 and 2003, no other customer accounted for 10% or more of our consolidated net revenues.

### (4) INVENTORIES

Inventories held at December 31 were comprised of the following:

	2005	2004
Raw materials	\$4,835	\$7,488
Work in process	418	289
Inventory consigned to others	205	541
Finished goods	777	1,083
	<u>\$6,235</u>	<u>\$9,401</u>

### (5) OTHER ACCRUED EXPENSES

Other accrued expenses consist of the following:

	December 31,	
	2005	2004
Accrued rent	\$ 274	\$200
Accrued professional fees	249	152
Accrued customer obligations	247	191
Accrued repairs	153	153
Other	349	197
	<u>\$1,272</u>	<u>\$893</u>

### (6) DEBT

*Line of Credit.* As of December 31, 2005, we had a secured credit facility which provided for maximum borrowings of \$250. We have not utilized this facility to borrow any funds. Our only usage consists of the issuance of two letters of credit in the face amounts of \$200 and \$50, respectively. We pay a quarterly fee of 1.5% per annum on the total amount of the outstanding letters of credit. The terms of the credit facility require that we maintain a minimum level of \$200 of cash with the bank. This credit facility expires on September 30, 2006.

*Letters of Credit.* As of December 31, 2005 and 2004 we had an outstanding letter of credit in the amount of \$200. This letter of credit was originally issued in December 2000 as a security deposit under a lease that our Temptronic subsidiary entered into for its new facility in Sharon, Massachusetts. This letter of credit expires January 1, 2007; however, the terms of the lease require that the letter of credit be renewed at least thirty days prior to its expiration date for successive terms of not less than one year throughout the entire lease term, which ends February 28, 2011.

As of December 31, 2005 and 2004 we also had an outstanding letter of credit in the amount of \$50. This letter of credit was issued in September 2004 as a portion of the security deposit under a lease that we entered into for a new facility for our tester interface operation based in northern California. We occupied this facility in late January 2005. This letter of credit expires September 13, 2006; however, the terms of the lease require that the letter of credit be renewed at least thirty days prior to its expiration date for successive terms of not less than one

# Notes to Consolidated Financial Statements

(In thousands, except share and per share data) (continued)

year until June 30, 2012, which is sixty days after the expiration of the lease term. However, providing that as of December 31, 2008, there have been no events of default or late payments of rent, we can request that the letter of credit be reduced to \$0 at that time.

*Capital Lease Obligations.* In January 2001, we entered into two capital lease agreements to finance equipment purchases. In December 2004, we entered into an additional capital lease agreement to finance the purchase of a vehicle. The minimum lease payments under the capital leases in effect at December 31, 2005 are as follows:

2006	\$25
2007	8
2008	8
2009	8
2010	1
Total minimum lease payments	50
Less: Amount representing interest	3
Present value of minimum lease payments	47
Less: Current portion of capital leases	24
Obligations under capital lease, excluding current portion	\$23

## (7) LEASEHOLD IMPROVEMENTS AND DEFERRED RENT

In accordance with FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*, we record tenant improvements made to our leased facilities based on the amount of the total cost to construct the improvements regardless of whether a portion of that cost was paid through an allowance provided by the facility's landlord. The amount of the allowance, if any, is recorded as deferred rent. We amortize deferred rent on a straight-line basis over the lease term and record the amortization as a reduction of rent expense.

In addition, certain of our operating leases contain predetermined fixed escalations of minimum rentals during the original lease terms. For these leases, we recognize the related rental expense on a straight-line basis over the life of the lease and record the difference between the amounts charged to operations and amounts paid as accrued rent which is included in other accrued expenses on our balance sheet.

During 2005, we recorded \$854 of additions to our leasehold improvements which were paid for on our behalf by the landlord of our new facility in San Jose, California. We

occupied this facility during the first quarter of 2005. We also recorded this amount as deferred rent. Amortization of deferred rent for 2005 was \$107.

## (8) COMMITMENTS AND CONTINGENCIES

*Operating Lease Commitments.* We lease our offices, warehouse facilities, automobiles and certain equipment under noncancellable operating leases which expire at various dates through 2012. Total rental expense for the years ended December 31, 2005, 2004 and 2003 was \$1,855, \$2,131 and \$2,076, respectively.

The aggregate minimum rental commitments under the noncancellable operating leases in effect at December 31, 2005 are as follows:

2006	\$1,730
2007	\$1,593
2008	\$1,571
2009	\$1,559
2010	\$1,346
Thereafter	\$ 495

*Minimum Purchase Commitments.* On June 1, 2004, we entered into an exclusive rights agreement to market and sell certain products which are the proprietary and confidential designs of one of the suppliers of our tester interface division. The terms of this agreement include payment of a \$150 nonrefundable fee and certain minimum purchase requirements (as set forth below). If we fail to satisfy the minimum purchase requirements, the supplier has the right to terminate our exclusive right to market and sell these products.

The minimum purchase requirements are applicable to the forty-eight month period beginning April 1, 2006 and are as follows:

2006	\$164
2007	\$383
2008	\$438
2009	\$438
2010	\$110

*Contingencies.* As part of a prior contractual arrangement with a former executive of a subsidiary, we have agreed to provide life insurance in the amount of \$300 to this former executive until he reaches the age of sixty-five. The provision of this life insurance benefit is self-insured by us. As of December 31, 2005, this individual was sixty-three years old. No amounts have been recorded by us for this contingency as of December 31, 2005.

## (9) RESTRUCTURING AND OTHER COSTS

During the fourth quarter of 2004, we began the process of restructuring our operations with the goal of significantly reducing our fixed operating costs to position ourselves to more effectively meet the needs and expectations of the fluid ATE market. In mid-November 2004, we announced organization changes and cost structure adjustments (the "2004 Workforce Reduction"). In mid-March 2005, we announced our decision to close our U.K. operations (the "UK Operation Closure"). In late July 2005, we made certain cost structure adjustments at our facility in San Jose, California (the "California Workforce Reduction").

**2004 Workforce Reduction.** In the quarter ended December 31, 2004, we accrued \$527 for severance and related costs resulting from the termination of 43 domestic and 2 foreign employees. Of this amount, \$266 was paid during the fourth quarter of 2004 and \$261 remained accrued as of December 31, 2004. The severance and related costs were comprised of \$383 in our Manipulator/Docking Hardware segment, \$100 in our Temperature Management segment and \$44 in our Tester Interface segment.

**U.K. Operation Closure.** In the quarter ended December 31, 2004, we recorded an impairment of long-lived assets of \$100 related to our U.K. operation, which is part of our Manipulator/Docking Hardware segment. Due to the history of operating losses experienced by our U.K. operation, combined with our forecasts that indicated potential future losses for this operation, we performed an assessment of the recoverability of the carrying value of this operation's long-lived assets. These long-lived assets consisted of property and equipment. In March 2005, we announced our intention to close our U.K. operation. We closed this operation during the quarter ended June 30, 2005. During 2005, we accrued \$234 for severance and related costs and \$303 for lease termination costs. The \$205 accrual remaining at December 31, 2005 relates primarily to estimated lease termination costs. In accordance with SFAS No. 146, our accrual for lease termination costs includes an estimate of future rental income from a sub-lease arrangement. However, at December 31, 2005, we had not sub-leased this facility. Our U.K. operation is included in our Manipulator/Docking Hardware segment.

**California Workforce Reduction.** In the quarter ended September 30, 2005 we accrued \$35 for severance and related costs resulting from the termination of six employees at our facility in San Jose, California. This entire amount was paid out during the third quarter of 2005. Our facility in San Jose is the headquarters for our tester interface product segment.

Our restructuring and other costs for 2005 and 2004 are summarized as follows:

	2004 Workforce Reduction	U.K. Operation Closure	California Workforce Reduction	Total
Balance—				
January 1, 2004	\$ —	\$ —	\$ —	\$ —
Accruals in 2004	527	—	—	527
Severance and other cash payments	(266)	—	—	(266)
Balance—				
December 31, 2004	\$ 261	\$ —	\$ —	\$ 261
Accruals in 2005	—	537	35	572
Severance and other cash payments	(261)	(332)	(35)	(628)
Balance—				
December 31, 2005	\$ —	\$ 205	\$ —	\$ 205

## (10) INCOME TAXES

We are subject to Federal and certain state income taxes. In addition, we are taxed in certain foreign countries. The cumulative amount of undistributed earnings of our foreign subsidiaries for which U.S. income taxes have not been provided was \$950, \$2,896 and \$1,732 at December 31, 2005, 2004 and 2003, respectively.

Income (loss) before income taxes was as follows:

	Years Ended December 31,		
	2005	2004	2003
Domestic	\$(4,171)	\$ 128	\$(3,106)
Foreign	787	1,540	(504)
	<u>\$(3,384)</u>	<u>\$1,668</u>	<u>\$(3,610)</u>

## Notes to Consolidated Financial Statements

(In thousands, except share and per share data) (continued)

Income tax expense was as follows:

	Years Ended December 31,		
	2005	2004	2003
Current			
Domestic—Federal	\$(229)	\$ —	\$ 185
Domestic—state	(9)	—	—
Foreign	474	398	216
	<u>236</u>	<u>398</u>	<u>401</u>
Deferred:			
Domestic—Federal	—	—	1,371
Domestic—state	—	—	69
	<u>—</u>	<u>—</u>	<u>1,440</u>
Income tax expense	<u>\$ 236</u>	<u>\$ 398</u>	<u>\$ 1,841</u>

Deferred income taxes reflect the net tax effect of net operating loss and credit carryforwards and temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The following is a summary of the significant components of our deferred tax assets and liabilities as of December 31, 2005 and 2004:

	December 31,	
	2005	2004
Deferred tax assets:		
Net operating loss (Federal, state and foreign)	\$ 2,397	\$ 1,740
Inventories	421	775
Accrued vacation pay	161	166
Foreign tax credit carryforward	547	249
Accrued warranty	270	334
Allowance for doubtful accounts	64	53
Accrued bonuses	—	117
Depreciation of property and equipment	427	9
Other	12	11
	<u>4,299</u>	<u>3,454</u>
Valuation allowance	(4,048)	(3,404)
Deferred tax assets	<u>251</u>	<u>50</u>
Deferred tax liabilities:		
Unremitted earnings of foreign subsidiaries	(207)	—
Accrued royalty income	(44)	(50)
Deferred tax liabilities	<u>(251)</u>	<u>(50)</u>
Net deferred tax asset	<u>\$ —</u>	<u>\$ —</u>

The valuation allowance for deferred tax assets as of the beginning of 2005 and 2004 was \$3,404 and \$3,191, respectively. The net change in the valuation allowance for the years ended December 31, 2005 and 2004 was an increase of \$644 and \$213, respectively. In assessing the ability to realize the deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. In order to fully realize the total deferred tax assets, we will need to generate future taxable income prior to the expiration of net operating loss and credit carryforwards which expire in various years through 2025. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the temporary differences are deductible, we believe it is more likely than not that we will not realize the benefit of the deferred tax asset and, as a result, have recorded a full valuation allowance at December 31, 2005.

An analysis of the effective tax rate for the years ended December 31, 2005, 2004 and 2003 and a reconciliation from the expected statutory rate of 34% is as follows:

	Years Ended December 31,		
	2005	2004	2003
Expected income tax provision at U.S. statutory rate	\$(1,151)	\$ 567	\$(1,227)
Increase (decrease) in tax from:			
Federal credits	(229)	—	185
State credit	(6)	—	—
Repatriation of international earnings	423	—	—
Foreign income tax rate differences	207	(126)	571
Effects of NOL and tax credit carryforwards and changes in valuation allowance	965	71	2,327
Extraterritorial income exclusion	(34)	(146)	(13)
Nondeductible expenses	61	32	19
Other	—	—	(21)
Income tax expense	<u>\$ 236</u>	<u>\$ 398</u>	<u>\$ 1,841</u>



## (11) LEGAL PROCEEDINGS

From time to time we may be a party to legal proceedings occurring in the ordinary course of business. We are not currently involved in any legal proceedings the resolution of which we believe could have a material effect on our business, financial position, results of operations or long-term liquidity.

On March 14, 2003, we settled and dismissed a suit we had initiated in December 2000 against Credence Systems Corporation claiming infringement of our U.S. patent number 4,589,815. Pursuant to the settlement, Credence made a cash payment to us in March 2003, and we established non-exclusive, fully paid cross-licensing agreements with respect to certain patents. In addition, Credence has agreed to utilize our manipulators with its ASL 3000 family of test systems.

## (12) RELATED PARTY TRANSACTIONS

On June 30, 2005, in connection with the closing of our U.K. manufacturing operation, we sold certain assets of this operation, including the machine shop assets, to the then managing director of our U.K. manufacturing operation for \$132. In connection with this transaction, we took back a \$132 note receivable with a five-year term with interest payable quarterly at the rate of 4.5%. At December 31, 2005, the balance outstanding under this note receivable was \$101 with interest receivable of \$3.

We paid consulting fees which totaled \$0, \$33 and \$107 during the years ended December 31, 2005, 2004 and 2003, respectively, to one individual who is a member of our Board of Directors.

Some of our foreign subsidiaries paid directors' fees to individuals who are our executive officers which totaled \$0, \$24 and \$52 during the years ended December 31, 2005, 2004 and 2003, respectively.

Temptronic has transactions in the normal course of business with Hakuto Co. Ltd ("Hakuto") and its subsidiaries. As of December 31, 2003, Hakuto owned 646,311 shares of our outstanding stock, all of which they sold during 2004. As a result, as of December 31, 2004, Hakuto was no longer considered a related party. During the years ended December 31, 2004 and 2003 Temptronic sold product at market prices to Hakuto and its subsidiaries totaling approximately \$3,016 and \$2,170, respectively. At December 31, 2004 accounts receivable from Hakuto and its subsidiaries amounted to approximately \$58.

## (13) STOCK-BASED COMPENSATION PLAN

The Amended and Restated 1997 Stock Plan (the "Plan") provides for the granting of incentive stock options and non-qualified stock options to purchase shares of our common stock and for other stock-based awards to key employees and directors and to non-employee consultants. The Plan consists of two parts: the Non-Qualified Plan (administered by our Board of Directors) and the Key Employee Plan (administered by the Compensation Committee of our Board of Directors). We have reserved 1,250,000 shares of common stock for issuance upon exercise of options or stock awards under the Plan.

*Restricted Stock Awards.* During the fourth quarter of 2004, we began granting shares of restricted stock under the Plan to certain directors, officers and key employees. As of December 31, 2005, we had granted a total of 260,000 shares of restricted stock, net of forfeitures of unvested shares. The fair value of these shares at the date of grant was recorded as deferred stock compensation in the consolidated financial statements. These shares vest over four years (twenty-five percent on each anniversary date). During 2005 and 2004, we granted a total of 35,000 and 230,000 shares with weighted average grant-date fair values of \$3.69 and \$4.80, respectively. Net compensation expense recognized related to these shares during 2005 and 2004 was \$277 and \$23, respectively.

*Options.* No option may be granted with an exercise period in excess of ten years from the date of grant. Generally, incentive stock options will be granted with an exercise price equal to the fair market value on the date of grant. The exercise price of non-qualified stock options will be determined by either the Board of Directors or the Compensation Committee of the Board of Directors. The options that have been issued under the Plan generally vest 20% one year from date of grant and 20% in each of the succeeding four years.

In connection with our merger with Temptronic, outstanding incentive and non-qualified stock options to acquire Temptronic common stock were converted into 175,686 stock options to acquire our stock at a conversion ratio of 0.925, with appropriate adjustment to the exercise price. These stock options, which are not subject to the Plan, generally vest over four to five years.

# Notes to Consolidated Financial Statements

(In thousands, except share and per share data) (continued)

On August 16, 2002, we commenced a voluntary stock option exchange program for certain of our eligible employees and directors. Under the program, eligible employees and directors were given the right to forfeit certain outstanding stock options previously granted to them at an exercise price greater than or equal to \$9.5625 per share, in exchange for the right to receive a new option to buy shares of our common stock to be granted on February 24, 2003. In total, 340,000 stock options were canceled on August 23, 2002 as a result of this program and 340,000 stock options were granted on February 24, 2003. The exchange program did not result in additional compensation charges or variable option plan accounting, as it was designed to comply with Interpretation No. 44, *Accounting for Certain Transactions Involving Stock-Based Compensation*. The new options had an exercise price equal to the fair market value of our common stock on the new grant date, so no compensation expense was recorded as a result of the exchange program. The new options were 50% vested on the date of grant and will vest an additional 25% on the first and second anniversary of the grant.

The following table summarizes the stock option activity for the three years ended December 31, 2005:

	Number of Shares	Weighted Average Exercise Price
Options outstanding, January 1, 2003 (365,715 exercisable)	692,075	\$4.20
Granted	340,000	3.04
Exercised	(37,500)	3.70
Canceled	(26,700)	4.07
Options outstanding, December 31, 2003 (597,725 exercisable)	967,875	3.82
Granted	20,000	3.04
Exercised	(232,659)	3.70
Canceled	(54,750)	4.07
Options outstanding, December 31, 2004 (522,166 exercisable)	700,466	3.82
Granted	10,000	3.25
Exercised	(30,091)	3.11
Canceled	(50,775)	4.26
Options outstanding, December 31, 2005 (629,600 exercisable)	629,600	3.87

The following table summarizes information about stock options outstanding at December 31, 2005:

Range of Exercise Prices	Number Outstanding at December 31, 2005	Weighted Average Remaining Life	Weighted Average Exercise Price of Outstanding Options	Number Exercisable at December 31, 2005	Weighted Average Exercise Price of Exercisable Options
\$2.99–\$3.35	394,750	6.75 years	\$3.12	394,750	\$3.12
\$3.61–\$4.25	106,000	4.72 years	\$3.99	106,000	\$3.99
\$5.66–\$6.75	128,850	3.61 years	\$6.07	128,850	\$6.07
	<u>629,600</u>		\$3.87	<u>629,600</u>	\$3.87

## (14) EMPLOYEE BENEFIT PLANS

We have a defined contribution 401(k) plan for our employees who work in the U.S. (the "inTEST 401(k) Plan"). All permanent employees of inTEST Corporation and inTEST Silicon Valley Corp. who are at least 18 years of age are eligible to participate in the plan. During the second and third quarters of 2004, we matched employee contributions dollar for dollar up to 10% of the employee's annual compensation, with a maximum limit of \$5. Matching contributions are discretionary. Both at the present time

and at various points in time in the past, these matching contributions have been temporarily suspended as a part of our cost containment efforts. The most recent suspension of the matching contribution was implemented at the beginning of the fourth quarter of 2004. Effective January 1, 2006, the plan was amended to reduce the vesting period for employer contributions from six years to four years. We contributed \$0, \$231 and \$0 to the plan for the years ended December 31, 2005, 2004 and 2003, respectively.

Temptronic adopted a defined contribution 401(k) plan for its domestic employees in 1988, that was merged into the inTEST 401(k) Plan effective September 1, 2002. The inTEST 401(k) Plan retains the matching provisions of the prior Temptronic plan for all Temptronic employees. The eligibility and vesting provisions of the prior Temptronic plan have been conformed to those for inTEST Corporation and inTEST Silicon Valley Corporation employees. Temptronic can make discretionary matching contributions determined annually by Temptronic of up to 6% of the employees' annual compensation. Effective October 1, 2001, we suspended the employer matching contributions due to our cost containment efforts. Matching contributions were reinstated in April 2004 but were suspended again at the end of November 2004. Temptronic contributed \$0, \$52 and \$0 to the plan for the years ended December 31, 2005, 2004 and 2003, respectively.

In addition to the employer matching for which Temptronic employees are eligible, upon the termination of the Temptronic Equity Participation Plan ("EPP"), we also acknowledged that it was our intention to contribute \$3,000 in the aggregate to the inTEST 401(k) Plan as a form of profit sharing (not to exceed \$300 per year) for the benefit of Temptronic employees. The amount of these contributions approximates the amount that we had been committed to contribute to the EPP as of its termination date. All such profit sharing contributions are at the discretion of management, and will be allocated to employees annually in the same manner in which the shares held by the EPP had been allocated. The vesting provisions for these contributions will be the same as those of the inTEST 401(k) Plan. Accruals for profit sharing contributions totaling \$150 were made during the second half of 2004. Accruals for profit sharing contributions totaling \$300 were made during 2005. We funded \$375 of these obligations through the use of 91,071 treasury shares during 2005. We expect to fund the balance of this obligation through the use of additional treasury shares during the first quarter of 2006.

## (15) SEGMENT INFORMATION

We have three reportable segments: Manipulator/Docking Hardware Products, Temperature Management Systems and Tester Interface Products. The Manipulator and Docking Hardware segment includes the operations of our Cherry Hill, New Jersey manufacturing facility as well as the operations of four of our foreign subsidiaries: inTEST Limited (U.K.), inTEST Kabushiki Kaisha (Japan), inTEST PTE, Limited (Singapore) and Intestlogic GmbH (Germany). We closed our U.K. operation during the quarter ended June 30, 2005. Sales of this segment consist primarily of manipulator and docking hardware products which we design, manufacture and market, as well as certain other related products which we design and market, but which are manufactured by third parties. The Temperature Management segment includes the operations of Temptronic in Sharon, Massachusetts as well as Temptronic GmbH (Germany). (This operation was formerly known as inTEST GmbH.) Sales of this segment consist primarily of temperature management systems which we design, manufacture and market under our Temptronic product line. In addition, this segment provides after sale service and support, which is paid for by its customers. The Tester Interface segment includes the operations of inTEST Silicon Valley Corporation. (This operation was formerly known as inTEST Sunnyvale Corp. In the first quarter of 2005, we renamed this operation in connection with its relocation from Sunnyvale, California to San Jose, California). Sales of this segment consist primarily of tester interface products which we design, manufacture and market under our TestDesign product line.

We operate our business worldwide, and all three segments sell their products both domestically and internationally. All three segments sell to semiconductor manufacturers and ATE manufacturers.

Intercompany pricing between segments is either a multiple of cost for component parts or a percentage discount from list price for finished goods.

# Notes to Consolidated Financial Statements

(In thousands, except share and per share data) (continued)

As of January 1, 2005, we implemented a new cost allocation structure, the effect of which is to better allocate operating expenses to the appropriate product segment. We have reclassified the amounts shown for the prior periods to be consistent with our new cost allocation structure.

	Years Ended December 31,		
	2005	2004	2003
<i>Net revenues from unaffiliated customers:</i>			
Manipulator/Docking Hardware	\$28,838	\$38,414	\$24,364
Temperature Management	19,967	22,581	16,780
Tester Interface	6,778	13,516	11,132
Intersegment sales	(2,224)	(3,300)	(4,248)
	<u>\$53,359</u>	<u>\$71,211</u>	<u>\$48,028</u>
<i>Intersegment sales:</i>			
Manipulator/Docking Hardware	\$ 1	\$ 53	\$ 10
Temperature Management	1,863	1,599	1,317
Tester Interface	360	1,648	2,921
	<u>\$ 2,224</u>	<u>\$ 3,300</u>	<u>\$ 4,248</u>
<i>Depreciation/amortization:</i>			
Manipulator/Docking Hardware	\$ 1,020	\$ 1,166	\$ 1,085
Temperature Management	459	508	523
Tester Interface	394	432	419
	<u>\$ 1,873</u>	<u>\$ 2,106</u>	<u>\$ 2,027</u>
<i>Operating income (loss):</i>			
Manipulator/Docking Hardware	\$ (316)	\$ 674	\$ (2,611)
Temperature Management	396	132	(1,849)
Tester Interface	(3,251)	1,169	882
Corporate	(391)	(309)	(256)
	<u>\$ (3,562)</u>	<u>\$ 1,666</u>	<u>\$ (3,834)</u>
<i>Earnings (loss) before income taxes:</i>			
Manipulator/Docking Hardware	\$ (226)	\$ 673	\$ (2,506)
Temperature Management	503	228	(1,733)
Tester Interface	(3,270)	1,076	885
Corporate	(391)	(309)	(256)
	<u>\$ (3,384)</u>	<u>\$ 1,668</u>	<u>\$ (3,610)</u>
<i>Income tax expense (benefit):</i>			
Manipulator/Docking Hardware	\$ 222	\$ 258	\$ 1,242
Temperature Management	52	140	376
Tester Interface	(38)	—	223
Corporate	—	—	—
	<u>\$ 236</u>	<u>\$ 398</u>	<u>\$ 1,841</u>
<i>Net earnings (loss):</i>			
Manipulator/Docking Hardware	\$ (448)	\$ 415	\$ (3,748)
Temperature Management	451	88	(2,109)
Tester Interface	(3,232)	1,076	662
Corporate	(391)	(309)	(256)
	<u>\$ (3,620)</u>	<u>\$ 1,270</u>	<u>\$ (5,451)</u>
<i>Capital expenditures:</i>			
Manipulator/Docking Hardware	\$ 222	\$ 1,426	\$ 560
Temperature Management	175	457	728
Tester Interface	1,051	443	369
	<u>\$ 1,448</u>	<u>\$ 2,326</u>	<u>\$ 1,657</u>

	December 31,	
	2005	2004
<i>Identifiable assets:</i>		
Manipulator/Docking Hardware	\$18,533	\$19,907
Temperature Management	8,353	8,507
Tester Interface	3,983	4,753
	<u>\$30,869</u>	<u>\$33,167</u>

The following table provides information about our geographic areas of operation. Net revenues from unaffiliated customers are based on the location of the selling entity.

	Years Ended December 31,		
	2005	2004	2003
<i>Net revenues from unaffiliated customers:</i>			
U.S.	\$36,894	\$54,123	\$36,762
Europe	6,050	7,343	4,584
Asia-Pacific	10,415	9,745	6,682
	<u>\$53,359</u>	<u>\$71,211</u>	<u>\$48,028</u>

	December 31,	
	2005	2004
<i>Long-lived assets:</i>		
U.S.	\$ 3,629	\$ 3,711
Europe	266	739
Asia-Pacific	56	104
	<u>\$ 3,951</u>	<u>\$ 4,554</u>

## (16) QUARTERLY CONSOLIDATED FINANCIAL DATA (Unaudited)

The following tables present certain unaudited consolidated quarterly financial information for each of the eight quarters ended December 31, 2005. In our opinion, this quarterly information has been prepared on the same basis as the consolidated financial statements and includes all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the information for the periods presented. The results of operations for any quarter are not necessarily indicative of results for the full year or for any future period.

Year-over-year quarterly comparisons of our results of operations may not be as meaningful as the sequential quarterly comparisons set forth below that tend to reflect the cyclical activity of the semiconductor industry as a whole. Quarterly fluctuations in expenses are related directly to sales activity and volume and may also reflect the timing of operating expenses incurred throughout the year.

	Quarters Ended				Total
	3/31/05 <sup>(1)</sup>	6/30/05 <sup>(2)</sup>	9/30/05 <sup>(3)</sup>	12/31/05 <sup>(4)</sup>	
Net revenues	\$10,685	\$12,155	\$16,448	\$14,071	\$53,359
Gross margin	3,137	4,218	6,469	5,902	19,726
Earnings (loss) before income taxes	(2,406)	(1,912)	516	418	(3,384)
Income tax expense (benefit)	6	(119)	123	226	236
Net earnings (loss)	(2,412)	(1,793)	393	192	(3,620)
Net earnings (loss) per common share—basic	\$ (0.28)	\$ (0.21)	\$ 0.05	\$ 0.02	\$ (0.41)
Weighted average common shares outstanding—basic	8,722,205	8,745,042	8,823,979	8,932,384	8,806,528
Net earnings (loss) per common share—diluted	\$ (0.28)	\$ (0.21)	\$ 0.04	\$ 0.02	\$ (0.41)
Weighted average common shares outstanding—diluted	8,722,205	8,745,042	8,911,672	9,005,557	8,806,528

	Quarters Ended				Total
	3/31/04 <sup>(5)</sup>	6/30/04 <sup>(6)</sup>	9/30/04 <sup>(7)</sup>	12/31/04 <sup>(8)</sup>	
Net revenues	\$ 17,008	\$ 22,714	\$ 19,509	\$ 11,980	\$ 71,211
Gross margin	7,211	10,416	7,783	3,380	28,790
Earnings (loss) before income taxes	1,123	3,185	857	(3,497)	1,668
Income tax expense (benefit)	125	680	(384)	(23)	398
Net earnings (loss)	998	2,505	1,241	(3,474)	1,270
Net earnings (loss) per common share—basic	\$ 0.12	\$ 0.30	\$ 0.15	\$ (0.40)	\$ 0.15
Weighted average common shares outstanding—basic	8,362,725	8,362,857	8,500,225	8,691,301	8,479,914
Net earnings (loss) per common share—diluted	\$ 0.11	\$ 0.29	\$ 0.14	\$ (0.40)	\$ 0.14
Weighted average common shares outstanding—diluted	8,724,290	8,703,903	8,902,440	8,691,301	8,804,479

*Footnotes*

(1) The quarter ended March 31, 2005 included \$100 of restructuring charges.

(2) The quarter ended June 30, 2005 included \$320 of restructuring charges and a tax benefit of \$191 related to a domestic income tax refund received during the quarter.

(3) The quarter ended September 30, 2005 included \$559 of inventory obsolescence charges, \$28 of restructuring charges and a tax benefit of \$52 related to a domestic income tax refund received during the quarter.

(4) The quarter ended December 31, 2005 included \$124 of restructuring charges.

(5) The quarter ended March 31, 2004 included \$392 of product warranty expense.

(6) The quarter ended June 30, 2004 included \$548 of inventory obsolescence charges and \$493 of product warranty expense.

(7) The quarter ended September 30, 2004 included \$446 of inventory obsolescence charges and \$642 of product warranty expense.

(8) The quarter ended December 31, 2004 included \$456 of product warranty expense and \$627 of restructuring and other charges.

## LEGAL COUNSEL

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Philadelphia, PA 19102-2186

## INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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## TRANSFER AGENT

Computershare Investor Services  
P. O. Box 43023  
Providence, RI 02940-3023  
877-282-1168

## INVESTOR RELATIONS

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New York, NY 10017  
646-536-7000  
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## FORM 10-K

A copy of our Annual Report on Form 10-K, as filed with the Securities and Exchange Commission, is available (without exhibits) without charge upon written request to: Investor Relations  
inTEST Corporation  
7 Esterbrook Lane  
Cherry Hill, NJ 08003

Our Annual Report on Form 10-K is also available through our website, [www.intest.com](http://www.intest.com).

## ANNUAL STOCKHOLDERS' MEETING

Our 2006 Annual Meeting of Stockholders will be held at 11:00 A.M. Eastern Daylight Time on Wednesday, August 2, 2006, at our offices, 7 Esterbrook Lane, Cherry Hill, NJ 08003.

## COMMON STOCK—MARKET PRICE AND DIVIDENDS

Our common stock is traded on the Nasdaq National Market under the symbol "INTT." The following table sets forth the high and low sale prices of our common stock, as reported on the Nasdaq National Market, for the periods indicated. Sale prices have been rounded to the nearest full cent.

	Sales Price	
	High	Low
<b>2005</b>		
First Quarter	\$ 4.89	\$3.88
Second Quarter	4.72	3.00
Third Quarter	4.29	3.15
Fourth Quarter	4.21	3.05
<b>2004</b>		
First Quarter	\$ 6.88	\$ 5.13
Second Quarter	6.80	5.07
Third Quarter	10.00	5.43
Fourth Quarter	9.18	3.80

On March 17, 2006, the closing price for our common stock as reported on the Nasdaq National Market was \$3.80. As of March 17, 2006, we had 9,198,241 shares outstanding that were held of record by approximately 1,200 shareholders.

We have not paid dividends on our common stock since our initial public offering in 1997, and we do not plan to pay cash dividends in the foreseeable future. Our current policy is to retain any future earnings for reinvestment in the operation and expansion of our business, including possible acquisitions of other businesses, technologies or products. Payment of any future dividends will be at the discretion of our board of directors. In addition, our current credit agreement prohibits us from paying cash dividends without the lender's prior consent.

## EXECUTIVE OFFICERS

### **Alyn R. Holt**

Chairman

### **Robert E. Matthiessen**

President and Chief Executive Officer

### **Hugh T. Regan, Jr.**

Secretary, Treasurer and Chief Financial Officer

### **Daniel J. Graham**

General Manager—Manipulator and Docking Hardware  
Product Segment

### **James Pelrin**

General Manager—Temperature Management  
Product Segment

### **Dale E. Christman**

General Manager—Tester Interface Product Segment

## BOARD OF DIRECTORS

### **Alyn R. Holt**

Chairman, inTEST Corporation

### **Robert E. Matthiessen**

President and CEO, inTEST Corporation

### **Richard O. Endres**

President, VRA, Inc., Business and Financial Planning

### **Stuart F. Daniels, Ph.D.**

Principal, The Daniels Group, Technology Assessment,  
Protection and Commercialization Consulting

### **James J. Greed, Jr.**

Principal, Foothill Technology, Consulting to the  
Semiconductor Industry

### **Thomas J. Reilly, Jr.**

Retired—Former Audit Partner at Arthur Andersen LLP

### **Joseph A. Savarese**

Retired—Former Vice President of Business Development  
for Electroglas, Inc.

### **James W. Schwartz, Esq.**

Of Counsel, Saul Ewing LLP



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