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## SL INDUSTRIES INC

## Form 10-Q

August 13, 2007

UNITED STATES<br>SECURITIES AND EXCHANGE COMMISSION<br>Washington, D.C. 20549<br>FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 1-4987

SL INDUSTRIES, INC.
(Exact Name of Registrant as Specified in Its Charter)

NEW JERSEY
(State or other jurisdiction of incorporation or organization)

21-0682685
(I.R.S. Employer

Identification No.)

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule $12 \mathrm{~b}-2$ of the Exchange Act).

Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes [ ] No [X]

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The number of shares of common stock outstanding as of August 3, 2007 was 5,689,588.

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Item 1. Financial Statements
SL INDUSTRIES, INC.CONSOLIDATED BALANCE SHEETS
June 30,

```
    Receivables, net 32,362,000
    Note receivable
    Inventories, net
    Prepaid expenses
    Deferred income taxes, net
    Total current assets
Property, plant and equipment, net
Deferred income taxes, net
Goodwill
Other intangible assets, net
Other assets and deferred charges
    Total assets
LIABILITIES
Current liabilities:
    Debt, current portion
    Accounts payable
    Accrued income taxes
    Accrued liabilities:
        Payroll and related costs
        Other
            Total current liabilities
Debt, less current portion
Deferred compensation and supplemental retirement benefits
Other liabilities
Total liabilities
Commitments and contingencies
SHAREHOLDERS' EQUITY
Preferred stock, no par value; authorized, 6,000,000 shares; none issued \$
\$ 15,560,000 15,423,000 935,000
6,964,000
7,088,000
45,970,000
-------------
2,844,000
4,141,000
52,955,000
Common stock, \(\$ 0.20\) par value; authorized, \(25,000,000\) shares;
issued, 8,298,000 shares
Capital in excess of par value
Retained earnings
Accumulated other comprehensive income (loss)
Treasury stock at cost, 2,636,000 and 2,658,000 shares, respectively
Total shareholders' equity
Total liabilities and shareholders' equity
\begin{tabular}{rr}
\(1,660,000\) & 1,66 \\
\(41,613,000\) & 40,88 \\
\(32,876,000\) & 28,39 \\
36,000 & \((2\) \\
\((20,950,000)\) & \((20,49\) \\
\(-55,235,000\) & 50,41 \\
\(---108,190,000\) & \(\$ 106,54\) \\
\hline-1
\end{tabular}
```

See accompanying notes to consolidated financial statements.

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SL INDUSTRIES, INC.
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)



2007
-------------

## OPERATING ACTIVITIES

Net income
Adjustment for losses from discontinued operations

Income from continuing operations

Adjustments to reconcile income from continuing operations to net cash provided by operating activities:

Depreciation
Amortization
Amortization of deferred financing costs
Non-cash compensation expense
Stock-based compensation
Provisions for losses on accounts receivable
Deferred compensation and supplemental retirement benefits
Deferred compensation and supplemental retirement benefit payments
Deferred income taxes
Loss on sale of equipment
Changes in operating assets and liabilities, excluding effects of business acquisition:

Accounts and note receivable
Inventories
Prepaid expenses
Other assets
Accounts payable
Accrued liabilities
Accrued income taxes

Net cash provided by operating activities from continuing operations Net cash (used in) operating activities from discontinued operations

NET CASH PROVIDED BY OPERATING ACTIVITIES

INVESTING ACTIVITIES
Acquisition of a business, net of cash acquired Purchases of property, plant and equipment

$1,150,000$
678,000
44,000
190,000
$(18,000)$
217,000
(255,000)
447,000
29,000
$(1,122,000)$
$(1,557,000)$
$(670,000)$
74,000
1,521,000
(444,000)
38,000
-------------

5,597,000
$(1,244,000)$
$4,353,000$
-------------
$(65,000)$
$(1,022,000)$


297
3,340

## -_-----

988
193

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```
NET CASH (USED IN) INVESTING ACTIVITIES
FINANCING ACTIVITIES
    Proceeds from Revolving Credit Facility
    Payments of Revolving Credit Facility
    Proceeds from stock options exercised
    Tax benefit from exercise of stock options
    Treasury stock (purchases) sales
NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES
    Effect of exchange rate changes on cash
NET CHANGE IN CASH AND CASH EQUIVALENTS
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD
CASH AND CASH EQUIVALENTS AT END OF PERIOD
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION
    Cash paid during the period for:
        Interest $ 611,000
        Income taxes
See accompanying notes to consolidated financial statements.
3
SL INDUSTRIES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
```


## 1. BASIS OF PRESENTATION

```
The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation \(S-X\). Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the accompanying financial statements contain all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation. Operating results for interim periods are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These financial statements should be read in conjunction with the Company's audited financial statements and notes thereon included in the Company's Annual Report on Form \(10-\mathrm{K}\) for the year ended December 31, 2006.
```


$17,170,000$
$(21,410,000)$ 471,000
75,000
$(282,000)$
------------
$(3,976,000)$
-----------
$(47,000)$
------------


757,000
-------------
$===========$
$\qquad$

## 2. RECEIVABLES

Receivables consist of the following:

| June 30, | December 31, |
| :---: | ---: |
| 2007 | 2006 |
| -------- | --------------1 |

(in thousands)

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| Trade receivables | \$32,804 | \$31,044 |
| :---: | :---: | :---: |
| Less: allowance for doubtful accounts | (812) | (830) |
|  | 31,992 | 30,214 |
| Other | 370 | 407 |
|  | \$32,362 | \$30,621 |

## 3. INVENTORIES <br> Inventories consist of the following:

| June 30, | December 31, |
| :---: | :---: |
| 2007 | 2006 |

(in thousands)
Raw materials
Work in process
Finished goods

Less: allowances

| $\$ 16,007$ | $\$ 15,307$ |
| ---: | ---: |
| 4,926 | 4,213 |
| 4,899 | 4,442 |
| ------ | ------ |
| 25,832 | 23,962 |
| $(3,186)$ | $(2,872)$ |
| ------- | ------- |
| $\$ 22,646$ | $\$ 21,090$ |
| $=======$ | $=======$ |

## 4. INCOME PER SHARE

The Company has presented net income per common share pursuant to the Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standard No. 128, "Earnings per Share." Basic net income per common share is computed by dividing reported net income
available to common shareholders by the weighted average number of shares outstanding for the period.

Diluted net income per common share is computed by dividing reported net income available to common shareholders by the weighted average shares outstanding for the period, adjusted for the dilutive effect of common stock equivalents, which consist of stock options, using the treasury stock method.

The table below sets forth the computation of basic and diluted net income per share:

| 2007 | 2006 |
| :---: | :---: |

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For the six-month period ended June 30,2007 , no stock options were excluded from the dilutive computations because there were no option exercise prices greater than the average market price of the Company's common stock. For the six-month period ended June $30,2006,6,250$ stock options were excluded from the dilutive computations because the option exercise prices were greater than the average market price of the Company's common stock.

STOCK-BASED COMPENSATION

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard No. 123(R), "Share-Based Payment" ("SFAS No. $123(R) ")$, using the modified prospective application method. Prior to adopting SFAS No. 123(R), the Company followed the intrinsic
value method of accounting for stock-based employee compensation in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations.

The Company maintains two shareholder approved stock option plans: the

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Non-Employee Director Nonqualified Stock Option Plan (the "Director Plan") and the Long-Term Incentive Plan (the "1991 Incentive Plan"). Both plans have expired; however, stock options issued under each plan remain outstanding

The Director Plan provided for the granting of nonqualified options to purchase up to 250,000 shares of the Company's common stock to non-employee directors of the Company in lieu of paying quarterly retainer fees and regular quarterly meeting attendance fees, when elected. The Director Plan enabled the Company to grant options, with an exercise price per share not less than fair market value of the Company's common stock on the date of grant, which are exercisable at any time. Each option granted under the Director Plan expires no later than ten years from date of grant. The expiration date of the Director Plan was May 31, 2003. The 1991 Incentive Plan enabled the Company to grant either nonqualified options, with an exercise price per share established by the Board's Compensation Committee, or incentive stock options, with an exercise price per share not less than the fair market value of the Company's common stock on the date of grant, which are exercisable at any time. Each option granted under the 1991 Incentive Plan expires no later than ten years from date of grant. The Plan expired on September 25, 2001 and no future options can be granted under the Plan.

During 2005, the Company issued, to a newly retained executive, 25,000 incentive stock options in accordance with the rules and regulations of the Securities and Exchange Commission. At December 31, 2006, approximately 12,000 of these options were vested. These options were forfeited, unexercised, in March 2007.

For the six months ended June 30 , 2007 , the Company did not recognize any stock-based employee compensation expense under the provisions of the SFAS No. $123(R)$. For the six months ended June 30, 2006, the Company recognized stock-based employee compensation expense of $\$ 33,000$, less a related income tax benefit of approximately $\$ 13,000$ under the provisions of the SFAS No. 123(R). Under this standard, excess income tax benefits related to share-based compensation expense that must be recognized directly in equity are treated as cash flow from financing rather than operating activities. Also, the Company has recognized an expense of approximately $\$ 369,000$ and a benefit of approximately $\$ 28,000$ in the three-month periods ended June 30, 2007 and June 30, 2006, respectively, and expenses of approximately $\$ 190,000$ and $\$ 36,000$ in the six-month periods ended June 30,2007 and June 30,2006 , respectively, in compensation expense related to certain stock-based compensation arrangements.

The following table summarizes stock option activity for all plans:

|  | Weighted Average | Weighted Average | Aggregate |
| :---: | :---: | :---: | :---: |
| Outstanding | Exercise | Remaining | Intrinsic |
| Options | Price | Life | Value |

Outstanding as of December 31, 2006
Granted
Exercised

| 528 | $\$ 10.30$ | 3.80 |
| :---: | ---: | ---: |
| -- | -- |  |
| $(40)$ | $\$ 11.80$ |  |
| $(12)$ | $\$ 17.01$ |  |
| -- | -- |  |
| ---- | $-\quad-\quad$ |  |

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Outstanding as of June 30, 2007

Exercisable as of June 30, 2007

| 476 | $\$ 10.00$ | 3.29 | $\$ 3,558$ |
| ---: | :--- | :--- | :--- |
| $====$ | $======$ | = <br> 476 | $\$ 10.00$ |

During the six month periods ended June 30, 2007 and June 30, 2006, the total intrinsic value of options exercised was $\$ 204,000$ and $\$ 328,000$, respectively, and the actual tax benefit realized for the tax deduction from these option exercises was $\$ 75,000$ and $\$ 106,000$, respectively. During the six months ended June 30 , 2007, options to purchase approximately 40,000 shares of common stock with an aggregate exercise price of $\$ 471,000$ were exercised by option holders. During the six months ended June 30,2006 , options to purchase approximately 53,000 shares of common stock with an aggregate exercise price of $\$ 524,000$ were exercised by option holders.

There were no options granted during the six month periods ended June 30, 2007 and June 30, 2006.

## 5. INCOME TAX

In June 2006, the FASB issued Interpretation 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standard No. 109, "Accounting for Income Taxes" ("SFAS 109"). This Interpretation defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 was effective for fiscal years beginning after December 15, 2006.

On January 1, 2007, the Company adopted the provisions of FIN 48. At the adoption date, the Company applied the provisions of FIN 48 to all tax positions for which the statute of limitations remained open. Any cumulative effect of the change from this accounting principle was to be recorded in the opening balance in retained earnings. As a result of the implementation of FIN 48, the Company did not recognize any change in its unrecognized tax benefits and did not adjust the January 1, 2007 balance of retained earnings. The amount of unrecognized tax benefits as of June 30,2007 was $\$ 1,979,000$, excluding interest and penalties. This represents unrecognized tax benefits, which, if ultimately recognized, will reduce the Company's effective tax rate.

The Company is subject to federal and state income taxes in the United States, as well as income taxes in certain foreign jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. With few exceptions, the Company is not subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for the years before 2003.

The Company is currently under examination by United States and Chinese taxing authorities for years subsequent to 2003. The Company expects these examinations to be concluded and settled within the next twelve months. The Company has unrecognized benefits of $\$ 23,000$ for foreign taxes primarily related to expenses. It is reasonably possible that the resolution of these issues could result in tax payments of approximately $\$ 23,000$.

In adopting FIN 48, the Company classifies interest and penalties related to unrecognized tax benefits as income tax expense. Previously, these items were

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classified as interest and income tax expense. At June 30, 2007, the Company has accrued approximately $\$ 169,000$ for the payment of interest and penalties. Due to the recognition of previously unrecognized tax benefits during the second quarter, the Company reduced the amount of accrued interest and penalty by \$38, 000 .

The following is a reconciliation of income tax expense (benefit) at the applicable federal statutory rate and the effective rates from continuing operations:

|  | Six Months <br> Ended <br> June 30, |  |
| :---: | :---: | :---: |
|  | 2007 | 2006 |
| Statutory rate | 34\% | $34 \%$ |
| Tax rate differential on extraterritorial income exclusion benefit earnings | -- | (1) |
| Tax rate differential on domestic manufacturing deduction | (1) | (1) |
| International rate differences | -- | (2) |
| State income taxes, net of federal income tax benefit | 3 | 3 |
| FIN 48 liability | (4) | -- |
| Research and development credits | (2) | ( 4 ) |
| Foreign tax credits | (1) | -- |
|  | --- | --- |

During the quarter ended June 30, 2007, the Company recorded additional benefits from research and development tax credits of $\$ 476,000$. As of June 30, 2007 , the Company's gross research and development tax credit carryforwards totaled approximately $\$ 1,350,000$. Of these credits, approximately $\$ 955,000$ can be carried forward for fifteen years and will expire between 2013 and 2022, while $\$ 395,000$ can be carried forward indefinitely.

As of June 30, 2007, the Company's gross foreign tax credits totaled approximately $\$ 1,492,000$. These credits can be carried forward for ten years and will expire between 2009 and 2017.

## 6. RECENT AND PROPOSED ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued Statement of Financial Accounting Standard No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The statement does not require new fair value measurements, but is applied to the extent that other accounting pronouncements require or permit fair value measurements. The statement emphasizes that fair value is a market-based measurement that

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in pricing an asset or liability. Companies will be required to disclose the extent to which fair value is used to measure assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets) for the period. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is evaluating the potential effects that SFAS 157 will have on the reporting of its financial position, results of operations or debt covenants.

In February 2007, the FASB issued Statement of Financial Accounting Standard No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities," ("SFAS 159"). The Statement provides companies an option to report certain financial assets and liabilities at fair value. The intent of SFAS 159 is to reduce the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS 159 is effective for financial statements issued for fiscal years after November 15, 2007. The Company is evaluating the impact this new standard will have on the reporting of its financial position, results of operations or debt covenants.

In June 2007, the FASB Emerging Issues Task Force ("EITF") published Issue No. 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities." The EITF reached a consensus that these payments made by an entity to third parties should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. Entities should report the effects of applying this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. EITF Issue No. 07-3 is effective for the Company beginning on January 1, 2008. Earlier application is not permitted. The Company does not expect that adoption of this new Standard will have a material effect on the reporting of its financial position or results of operations.

## 7. GOODWILL AND INTANGIBLE ASSETS

Goodwill and intangible assets consist of the following:

June 30, 2007

|  | Accumulated |  |
| :---: | :---: | :---: |
| Gross Value | Amortization | Net Value |

December 31,


| Goodwill | \$21, 772 | \$ | 0 | \$21,772 | \$ 22,548 | \$ 0 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Other intangible assets: |  |  |  |  |  |  |
| Customer relationships | 3,700 |  | 300 | 3,400 | 3,300 | 45 |
| Patents | 1,219 |  | 865 | 354 | 1,219 | 805 |
| Trademarks | 1,672 |  | -- | 1,672 | 1,772 | -- |
| Developed technology | 1,700 |  | 182 | 1,518 | 1,700 | 30 |
| Licensing fees | 355 |  | 106 | 249 | 355 | 89 |
| Covenant-not-to-compete | 100 |  | 45 | 55 | 100 | 15 |
| Other | 51 |  | 44 | 7 | 51 | 41 |
| Total other intangible assets | 8,797 |  | 542 | 7,255 | 8,497 | 1,025 |


| ------- | ------ | ------- | -------- | ------ |
| :--- | :--- | :--- | :--- | :--- |
| $\$ 30,569$ | $\$ 1,542$ | $\$ 29,027$ | $\$ 31,045$ | $\$ 1,025$ |
| $=======$ | $======$ | $=======$ | $========$ | $======$ |

The other intangible assets that have definite lives are all amortizable and have original estimated useful lives as follows: customer relationships are amortized over approximately six years and eight years; patents are amortized over approximately 13 years, seven years or five years; developed technology is amortized over approximately five years and six years; licensing fees are amortized over approximately 10 years; covenants-not-to-compete are amortized over approximately one and two-thirds years. Trademarks are not amortized. Amortization expense for intangible assets for each of the three-month periods ended June 30, 2007 and June 30,2006 was $\$ 259,000$ and $\$ 28,000$, respectively. Amortization expense for intangible assets for each of the six-month periods ended June 30, 2007 and June 30 , 2006 was $\$ 516,000$ and $\$ 55,000$, respectively. Amortization expense for intangible assets subject to amortization in each of the next five fiscal years is estimated to be: \$1,030,000 in 2007, \$951,000 in 2008, $\$ 898,000$ in each of 2009 and 2010 and $\$ 863,000$ in 2011. Intangible assets subject to amortization have a weighted average life of approximately seven years.

Changes in goodwill balances by segment are as follows:

|  | Balance December 31, 2006 | Deferred Taxes | Intangible Assets | Acquisition <br> Costs <br> Purchase <br> Adjustments | Balance June 30, 2007 |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | (in thousands) |  |  |
| SLPE (Ault) | \$ 3,999 | (\$657) | \$ 0 | (\$2) | \$ 3,340 |
| High Power Group (MTE) | 8,245 | 118 | (300) | 65 | 8,128 |
| High Power Group (Teal) | 5,055 | -- | -- | -- | 5,055 |
| RFL | 5,249 | -- | -- | -- | 5,249 |
| Total | \$22,548 | (\$539) | (\$300) | \$63 | \$21,772 |

During the six months ended June 30, 2007, the Company reduced goodwill related to the acquisition of Ault Incorporated ("Ault") in the amount of $\$ 659,000$. The change in the carrying amount of goodwill (in thousands) for the six months ended June 30, 2007 is as follows:

| Balance as of December 31, 2006 | $\$ 3,999$ |
| :---: | ---: |
| Deferred tax assets | $(657)$ |
| Acquisition costs | $(2)$ |
|  |  |
| Balance as of June 30,2007 | (3,--- |
|  | $======$ |

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The Company reduced goodwill during the period due to a change in the estimated expected tax rate applied to the Company's deferred tax assets, primarily related to net operating losses, recorded at acquisition.

During the six months ended June 30, 2007, the Company reduced goodwill related to the acquisition of MTE Corporation ("MTE") in the amount of $\$ 117,000$. MTE was acquired on October 31,2006 . MTE is expected to broaden the product portfolio of the Power Electronics Group within the high power market. MTE has excellent brand reputation, stable customer base and provides immediate cross selling opportunities with Teal with no customer overlap. Also, MTE's engineering group would compliment Teal.

The change in the carrying amount of goodwill (in thousands) for the six months ended June 30, 2007 is as follows:

| Balance as of December 31, 2006 | $\$ 8,245$ <br> $(300)$ |
| :---: | ---: |
| Intangible assets | 118 |
| Deferred tax assets | 65 |
| Acquisition costs | ------ <br> Balance as of June 30,2007 <br> B8, 128 <br> $======$ |

Upon closing an acquisition, the Company estimates the fair values of assets and liabilities acquired and consolidates the acquisition as quickly as possible. The adjustments made during the six month period ended June 30, 2007 relate to revisions made to the initial fair values of intangible assets, the related deferred taxes recorded at acquisition and additional direct acquisition costs. The adjustments resulted in a decrease in the value of trademarks of $\$ 100,000$, an increase in the value of customer relationships of $\$ 400,000$, a reduction to deferred taxes of $\$ 118,000$ (related to the above adjustments) and additional direct acquisition costs of $\$ 65,000$. The Company may further adjust its initial estimates in subsequent periods.

## 8. DEBT

Debt consists of the following:

|  | $\begin{gathered} \text { June } 30, \\ 2007 \end{gathered}$ |  | $\begin{gathered} \text { December } 31, \\ 2006 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: |
|  | (in thousands) |  |  |  |
| Prime rate loan | \$ |  | \$ | 0 |
| LIBOR rate loan |  |  |  |  |
|  |  |  |  |  |
| Less current portion |  |  |  | -- |
| Total long-term debt | \$ | 0 |  |  |

On August 3, 2005, the Company entered into a revolving credit facility (the "Revolving Credit Facility") with Bank of America, N.A. ("Bank of America") to replace its former senior credit facility. The Revolving Credit Facility (with a standby and commercial letter of credit sub-limit of $\$ 5,000,000$ provides for borrowings up to $\$ 30,000,000$. The Revolving Credit Facility expires on June 30 , 2008. Borrowings under the Revolving Credit Facility bear interest, at the Company's option, at the London interbank offering rate ("LIBOR") plus a margin rate ranging from $0.9 \%$ to $1.9 \%$ or the higher of a Base Rate plus a margin rate ranging from $0 \%$ to $0.5 \%$. The Base Rate is equal to the higher of (i) the Federal Funds Rate plus 0.5\%, or (ii) Bank of America's publicly announced prime rate. The margin rates are based on certain leverage ratios, as defined. The Company is subject to compliance with certain financial covenants set forth in the Revolving Credit Facility, including but not limited to, capital expenditures, consolidated net worth and certain interest and leverage ratios, as defined. As of June 30, 2007, the Company had outstanding balances under its Revolving Credit Facility of $\$ 2,060,000$ at the Bank of America prime rate, which bore interest at $8.25 \%$, and $\$ 13,500,000$ at the LIBOR rate, which bore interest at $6.22 \%$. The Revolving Credit Facility is currently classified as short-term, as it expires on June 30,2008 . The company expects to enter into a new facility with similar terms and conditions. As of December 31, 2006, the Company had an outstanding balance under the Revolving Credit Facility of $\$ 19,800,000$ at the LIBOR rate, which bore interest at $6.25 \%$.
9. ACCRUED LIABILITIES - OTHER

Accrued liabilities - other consist of the following:

| June 30, | December 31, |
| :---: | :---: |
| 2007 | 2006 |

(in thousands)

| Commissions | \$ | 838 |
| :--- | ---: | ---: |
| Litigation and legal fees | 596 | 892 |
| Other professional fees | 462 | 776 |
| Environmental | 1,446 | 1,455 |
| Warranty | 1,172 | 1,197 |
| Deferred revenue | 548 | 690 |
| Other | 2,026 | 1,844 |
|  | ------ | $--=---$ |
|  | $\$ 7,088$ | $\$ 7,295$ |
|  | $======$ | $======$ |

A summary of the Company's warranty reserve is as follows:
Six Months Ended
June 30,2007
---------------
(in thousands)
$\$ 1,197$

| Expense for new warranties issued | 107 |
| :--- | ---: |
| Expense related to accrual revisions for prior year | 46 |
| Warranty claims | $(178)$ |
|  |  |
| Liability, end of period | ------ |
|  | $\$ 1,172$ |
| $======$ |  |

## 10. COMMITMENTS AND CONTINGENCIES

## LITIGATION

In the ordinary course of its business, the Company is subject to loss contingencies pursuant to foreign and domestic federal, state and local governmental laws and regulations and is also party to certain legal actions, which may occur in the normal operations of the Company's business.

The Company, through its wholly-owned subsidiary SLW Holdings, Inc., has been a party to an arbitration proceeding brought by Niles Audio, Inc. SLW Holdings, Inc., formerly known as SL Waber, Inc., sold all of its assets in August 2001. Niles Audio, Inc. was a former customer of SLW Holdings. The parties are currently in discussions to settle this dispute. The Company believes that neither the results of arbitration nor the terms of a potential settlement, as the case may be, will have a material adverse impact on its consolidated financial position or results of operations of the Company.

On June 12, 2002, the Company and SL Surface Technologies, Inc. ("SurfTech") (a wholly owned subsidiary, the operating assets of which were sold in November 2003), were served with a class action complaint by twelve individual plaintiffs (the "Complaint") filed in Superior Court of New Jersey for Camden County (the "Private Action"). The Company and SurfTech are currently two of approximately 39 defendants named in the Private Action. The Complaint alleges, among other things, that the plaintiffs may suffer personal injuries as a result of consuming water distributed from the Puchack Wellfield located in Pennsauken Township, New Jersey (which supplied Camden, New Jersey).

The Private Action arises from similar factual circumstances as current environmental litigation and administrative actions involving the Pennsauken Landfill and Puchack Wellfield, with respect to which the Company has been identified as a potentially responsible party. These actions and the Private Action both allege that SurfTech and other defendants contaminated ground water through the disposal of hazardous substances at facilities in the area. SurfTech once operated a chrome-plating facility in Pennsauken Township, New Jersey. These actions are discussed below.

With respect to the Private Action, the Superior Court denied class certification in June 2006. In early 2007, the Superior Court dismissed the claims of eleven plaintiffs on statute of limitations grounds. On July 31, 2007, the Superior Court dismissed the claim of the final plaintiff on statute
of limitations grounds. The plaintiffs have 45 days following an entry of an order to appeal the Court's decision.

It is management's opinion that the impact of legal actions brought against the Company and its operations will not have a material adverse effect on its consolidated financial position or results of operations. However, the ultimate outcome of these matters, as with litigation generally, is inherently uncertain, and it is possible that some of these matters may be resolved adversely to the

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Company. The adverse resolution of any one or more of these matters could have a material adverse effect on the business, operating results, financial condition or cash flows of the Company.

## ENVIRONMENTAL

Loss contingencies include potential obligations to investigate and eliminate or mitigate the effects on the environment of the disposal or release of certain chemical substances at various sites, such as Superfund sites and other facilities, whether or not they are currently in operation. The Company is currently participating in environmental assessments and cleanups at a number of sites under these laws and may in the future be involved in additional environmental assessments and cleanups. Based upon investigations completed by the Company and its independent engineering-consulting firms to date, management has provided an estimated accrual for all known costs believed to be probable in the amount of $\$ 5,179,000$, of which $\$ 3,733,000$ is included as other long-term liabilities as of June 30, 2007. However, it is the nature of environmental contingencies that other circumstances might arise, the costs of which are indeterminable at this time due to such factors as changing government regulations and stricter standards, the unknown magnitude of defense and cleanup costs, the unknown timing and extent of the remedial actions that may be required, the determination of the Company's liability in proportion to other responsible parties, and the extent, if any, to which such costs are recoverable from other parties or from insurance. Although these contingencies could result in additional expenses, judgments or offsets thereto, at the present time such expenses or judgments are not expected to have a material adverse effect on the Company's consolidated financial position or results of operations, beyond the amount already reserved. Most of the Company's environmental costs relate to discontinued operations and such costs have been recorded in discontinued operations.

There are two sites on which the Company may incur material environmental costs in the future as a result of past activities of SurfTech. These sites are the Company's properties located in Pennsauken Township, New Jersey (the "Pennsauken Site"), and in Camden, New Jersey (the "Camden Site"). With respect to the Pennsauken Site, the Company is the subject of various lawsuits and administrative actions relating to environmental issues concerning the Pennsauken Landfill and the Puchack Wellfield. In 1991 and 1992, the New Jersey Department of Environmental Protection (the "NJDEP") served directives that would subject the Company to, among other things, $\$ 9,266,000$ in collective reimbursements (with other parties) for the remediation of the Puchack Wellfield. The Company believes it has a significant defense against all or part of the directives based on technical data. Moreover, the Company believes the recent action by the EPA, discussed below, may have superseded the NJDEP directives.

In late August 2006, the United States Environmental Protection Agency (the "EPA") notified the Company that it was a potential responsible party (a "PRP"), jointly and severally liable, for the investigation and remediation of the Puchack Wellfield Superfund Site under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 , as amended.

Thereafter, in September 2006, the EPA issued a Record of Decision for the national priority listed Puchack Wellfield Superfund Site and selected a remedy to address the first phase of groundwater contamination that the EPA contemplates being conducted in two phases (known as operable units). The estimated cost of the EPA selected remedy for the first groundwater operable

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unit, to be conducted over a five to ten year timeframe, is approximately $\$ 17.6$ million. Prior to the issuance of the EPA's Record of Decision, the Company had retained an experienced environmental consulting firm to prepare technical comments on the EPA's proposed remediation of the Puchack Wellfield Superfund Site. In those comments, the Company's consultant, among other things, identified flaws in the EPA's conclusions and the factual predicates for certain of the EPA's decisions and for the proposed selected remedy.

Following the issuance of its Record of Decision, in early November 2006, the EPA sent another letter to the Company encouraging the Company to either perform or finance the remedial actions for operable unit 1 identified in the EPA's Record of Decision. The Company advised the EPA that it is willing to investigate the existence of other PRPs and to undertake the activities necessary to design a final remediation for the Superfund Site. In July 2007, the EPA declined the Company's offer to prepare the remediation design for the Superfund Site, but encouraged it to submit probative evidence with respect to other PRPs.

Prior to its last communication, in May 2007, the EPA sent a letter to the Company demanding reimbursement of approximately $\$ 11,500,000$ for past costs associated with the Superfund Site. The Company has requested documentation to support the EPA's claim.

Notwithstanding these assertions, based on discussions with its attorneys and consultants, the Company believes the EPA analytical effort is far from complete. Further, technical data has not established that offsite migration of hazardous substances from the Pennsauken Site contributed to the contamination of the Puchack Wellfield. In any event, the evidence establishes that hazardous substances from the Pennsauken Site could have contributed only a portion of the total contamination delineated at the Puchack Wellfield. There are other technical factors and defenses that indicate that the remediation proposed by the EPA is technically flawed. Based on the foregoing, the Company believes that it has significant defenses against all or part of the EPA claim and that other PRPS should be identified to support the ultimate cost of remediation. Nevertheless, the Company's attorneys have advised that it is likely that it will incur some liability in this matter. Based on the information so far, the Company has estimated remediation liability for this matter of $\$ 4,000,000$ ( $\$ 2,480,000$, net of tax), which has been reserved and recorded as part of discontinued operations in the fourth quarter of 2006.

The Company has reported a ground water contamination plume at the Camden Site. In March 2007, the Company submitted to the NJDEP a Preliminary Assessment Report/Remedial Investigation Report to address requests and directives of the NJDEP with respect to potential areas of concern for the Camden Site. This Report is currently under review. Based on the information so far, the Company believes that the cost to remediate the Camden Site should not exceed $\$ 560,000$, which has been fully reserved. These costs have been recorded as a component of discontinued operations in previous years.

The Company is investigating soil and ground water contamination at the facility of SL Montevideo Technology, Inc. ("SL-MTI") located in Montevideo, Minnesota. SL-MTI has conducted analysis of the contamination and performed remediation at the site. Further remediation efforts will be required and the Company is engaged in discussions with the

Minnesota Pollution Control Agency to develop a remediation plan. Based on the current information, the Company believes it will incur remediation costs at

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this site of approximately $\$ 179,000$, which has been accrued at June 30, 2007. These costs are recorded as a component of continuing operations.

The Company filed claims with several of its insurers seeking reimbursement for past and future environmental costs. In settlement of its claims, the Company received aggregate cash payments of $\$ 2,800,000$ prior to fiscal 2001 and contingent commitments from three insurers to pay a portion of environmental costs associated with the SurfTech Site equal to: 15\% of costs up to $\$ 300,000$, $15 \%$ of costs up to $\$ 150,000$ and $20 \%$ of costs up to $\$ 400,000$, respectively. The Company has received from these three insurers a total of $\$ 821,000$ as payment of their contingent commitments through 2006. These payments have been recorded as income, net of tax, in discontinued operations.

As of June 30, 2007 and December 31, 2006, the Company recorded environmental accruals of $\$ 5,179,000$ and $\$ 5,188,000$, respectively.

## 11. SEGMENT INFORMATION

The Company currently operates under four business segments: SL Power Electronics Corp. ("SLPE"), the High Power Group, SL Montevideo Technology, Inc. ("SL-MTI") and RFL Electronics Inc. ("RFL"). Following its acquisition of Ault on January 26, 2006, the Company consolidated the operations of Ault and its subsidiary, Condor D.C. Power Supplies, Inc. ("Condor"), into SLPE. In accordance with the guidance provided in Statement of Financial Accounting Standard No. 131, "Disclosures about Segments of an Enterprise and Related Information," ("SFAS No. 131") this subsidiary is reported as one business segment. Following the acquisition of MTE on October 31, 2006, the Company combined MTE with its subsidiary, Teal Electronics Corp. ("Teal"), into one business segment, which is reported as the High Power Group. Management has combined SLPE and the High Power Group into one business unit classified as the Power Electronics Group. The Company aggregates operating business subsidiaries into a single segment for financial reporting purposes if aggregation is consistent with the objectives of SFAS No. 131 and if the segments have similar characteristics in each of the following areas:

- nature of products and services
- nature of production process
- type or class of customer
- methods of distribution

SLPE produces a wide range of custom and standard internal and external power supply products that convert AC or DC power to direct electrical current to be used in customers' end products. Power supplies closely regulate and monitor power outputs, using patented filter and other technologies, resulting in little or no electrical interference. SLPE, which sells products under two brand names (Condor and Ault), is a major supplier to original equipment manufacturers ("OEMs") of medical equipment, wireless and wire line communications infrastructure, computer peripherals, handheld devices and industrial equipment. The High Power Group sells products under two brand names (Teal and MTE). Teal designs and manufactures custom power conditioning and power distribution units. Products are developed and manufactured for custom electrical subsystems for OEMs of semiconductor, medical imaging, graphics and telecommunication systems. MTE designs and manufactures power quality electromagnetic

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products used to protect equipment from power surges, bring harmonics into compliance and improve the efficiency of variable speed motor drives. SL-MTI designs and manufactures high power density precision motors. New motor and motion controls are used in numerous applications, including military and commercial aerospace equipment, medical devices and industrial products. RFL designs and manufactures communication and power protection products/systems that are used to protect utility transmission lines and apparatus by isolating faulty transmission lines from a transmission grid. The Other segment includes corporate related items, financing activities and other costs not allocated to reportable segments, which includes but is not limited to certain legal, litigation and public reporting charges and the results of insignificant operations.

The unaudited comparative results for the three month and six month periods ended June 30, 2007 and June 30, 2006 are as follows:


NET SALES
Power Electronics Group:

| SLPE | \$25,794 | \$22,921 | \$ 47,255 | \$41,162 |
| :---: | :---: | :---: | :---: | :---: |
| High Power Group | 14,287 | 8,674 | 28,822 | 17,792 |
| Total | 40,081 | 31,595 | 76,077 | 58,954 |
| SL-MTI | 7,252 | 6,098 | 14,065 | 12,688 |
| RFL | 5,397 | 5,421 | 10,915 | 10,757 |
| Consolidated | \$52, 730 | \$43,114 | \$101, 057 | \$82,399 |



INCOME FROM OPERATIONS
Power Electronics Group:

SLPE

High Power Group

Total
SL-MTI
RFL
Other

Consolidated

| $\$ 2,907$ | $\$ 2,516$ | $\$ 4,192$ | $\$ 3,343$ |
| ---: | ---: | ---: | ---: |
| 1,593 | 1,218 | 3,791 | 2,835 |
| ------ | ------ | ------ | ------ |
| 4,500 | 3,734 | 7,983 | 6,178 |
| ----------- | ------ | ----- |  |
| 828 | 145 | 1,701 | 501 |
| 443 | 360 | 849 | 710 |
| $(1,059)$ | $(1,131)$ | $(2,510)$ | $(2,356)$ |
| ------ | ------ | ------ | ------ |
| $\$ 4,712$ | $\$ 3,108$ | $\$ 8,023$ | $\$ 5,033$ |
| $=======$ | $=======$ | $=======$ | $=======$ |

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* SLPE includes net sales and income from operations of Ault from the acquisition date, January 26,2006 to June 30,2006 . The High Power Group does not include net sales and income from operations of MTE, for the three and six month periods ended June 30, 2006 , since the acquisition was not completed until October 31, 2006.

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| June 30, | December 31, |
| :---: | ---: |
| 2007 | 2006 |
| -------- | $------------\quad$, |

(in thousands)

TOTAL ASSETS
Power Electronics Group:

| SLPE | $\$ 42,432$ | $\$ 41,809$ |
| :--- | ---: | ---: |
| High Power Group | 31,444 | 29,606 |
| Total | -------- | -------- |
|  | $\$ 73,876$ | $\$ 71,415$ |
| SL-MTI | -------- | -------- |
| RFL | 12,421 | 12,035 |
| Other | 16,101 | 16,271 |
|  | 5,792 | 6,822 |
| Consolidated | -------- | -------- |
|  | $\$ 108,190$ | $\$ 106,543$ |


| June 30, | December |
| :---: | :---: |
| 2007 | 2006 |

(in thousands)

INTANGIBLE ASSETS, NET
Power Electronics Group:

| SLPE | \$ 5,431 | \$ 6,298 |
| :---: | :---: | :---: |
| High Power Group | 18,091 | 18,197 |
| Total | \$23,522 | \$24,495 |
| SL-MTI | 7 | 10 |
| RFL | 5,498 | 5,515 |
| Consolidated | \$29,027 | \$30,020 |

12. RETIREMENT PLANS AND DEFERRED COMPENSATION

The Company maintained two defined contribution pension plans covering all of its full-time, U.S. employees during the quarter ended June 30, 2007. The Company's contributions to these plans are based on a percentage of employee contributions and/or plan year gross wages, as defined, in each plan year. Both plans provide for contributions based on a percentage of employee contributions.

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The plan that covers employees of SLPE, Teal, SL-MTI, RFL and the corporate office also provides profit sharing contributions annually, based on plan year gross wages. On May 1, 2007, the plan covering employees of MTE was merged into the existing plan. Costs incurred under existing plans amounted to $\$ 586,000$ during the six-month period ended June 30,2007 and $\$ 461,000$ for the six-month period ended June 30 , 2006. During 2006, the Company maintained five separate plans, four of which were merged into one plan on January 2, 2007.

The Company has agreements with certain active and retired directors, officers and key employees providing for supplemental retirement benefits. The liability for supplemental retirement benefits is based on the most recent mortality tables available and discount rates ranging from $6 \%$ to $12 \%$. The amount charged to income in connection with these agreements amounted to $\$ 193,000$ and $\$ 208,000$ for the six-month periods ended June 30, 2007 and June 30, 2006, respectively.

## 13. RELATED PARTY TRANSACTIONS

RFL has an investment of $\$ 15,000$ in RFL Communications PLC, ("RFL
Communications"), representing $4.5 \%$ of the outstanding equity thereof. RFL
Communications is a distributor of teleprotection and communication equipment located in the United Kingdom. It is authorized to sell RFL products in accordance with an international sales agreement. Sales to RFL Communications for each of the six-month periods ended June 30, 2007 and June 30, 2006 were $\$ 499,000$ and $\$ 430,000$, respectively. Accounts receivable due from RFL Communications at June 30, 2007 were $\$ 251,000$.

As a result of certain services being provided to the Company by Steel Partners, Ltd. ("SPL"), a company controlled by Warren Lichtenstein, the Chairman of the Board of the Company, the Compensation Committee has approved fees for services provided by SPL. These fees are the only consideration for the services of Mr. Lichtenstein and the Company's Vice Chairman, Glen Kassan, and other assistance from SPL. The services provided include management and advisory services with respect to operations, strategic planning, finance and accounting, merger, sale and acquisition activities and other aspects of the businesses of the Company. Fees of $\$ 237,000$ were expensed by the Company for SPL's services for each of the six-month periods ended June 30, 2007 and June 30,2006 pursuant to a Management Agreement dated as of January 23, 2002 by and between the Company and SPL. Approximately $\$ 40,000$ was payable at June 30, 2007.

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

The Company, through its subsidiaries, designs, manufactures and markets power electronics, motion control, power protection, power quality electromagnetics and specialized communication equipment that is used in a variety of commercial and military aerospace, computer, datacom, industrial, medical, telecom, transportation and utility equipment applications. The Company is comprised of four domestic business segments, three of which have significant manufacturing operations in Mexico. With the acquisition of Ault on January 26, 2006, the Company added manufacturing, engineering and sales capability in the People's Republic of China. Most of the Company's sales are made to customers who are based in the United States. However, over the years the Company has increased its presence in international markets. The Company places an emphasis on high quality, well-built, dependable products and continues its dedication to product enhancement and innovations.

The Company's business strategy has been to enhance the growth and profitability

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of each of its businesses through the penetration of attractive new market niches, further improvement of operations and expansion of global capabilities. The Company expects to achieve these goals through organic growth and strategic acquisitions. The Company also continues to pursue strategic alternatives to maximize the value of its businesses. Some of these alternatives have included, and will continue to include, selective acquisitions, divestitures and sales of certain assets. The Company has provided, and may from time to time in the future provide, information to interested parties regarding portions of its businesses for such purposes.

## CRITICAL ACCOUNTING POLICIES

The Company's Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States. These generally accepted accounting principles require management to make estimates and assumptions that affect the
amounts of reported and contingent assets and liabilities at the date of the Consolidated Financial Statements and the amounts of reported net sales and expenses during the reporting period.

In December 2001, the Securities and Exchange Commission (the "SEC") issued disclosure guidance for "critical accounting policies." The SEC defines "critical accounting policies" as those that require application of management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods.

The Company's significant accounting policies are described in Note 1 in the Notes to Consolidated Financial Statements included in Part IV of the Company's Annual Report on Form 10-K. Not all of these significant accounting policies require management to make difficult, subjective or complex judgments or estimates. However, the following policies are deemed to be critical within the SEC definition. The Company's senior management has reviewed these critical accounting policies and estimates and the related Management's Discussion and Analysis of Financial Condition and Results of Operations with the Audit Committee of the Board of Directors.

REVENUE RECOGNITION

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the purchase price is fixed or determinable and collectibility is reasonably assured. Revenue is recorded in accordance with Staff Accounting Bulletin ("SAB") No. 104 and in certain circumstances in accordance with the guidance provided by the EITF "Revenue Arrangements with Multiple Deliverables" $00-21$. The major portion of revenue is derived from equipment sales. However, RFL has customer service revenue, which accounted for less than one percent of consolidated net revenue for each of the six month periods ended June 30, 2007 and June 30 , 2006. The Company recognizes equipment revenue upon shipment and transfer of title. Provisions are established for product warranties, principally based on historical experience. At times the Company establishes reserves for specific warranty issues known by management. Service and installation revenue is recognized when completed. At $S L-M T I$, revenue from one particular contract is considered a multiple element arrangement and, in that case, is allocated among the separate accounting units based on relative fair value. In this case the total arrangement consideration is fixed and there is objective and reliable

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evidence of fair value. SLPE has two sales programs with distributors in which credits are given with no cash paid to distributors: (1) a scrap program and (2) a competitive discount program. The distributor scrap program allows distributors to scrap up to a pre-determined percentage of their purchases over the previous six month period. SLPE provides for this allowance as a decrease to revenue based upon the amount of sales to each distributor and other historical factors. The competitive discount program allows distributors to sell a product out of their inventory at less than list price in order to meet certain competitive situations. SLPE records this discount as a reduction to revenue based on the distributor's eligible inventory. The eligible distributor inventory is reviewed at least quarterly. These distributor programs affected consolidated gross revenue for the six months ended June 30, 2007 by less than one percent.

Certain judgments affect the application of the Company's revenue policy, as mentioned above. Revenue recognition is significant because net revenue is a key component of results of operations. In addition, revenue recognition determines the timing of certain expenses, such as commissions and royalties. Revenue results are difficult to predict. Any shortfall in revenue or
delay in recognizing revenue could cause operating results to vary significantly from quarter to quarter and could result in future operating losses.

## ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Company's estimate for the allowance for doubtful accounts related to trade receivables is based on two methods. The amounts calculated from each of these methods are combined to determine the total amount reserved. First, the Company evaluates specific accounts where it has information that the customer may have an inability to meet its financial obligations (e.g., bankruptcy or insolvency). In these cases, the Company uses its judgment, based on the best available facts and circumstances, and records a specific reserve for that customer against amounts due to reduce the receivable to the amount that is expected to be collected. These specific reserves are reevaluated and adjusted as additional information is received that impacts the amount reserved. Second, a general reserve is established for all customers based on several factors, including historical write-offs as a percentage of sales. If circumstances change (e.g., higher than expected defaults or an unexpected material adverse change in a major customer's ability to meet its financial obligation), the Company's estimates of the recoverability of amounts due could be reduced by a material amount. The Company's allowance for doubtful accounts represented $2.5 \%$ and $2.7 \%$ of gross trade receivables at June 30, 2007 and December 31, 2006, respectively.

## INVENTORIES

The Company values inventory at the lower of cost or market, and continually reviews the book value of discontinued product lines to determine if these items are properly valued. The Company identifies these items and assesses the ability to dispose of them at a price greater than cost. If it is determined that cost is less than market value, then cost is used for inventory valuation. If market value is less than cost, then related inventory is adjusted to market value.

If a write down to the current market value is necessary, the market value cannot be greater than the net realizable value, which is defined as selling price less costs to complete and dispose, and cannot be lower than the net realizable value less a normal profit margin. The Company also continually evaluates the composition of its inventory and identifies slow-moving and excess

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inventories. Inventory items identified as slow-moving or excess are evaluated to determine if reserves are required. If the company were not able to achieve its expectations of the net realizable value of the inventory at current market value, it would have to adjust its reserves accordingly.

## ACCOUNTING FOR INCOME TAXES

On January 1, 2007, the Company adopted the provisions of FIN 48. At the adoption date, the Company applied the provisions of FIN 48 to all tax positions for which the statute of limitations remained open. As required, the cumulative effect of the change from the adoption of FIN 48 was to be recorded in the opening balance as retained earnings. As a result of the implementation of $F I N$ 48, the Company did not recognize any change in its unrecognized tax benefits and did not adjust the January 1, 2007 balance of retained earnings. The amount of unrecognized tax benefits as of January 1,2007 was $\$ 1,979,000$, excluding interest and penalties. This represents unrecognized tax benefits, which, if ultimately recognized, will reduce the Company's effective tax rate.

Significant management judgment is required in determining the provision for income taxes, the deferred tax assets and liabilities and any valuation allowance recorded against deferred tax
assets. As of June 30, 2007 and December 31, 2006, the Company had recorded total valuation allowances of $\$ 2,832,000$ and $\$ 2,157,000$, respectively. Such valuation allowances were attributable to uncertainties related to the company's ability to utilize certain deferred tax assets prior to expiration. These deferred tax assets primarily consist of loss carryforwards and foreign tax credits. The valuation allowance is based on estimates of taxable income, expenses and credits by the jurisdictions in which the Company operates and the period over which deferred tax assets will be recoverable. In the event that actual results differ from these estimates or these estimates are adjusted in future periods, the Company may need to establish an additional valuation allowance that could materially impact its consolidated financial position and results of operations.

The net deferred tax assets as of June 30, 2007 and December 31, 2006 were $\$ 8,822,000$ and $\$ 8,530,000$, respectively, net of valuation allowances of $\$ 2,832,000$ and $\$ 2,157,000$, respectively. The carrying value of the Company's net deferred tax assets assumes that the Company will be able to generate sufficient future taxable income in certain tax jurisdictions, based on estimates and assumptions to utilize these assets. If these estimates and related assumptions change in the future, the Company may be required to record additional valuation allowances against its deferred tax assets resulting in additional income tax expense in the consolidated statement of income. Each quarter, management evaluates the ability to realize the deferred tax assets and assesses the need for additional valuation allowances.

## LEGAL CONTINGENCIES

The Company is currently involved in certain legal proceedings. As discussed in Note 10 in the Notes to the Consolidated Financial Statements included in Part I to this Quarterly Report on Form 10-Q, the Company has accrued an estimate of the probable costs for the resolution of these claims. This estimate has been developed after investigation and is based upon an analysis of potential results, assuming a combination of litigation and settlement strategies. Management does not believe these proceedings will have a further material adverse effect on the Company's consolidated financial position. It is possible,

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however, that future results of operations for any particular quarterly or annual period could be materially affected by changes in these assumptions, or the effectiveness of these strategies, related to these proceedings.

GOODWILL

The Company has allocated its adjusted goodwill balance to its reporting units. The Company tests goodwill for impairment annually and in interim periods if certain events occur indicating that the carrying value of goodwill may be impaired. The goodwill impairment test is a two-step process. The first step of the impairment analysis compares the fair value to the net book value. In determining fair value, the accounting guidance allows for the use of several valuation methodologies, although it states quoted market prices are the best evidence of fair value. The Company uses a combination of expected present values of future cash flows and comparable or quoted market prices, when applicable. If the fair value is less than the net book value, the second step of the analysis compares the implied fair value of goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, the Company recognizes an impairment loss equal to that excess amount. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units and determining the fair value of each reporting unit. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair
value for each reporting unit. There were no impairment charges in either of the six month periods ended June 30, 2007 and June 30, 2006. As of June 30, 2007 and December 31, 2006, goodwill totaled $\$ 21,772,000$ (representing $20 \%$ of total assets) and $\$ 22,548,000$ (representing 21\% of total assets), respectively. For the six month period ended June 30,2007 and fiscal year ended December 31, 2006, there were four reporting units identified for impairment testing. Those units are Ault, MTE, Teal and RFL.

## IMPAIRMENT OF LONG-LIVED AND INTANGIBLE ASSETS

The Company's long-lived and intangible assets primarily consist of fixed assets, goodwill and other intangible assets. The Company periodically reviews the carrying value of its long-lived assets held and used, other than goodwill and intangible assets with indefinite lives, and assets to be disposed of whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. The Company assesses the recoverability of the asset by estimated cash flows and at times by independent appraisals. It compares estimated cash flows expected to be generated from the related assets, or the appraised value of the asset, to the carrying amounts to determine whether impairment has occurred. If the estimate of cash flows expected to be generated changes in the future, the Company may be required to record impairment charges that were not previously recorded for these assets. If the carrying value of $a$ long-lived asset is considered impaired, an impairment charge is recorded for the amount by which the carrying value of the long-lived asset exceeds its fair value. Asset impairment evaluations are by nature highly subjective. There were no asset impairment changes for the periods presented.

ENVIRONMENTAL EXPENDITURES

The Company is subject to United States, Mexican and Chinese environmental laws

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and regulations concerning emissions to the air, discharges to surface and subsurface waters, and generation, handling, storage, transportation, treatment and disposal of waste materials. The Company is also subject to other federal, state and local environmental laws and regulations, including those that require it to remediate or mitigate the effects of the disposal or release of certain chemical substances at various sites, including some where the Company has ceased operations. It is impossible to predict precisely what effect these laws and regulations will have in the future.

Expenditures that relate to current operations are charged to expense or capitalized, as appropriate. Expenditures that relate to an existing condition caused by formerly owned operations are expensed and recorded as part of discontinued operations. Expenditures include costs of remediation and legal fees to defend against claims for environmental liability. Liabilities are recorded when remedial efforts are probable and the costs can be reasonably estimated. The liability for remediation expenditures includes, as appropriate, elements of costs such as site investigations, consultants' fees, feasibility studies, outside contractor expenses and monitoring expenses. Estimates are not discounted and they are not reduced by potential claims for recovery from insurance carriers. The liability is periodically reviewed and adjusted to reflect current remediation progress, prospective estimates of required activity and other relevant factors, including changes in technology or regulations. During the fourth quarter of fiscal 2006 , the Company recorded a $\$ 4,000,000$ reserve in response to an EPA letter related to remediation of a designated Superfund Site. Additional information pertaining to environmental matters is found in the Notes to the Consolidated Financial Statements included in Part IV of the Company's Annual Report on Form 10-K.

The above listing is not intended to be a comprehensive list of all of the Company's accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles with no need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternatives would not produce a materially different result. See the Company's audited Consolidated Financial Statements and Notes thereto included in Part IV of the Company's Annual Report on Form 10-K, which contain accounting policies and other disclosures required by generally accepted accounting principles.

LIQUIDITY AND CAPITAL RESOURCES

| $\begin{gathered} \text { June 30, } \\ 2007 \end{gathered}$ | $\begin{gathered} \text { December } 3 \\ 2006 \end{gathered}$ | \$ | Variance | \% Variance |
| :---: | :---: | :---: | :---: | :---: |
|  | (in thousands) |  |  |  |
| \$ 0 | \$ 757 |  | (\$757) | (100\%) |
| \$15,560 | \$19,800 |  | (\$4,240) | (21\%) |
| \$13,891 | \$26,754 |  | (\$12,863) | (48\%) |
| \$55,235 | \$50,419 | \$ | 4,816 | 10\% |

During the six-month period ended June 30, 2007, net cash provided by continuing operations was $\$ 5,597,000$, as compared to net cash provided by continuing operations of $\$ 967,000$ during the six-month period ended June 30,2006 . The primary sources of cash from operating activities for the six-month period ended June 30, 2007 were income from continuing operations of $\$ 5,275,000$ and an

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increase in accounts payable of $\$ 1,521,000$. These increases in cash were partially offset by increases in inventory of $\$ 1,557,000$ and an increase in accounts receivable of $\$ 1,122,000$. SLPE experienced an increase in inventory of $\$ 1,902,000$ during the period. Work-in-process and finished goods inventories at SLPE increased as a result of higher sales volume and an increase in backlog of $\$ 1,385,000$ from year-end. All other operating entities inventory either decreased or remained relatively stable from year-end levels. The increase in accounts receivable is primarily related to Teal, which experienced an increase of $\$ 1,289,000$. To a lesser extent, SL-MTI and MTE reported increased accounts receivable due to higher sales volume in the second quarter of 2007 , compared to year-end levels. Two of Teal's larger customers no longer accept discounts and are paying on terms. The increases noted above were partially offset by a decrease noted at SLPE due to improved collections in 2007, compared to year-end levels. RFL also experienced a decrease in accounts receivable primarily due to decreased sales to international customers, who typically have longer payment terms.

The primary sources of cash from operating activities for the six-month period ended June 30, 2006 were income from continuing operations of $\$ 3,340,000$ and increases in accrued income taxes of $\$ 804,000$. These sources of cash were partially offset by increases in inventory of $\$ 3,034,000$. All entities reported increased inventories over the first six months of 2006 .

During the six-month period ended June 30, 2007, net cash used in investing activities was $\$ 1,087,000$. This use of cash in investing activities was primarily related to the purchase of machinery and equipment. During the six-month period ended June 30, 2006, net cash used in investing activities was $\$ 17,783,000$. The primary use of cash in investing activities for the first six months of 2006 were related to the purchase of Ault on January 26 , 2006 in the amount of $\$ 16,133,000$, net of cash acquired, (cash in the amount of $\$ 1,034,000$ was used in 2005). In addition, the Company purchased machinery and equipment in the amount of $\$ 1,650,000$.

During the six-month period ended June 30 , 2007, net cash used in financing activities was $\$ 3,976,000$. This use of cash was principally related to the repayment of debt under the Revolving Credit Facility in the net amount of $\$ 4,240,000$. During the six-month period ended June 30, 2006, net cash provided by financing activities was $\$ 7,180,000$. This source of cash was principally related to proceeds from the Company's Revolving Credit Facility in the net amount of $\$ 6,822,000$. Of this amount, approximately $\$ 5,900,000$ was used in the acquisition of Ault. Also, $\$ 524,000$ was received as proceeds from the exercise of stock options.

The Company's current ratio was 1.30 to 1 at June 30,2007 and 1.94 to 1 at December 31, 2006. Current assets increased by $\$ 3,064,000$ from December 31, 2006, while current liabilities increased by $\$ 16,684,000$ during the same period. The increase in current assets is primarily due to a significant increase in accounts receivable and inventories resulting from strong sales in the first six months of 2007. The increase in current liabilities is due to the reclassification of bank debt under the Revolving Credit Facility, which expires on June 30, 2008.

Total borrowings by the Company, as a percentage of total capitalization, consisting of debt and shareholders' equity were $22.0 \%$ at June 30, 2007 and $28.2 \%$ at December 31, 2006. During the first six months of 2007 , total debt decreased by $\$ 4,240,000$.

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Capital expenditures of $\$ 1,022,000$ were made during the first six months of 2007. These expenditures are primarily related to computer equipment and factory machinery and equipment. Capital expenditures for the period represent a decrease of $\$ 628,000$ from the comparable period in 2006 .

The Company has been able to generate adequate amounts of cash to meet its operating needs and expects to do so in the future.

With the exception of the segment reported as "Other" (which consists primarily of corporate office expenses, financing activities, public reporting costs and accruals not specifically allocated to the reportable business segments) all of the Company's operating segments recorded income from operations for the periods presented.

## CONTRACTUAL OBLIGATIONS

The following is a summary of the Company's contractual obligations at June 30 , 2007 for the periods indicated:

| Less Than 1 Year | $\begin{array}{r} 1 \text { to } 3 \\ \text { Years } \end{array}$ | $\begin{array}{r} 4 \text { to } 5 \\ \text { Years } \end{array}$ | After 5 Years | Total |
| :---: | :---: | :---: | :---: | :---: |
| (in thousands) |  |  |  |  |
| \$ 1,580 | \$1,850 | \$1,187 | \$259 | \$ 4,876 |
| 15,560 | -- | -- | -- | 15,560 |
| 8 | 17 | -- | -- | 25 |
| 56 | 192 | 150 | 50 | 448 |
| \$17,204 | \$2,059 | \$1,337 | \$309 | \$20,909 |
| ====== | = = = = | ===== | === | === |

Other obligations include the Company's withdrawal liability to a union-administered defined benefit multi-employer pension plan to which SurfTech had made contributions.

## OFF-BALANCE SHEET ARRANGEMENTS

It is not the Company's usual business practice to enter into off-balance sheet arrangements such as guarantees on loans and financial commitments, indemnification arrangements and retained interests in assets transferred to an unconsolidated entity for securitization purposes. Consequently, the Company has no off-balance sheet arrangements, except for operating lease commitments disclosed in the table above, which have, or are reasonably likely to have, a material current or future effect on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30, 2007, COMPARED WITH THREE MONTHS ENDED JUNE 30, 2006

The tables below show the comparisons of net sales and income from operations for the three months ended June 30, 2007 ("the second quarter 2007") and the

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three months ended June 30, 2006 ("the second quarter 2006"). For the second quarter 2007, sales and income from operations of Ault and MTE are included for the full period. Ault is included as part of SLPE, while MTE is recorded within the High Power Group. Sales and income from operations of Ault are reflected for the second quarter 2006. Sales and income from operations of MTE are not reflected in the second quarter 2006. MTE was acquired on October 31, 2006.

| Three Months Ended | Three Months Ended | \$ Variance Over | \% Variance Over |
| :---: | :---: | :---: | :---: |
| June 30, | June 30, | Same Quarter | Same Quarter |
| 2007 | 2006 | Last Year | Last Year |

(in thousands)


The table below shows the comparison of income from operations for 2007 and 2006:

| Three Months Ended | Three Months Ended | \$ Variance Over | \% Variance Over |
| :---: | :---: | :---: | :---: |
| June 30, | June 30, | Same Quarter | Same Quarter |
| 2007 | 2006 | Last Year | Last Year |

(in thousands)

| SLPE | \$ | 2,907 | \$ | 2,516 | \$ | 391 | 16\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| High Power Group |  | 1,593 |  | 1,218 |  | 375 | 31\% |
| Total |  | 4,500 |  | 3,734 |  | 766 | 21\% |
| SL-MTI |  | 828 |  | 145 |  | 683 | 471\% |
| RFL |  | 443 |  | 360 |  | 83 | 23\% |
| Other |  | (1,059) |  | $(1,131)$ |  | 72 | 6\% |
| Total |  | 4,712 | \$ | 3,108 |  | 604 | 52\% |

Consolidated net sales for the second quarter 2007 increased by $\$ 9,616,000$, or
$22 \%$, compared to the same period in 2006 . Without the sales of MTE recorded in
the second quarter 2007, consolidated sales increased by $\$ 4,556,000$, or $11 \%$. All of the operating entities, except RFL, reported increases in sales for the comparable periods. All of the operating entities reported increases in income from operations for the comparable periods.

The Company recorded income from operations of $\$ 4,712,000$ for the second quarter 2007, compared to income from operations of $\$ 3,108,000$ for the corresponding period last year, an increase of $\$ 1,604,000$, or $52 \%$. Without MTE, the increase would be $\$ 922,000$, or $30 \%$.

In the second quarter 2007, income from continuing operations was $\$ 3,236,000$, or $\$ 0.56$ per diluted share, compared to $\$ 2,107,000$, or $\$ 0.36$ per diluted share, for the second quarter 2006. Income from continuing operations was approximately 6\% of sales for the second quarter 2007, compared to $5 \%$ of sales for the same period last year. The Company's business segments and the components of operating expenses are discussed more fully in the following sections.

The Power Electronics Group, which is now comprised of SLPE (a combination of Condor and Ault) and the High Power Group (a combination of Teal and MTE) recorded a sales increase of $\$ 8,486,000$, or $27 \%$, when comparing the second quarter 2007 to the same period last year. Without the MTE acquisition, sales would have increased by $\$ 3,426,000$, or $11 \%$. Income from operations increased by $\$ 766,000$, or $21 \%$, primarily due to an increase at SLPE of $\$ 391,000$. MTE recorded income from operations of $\$ 682,000$.

As a percentage of SLPE's revenue, income from operations was $11 \%$ in each of the second quarters of 2007 and 2006. In the second quarter 2007, the High Power Group recorded income from operations, as a percentage of revenue, of $11 \%$, compared to $14 \%$ in the second quarter 2006 . This decline was primarily related to Teal, which experienced a sales increase of $\$ 553,000$, or $6 \%$, but a decrease of income from operations by $\$ 307,000$, or $25 \%$. Teal's sales increase was primarily due to increased demand from medical imaging equipment manufacturers and, to a lesser extent, semiconductor manufacturers. Improved results from Teal's sales increase, were offset by a $4 \%$ increase to cost of products sold, compared to the same period last year. Also, Teal's selling general and administrative costs increased by $\$ 113,000$, or $13 \%$, primarily due to increased stock-based compensation expense and recruiting and training costs related to the

Company's lean manufacturing programs. The second quarter 2007 included MTE, which recorded income from operations, as a percentage of sales, equal to $14 \%$.

For the second quarter 2007, SL-MTI's sales increased $\$ 1,154,000$, or $19 \%$ while income from operations increased by $\$ 683,000$, or $471 \%$, compared to the same period last year. The sales increase was driven by a $\$ 1,399,000$ increase in sales to customers in the defense and commercial aerospace industries. This increase was partially offset by a decrease in sales to medical equipment manufacturers. The increase in income from operations is primarily due to two factors: (1) a 6\% increase in gross margin due to higher volume, favorable product mix and greater manufacturing efficiencies, and (2) an $\$ 87,000$ decrease in engineering and product development costs, compared to the unusually large product development expenses incurred in the prior year. In 2006, MTI took several steps to reduce its direct labor costs, which positively impacted 2007 results. SL-MTI experienced a $\$ 138,000$ increase in selling, general and administrative expenses over the comparable periods, due primarily to increased volume.

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For the second quarter 2007, RFL's sales were relatively the same compared to the same period in 2006. Income from operations increased by $\$ 83,000$, or $23 \%$, for the comparable periods. Sales of RFL's protection products increased by $\$ 111,000$, or $5 \%$ while sales of its carrier communications product line decreased by $\$ 149,000$, or $5 \%$, for the comparable periods. RFL's other product line increased by $\$ 14,000$. Domestic sales increased by $\$ 908,000$, or $26 \%$, while international sales decreased by $\$ 932,000$, or $48 \%$. The increase in income from operations is primarily related to increased margins, partially offset by a 6\% increase in selling, general and administrative expenses.

COST OF PRODUCTS SOLD
As a percentage of net sales for the second quarter 2007 , cost of products sold was $66 \%$, compared to $67 \%$ in the second quarter 2006 . Without MTE, the comparable percentages remained the same. SLPE's cost of products sold percentage increased slightly, primarily as a result of higher raw materials costs and freight costs. Teal's cost of products sold percentage increased by approximately 4\%, primarily due to unfavorable product mix, increased raw material costs (copper and steel) and manufacturing inefficiencies caused by the transfer of production of several products to a new manufacturing facility in Tecate, Mexico. In the second quarter 2007, SL-MTI experienced a 6\% decrease in its cost of products sold, compared to the same period last year. This decrease is primarily related to higher volume, favorable product mix and greater manufacturing efficiencies, as discussed above. RFL's cost of products sold, as a percentage of sales, decreased by approximately $3 \%$ due to a favorable product mix and a higher proportion of domestic sales.

## ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES

For the second quarter 2007, engineering and product development expenses were approximately 6\% of net sales, compared to 7\% for the second quarter 2006. Engineering and product development expenses increased by $\$ 67,000$, or $2 \%$. Without MTE, engineering and product development expenses decreased $\$ 162,000$, or $5 \%$. This decrease was primarily attributable to a $13 \%$ decrease at SL-MTI, when compared to unusually large product development expenses incurred in the prior year. SLPE experienced a decrease of approximately 5\%, due to lower consulting and agency fees incurred in the second quarter 2007, compared to the second quarter 2006. RFL and Teal experienced relatively minor changes in the comparable periods. MTE's engineering and product development expenses for the second quarter 2007 were $\$ 229,000$.

## SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses, as a percentage of net sales, for the second quarter 2007 and for the second quarter 2006 were approximately 17\%. These expenses increased by $\$ 1,835,000$, or $25 \%$, with MTE contributing $\$ 740,000$ of the increase. Selling, general and administrative expenses, without MTE, increased by $\$ 1,095,000$, or $15 \%$, for the comparable periods. SLPE increased selling, general and administrative expenses by $17 \%$, on increased sales of $13 \%$. This increase is primarily related to increased bonus accruals based on improved performance and increased consulting fees related to a major software integration project. SL-MTI reported an increase of such expenses of $28 \%$, on increased sales of $19 \%$. This increase is primarily due to sales related costs and bonus accruals. Teal recorded increased selling, general and administrative expenses of $13 \%$, primarily related to increased sales, increased stock-based compensation expense and increased training and recruiting expenses. RFL recorded an increase of such expenses of $6 \%$, primarily due to increased matching

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costs related to its conversion to the Company's $401(k)$ Pension and Savings Plan. Corporate and Other selling, general and administrative expenses increased by $\$ 194,000$, or $17 \%$, primarily due to increased salary and bonus expenses of $\$ 107,000$ related to the addition of an executive position and increased stockbased compensation expense of $\$ 343,000$ (prior year a benefit of $\$ 24,000$ was recorded). These increases were partially offset by a decrease in professional fees of $\$ 85,000$ and a credit of $\$ 224,000$ recorded in the second quarter of 2007 . This credit is related to the Company's workers' compensation, auto and general liability insurance programs ("insurance programs"), as the Company has incurred favorable experience rates during the last several years. In addition, the Company's captive insurer has indicated that it expects to distribute profits to its members in 2007.

## DEPRECIATION AND AMORTIZATION

Depreciation and amortization expenses increased by $\$ 332,000$, or $56 \%$. The increase was largely attributable to the amortization of intangibles of $\$ 127,000$ and $\$ 105,000$ related to the acquisitions of MTE and Ault, respectively. Depreciation and amortization expense for the first quarters of 2007 and 2006 was approximately $2 \%$ and $1 \%$ of net sales, respectively.

AMORTIZATION OF DEFERRED FINANCING COSTS

In connection with entering into the Revolving Credit Facility on August 3, 2005, the Company incurred costs of approximately $\$ 258,000$. These costs have been deferred and are being amortized over the three-year term of the Revolving Credit Facility. For each of the second quarters 2007 and 2006 , amortization of deferred financing costs was $\$ 22,000$, all of which related to the Revolving Credit Facility.

## INTEREST INCOME (EXPENSE)

For the second quarter 2007, interest expense was $\$ 256,000$, compared to $\$ 170,000$ for the same period in 2006. The increase in interest expense is due to increased debt levels to finance the acquisitions of Ault and MTE.

## TAXES

The effective tax rate for continuing operations was $27 \%$ for the second quarter 2007 and $28 \%$ for the same period in 2006 . The effective tax rate reflects the statutory rate after adjustments for federal, state and international tax provisions and the recording of benefits primarily related to research and development tax credits.

## DISCONTINUED OPERATIONS

For the second quarter of 2007 and for the second quarter of 2006 , the Company recorded losses from discontinued operations, net of tax, of $\$ 418,000$ and $\$ 185,000$, respectively. These amounts represent legal and environmental charges, net of tax related to discontinued operations.

## RESULTS OF OPERATIONS

SIX MONTHS ENDED JUNE 30, 2007, COMPARED WITH SIX MONTHS ENDED JUNE 30, 2006
The tables below show the comparisons of net sales and income from operations for the six months ended June 30, 2007 (the "first half 2007") and the six

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months ended June 30, 2006 (the "first half 2006"). For the first half 2007, sales and income from operations of Ault and MTE are included for the full period. Ault is included as part of SLPE, while MTE is recorded within the High Power Group. For the first half 2006, sales and income from operations of Ault are reflected from the date of acquisition, January 26, 2006. Sales and income from operations of MTE are not reflected for 2006, as the acquisition was completed on October 31, 2006.

| Six Months | Six Months | \$ Variance | O Variance |
| :---: | :---: | :---: | :---: |
| Ended | Ended | Over | Over |
| June 30, | June 30, | Same Period | Same Period |
| 2007 | 2006 | Last Year | Last Year |

(in thousands)

| Power Electronics Group: |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| SLPE | \$ | 47,255 | \$41,162 | \$ 6,093 | 15\% |
| High Power Group |  | 28,822 | 17,792 | 11,030 | 62\% |
| Total |  | 76,077 | 58,954 | 17,123 | 29\% |
| SL-MTI |  | 14,065 | 12,688 | 1,377 | 11\% |
| RFL |  | 10,915 | 10,757 | 158 | 1\% |
| Total |  | 01,057 | \$82,399 | \$18,658 | 23\% |

The table below shows the comparison of income from operations for 2007 and 2006:

| Six Months <br> Ended | Six Months Ended | \$ Variance Over | \% Variance Over |
| :---: | :---: | :---: | :---: |
| June 30, | June 30, | Same Period | Same Period |
| 2007 | 2006 | Last Year | Last Year |

(in thousands)


Consolidated net sales for the first half 2007 increased by $\$ 18,658,000$, or $23 \%$, compared to the same period in 2006. Without the sales of MTE recorded in 2007,

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consolidated sales increased by $\$ 9,094,000$, or $11 \%$. All of the operating entities reported increases in sales and income from operations in the first half 2007, compared to the first half of 2006.

The Company recorded income from operations of $\$ 8,023,000$ for the first half 2007, compared to income from operations of $\$ 5,033,000$ for the corresponding period last year. This represents an increase of $\$ 2,990,000$, or $59 \%$. Without MTE, the increase would be $\$ 1,798,000$, or $36 \%$.

For the first half 2007, income from continuing operations was $\$ 5,275,000$, or $\$ 0.91$ per diluted share, compared to $\$ 3,340,000$, or $\$ 0.58$ per diluted share, for the same period in 2006. Income from continuing operations was approximately 5\% of sales in 2007, compared to $4 \%$ of sales in 2006 . The Company's business segments and the components of operating expenses are discussed more fully in the following sections.

The Power Electronics Group, which is now comprised of SLPE (a combination of Condor and Ault) and the High Power Group (a combination of Teal and MTE) recorded a sales increase of $\$ 17,123,000$, or $29 \%$ when comparing the first half 2007 to the first half of 2006 . Without MTE, sales would have increased by $\$ 7,559,000$, or $13 \%$. Income from operations increased by $\$ 1,805,000$, or $29 \%$, primarily attributable to an $\$ 849,000$ increase at SLPE (which included the Ault product line for a full six months in 2007). Teal's income from operations decreased by $\$ 236,000$. Income from operations from MTE was $\$ 1,192,000$ for the first half 2007.

For the first half 2007, income from operations, as a percentage of SLPE's revenue, was 9\%, compared to $8 \%$ in the same period in 2006 . The High Power Group recorded income from operations, as a percentage of revenue, of $13 \%$, compared to $16 \%$ for the first half of last year. This decline was partially due to including MTE in 2007, which recorded income from operations, as a percentage of sales, equal to $13 \%$. Teal experienced a sales increase of $\$ 1,466,000$, or $8 \%$ while income from operations decreased $\$ 236,000$, or $8 \%$, compared to prior year. Teal's sales increase was primarily due to increased demand from medical imaging equipment manufacturers. Teal's income from operations was negatively impacted by an increase in its percentage of cost of products sold by 3\%, as previously discussed. Teal's selling,
general and administrative costs increased by 6\%, primarily due to increased sales, the addition of a quality manager and increased training and recruiting expenses.

For the first half 2007, SL-MTI's sales increased $\$ 1,377,000$, or $11 \%$, while income from operations increased by $\$ 1,200,000$, or $240 \%$, compared to the same period last year. The sales increase was driven by a $\$ 1,823,000$ increase in sales to customers in the defense and commercial aerospace industries. This increase was partially offset by a decrease in sales to medical equipment manufacturers and other industrial customers. The increase in income from operations is primarily due to a $5 \%$ increase in gross margin resulting from higher volume, favorable product mix and greater manufacturing efficiencies. In addition, income from operations improved as a result of a $\$ 292,000$ decrease of engineering and product development costs, when compared to the relatively large product development costs incurred last year. SL-MTI experienced a $16 \%$ increase in selling, general and administrative expenses over the comparable periods primarily due to a significant increase in sales volume.

For the first half 2007, RFL's sales increased by $\$ 158,000$, or $1 \%$, compared to

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the first half of 2006. Income from operations increased by $\$ 139,000$, or $20 \%$, for the comparable periods. Sales of RFL's protection products increased by $\$ 791,000$, or $17 \%$, while sales of its carrier communications product line decreased by $\$ 610,000$, or $11 \%$, for the comparable periods. RFL's other product line decreased by $\$ 23,000$. Domestic sales increased by $\$ 1,156,000$, or $16 \%$, while international sales decreased by $\$ 998,000$, or $28 \%$. The increase in income from operations is primarily related to increased sales and improved gross margins, partially offset by higher selling, general and administrative costs.

## COST OF PRODUCTS SOLD

For the first half 2007, cost of products sold, as a percentage of net sales, was $66 \%$. For the first half of 2006 , this figure was approximately $67 \%$. Without MTE, cost of products sold was $67 \%$ of net sales for the first half 2007 . SLPE's cost of products sold percentage remained relatively the same. Teal's cost of products sold percentage increased by approximately $3 \%$, primarily due to increased copper costs, unfavorable product mix, manufacturing inefficiencies and increased prototype volume. In 2007, SL-MTI experienced a $5 \%$ decrease in its cost of products sold, compared to the same period last year. This decrease is primarily related to favorable product mix and greater manufacturing efficiencies, as previously discussed. RFL's cost of products sold, as a percentage of sales, improved by $2 \%$, primarily due to a higher proportion of domestic sales.

## ENGINEERING AND PRODUCT DEVELOPMENT EXPENSES

For the first half 2007, engineering and product development expenses were approximately 6\% of net sales, compared to 8\% for the same period in 2006. Engineering and product development expenses increased by $\$ 183,000$, or $3 \%$. Without MTE, engineering and product development expenses decreased $\$ 251,000$, or 4\%. This decrease was primarily attributable to a $21 \%$ decrease at SL-MTI, when compared to the unusually large development costs incurred last year, as previously mentioned. RFL and Teal also experienced relatively minor decreases in the first half 2007, compared to the same period in 2006. SLPE experienced an increase of $\$ 85,000$, or $3 \%$, partially due to the inclusion of the Ault product line for a full six months in 2007, compared to five months in 2006. MTE's engineering and product development expenses for the first half 2007 were \$434,000.

## SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

For the first half 2007, selling, general and administrative expenses, as a percentage of net sales, were $18 \%$, which was the same in the first half of 2006 . These expenses increased by $\$ 2,824,000$, or $19 \%$. MTE recorded selling, general and administrative costs of $\$ 1,488,000$. Selling, general and administrative expenses, without MTE, increased by $\$ 1,336,000$, or $9 \%$, for the comparable periods. MTI recorded an increase of $16 \%$ on increased sales of 11\%. SLPE recorded an increase of $7 \%$ on increased sales of $15 \%$. In addition, selling, general and administrative expenses associated with the Ault acquisition are recorded for six months in 2007 and five months in 2006. Teal's expenses increased 6\% and RFL's expenses increased 5\% on increased sales. The Corporate and Other selling, general and administrative expenses increased $\$ 428,000$, or $18 \%$, related to the addition of a senior executive to the corporate staff, stock-based compensation arrangements and an increase in professional services attributable to litigation fees, consulting costs for compliance reviews and international tax advice and planning. These costs were primarily incurred during the first quarter of 2007 . These increases were partially offset by a

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$\$ 224,000$ credit recorded in the second quarter of 2007 . This credit is related to the Company's insurance programs, as previously mentioned.

## DEPRECIATION AND AMORTIZATION

For the first half 2007, depreciation and amortization expenses increased by $\$ 647,000$, or $55 \%$, compared to prior year. These expenses were incurred in connection with the amortization of intangibles related to the MTE and Ault acquisitions of $\$ 254,000$ and $\$ 207,000$, respectively. Depreciation and amortization expense for the first half 2007 and 2006 was approximately $1 \%$ of net sales.

INTEREST INCOME (EXPENSE)

For the first half 2007, interest income was $\$ 18,000$, compared to $\$ 29,000$ for the same period last year. Interest expense was $\$ 579,000$ for the first half 2007, compared to $\$ 299,000$ for the first half 2006 . The increase in interest expense for 2007 is related to increased debt levels to finance the acquisitions of Ault and MTE.

## TAXES

The effective tax rate for continuing operations for the first half of each of 2007 and 2006 was approximately $29 \%$. The effective tax rate reflects the statutory rate after adjustments for state and international tax provisions and the recording of benefits primarily related to research and development tax credits.

## DISCONTINUED OPERATIONS

For the first half of each of 2007 and 2006 , the Company recorded losses from discontinued operations, net of tax, of $\$ 789,000$ and $\$ 297,000$, respectively. These amounts represent legal and environmental charges related to discontinued operations, net of tax.

FORWARD-LOOKING INFORMATION

From time to time, information provided by the Company, including written or oral statements made by representatives, may contain forward-looking information as defined in the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, contain forward-looking information, particularly statements which address activities, events or developments that the Company expects or anticipates will or may occur in the future, such as expansion and growth of the Company's business, future capital expenditures and the Company's prospects and strategy. In reviewing such information, it should be kept in mind that
actual results may differ materially from those projected or suggested in such forward-looking information. This forward-looking information is based on various factors and was derived utilizing numerous assumptions. Many of these factors previously have been identified in filings or statements made by or on behalf of the Company.

Important assumptions and other important factors that could cause actual results to differ materially from those set forth in the forward-looking information include changes in the general economy, changes in capital investment and/or consumer spending, competitive factors and other factors

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affecting the Company's business in or beyond the Company's control. These factors include a change in the rate of inflation, a change in state or federal legislation or regulations, an adverse determination with respect to a claim in litigation or other claims (including environmental matters), the ability to recruit and develop employees, the ability to successfully implement new technology and the stability of product costs. These factors also include the timing and degree of any business recovery in certain of the Company's markets that are currently experiencing a cyclical economic downturn.

Other factors and assumptions not identified above could also cause actual results to differ materially from those set forth in the forward-looking information. The Company does not undertake to update forward-looking information contained herein or elsewhere to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking information.

Future factors include the effectiveness of cost reduction actions undertaken by the Company; the timing and degree of any business recovery in certain of the Company's markets that are currently experiencing economic uncertainty; increasing prices, products and services offered by U.S. and non-U.S. competitors, including new entrants; rapid technological developments and changes and the Company's ability to continue to introduce and develop competitive new products and services on a timely, cost-effective basis; availability of manufacturing capacity, components and materials; credit concerns and the potential for deterioration of the credit quality of customers; customer demand for the Company's products and services; U.S. and non-U.S. governmental and public policy changes that may affect the level of new investments and purchases made by customers; changes in environmental and other U.S. and non-U.S. governmental regulations; protection and validity of patent and other intellectual property rights; compliance with the covenants and restrictions of bank credit facilities; and outcome of pending and future litigation and governmental proceedings. These are representative of the future factors that could affect the outcome of the forward-looking statements. In addition, such statements could be affected by general industry and market conditions and growth rates, general U.S. and non-U.S. economic conditions, including economic instability in the event of a future terrorist attack or sharp increases in the cost of energy and interest rate and currency exchange rate fluctuations and other future factors.

For a further description of future factors that could cause actual results to differ materially from such forward-looking statements, see the discussion in Part I, Item 1A - Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in quantitative and qualitative market risk from the disclosure contained in Item 7A of the Company's Annual Report on Form $10-K$ for the year ended December 31, 2006, which is incorporated herein by reference.

ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES: The Company, under the supervision and with the participation of its management, including the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the Company's "disclosure controls and

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procedures," as such term is defined in Rules 13a-15e and 15d-15e promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that (i) the Company's disclosure controls and procedures were effective as of June 30, 2007, and (ii) no change in internal control over financial reporting occurred during the quarter ended June 30, 2007, which has materially effected, or is reasonably likely to materially effect, such internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Please see Note 10 in the Notes to the Consolidated Financial Statements included in Part $I$ to this Quarterly Report on Form 10-Q. Also, see Note 12 to the Consolidated Financial Statements and the Company's Annual Report on Form $10-K$ for the year ended December 31, 2006, which is incorporated herein by reference.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On March 26, 2007, the Company announced that its Board of Directors had authorized the repurchase of up to 560,000 shares of the Company's common stock. Any repurchases pursuant to the Company's stock repurchase program would be made if and when management considers appropriate and in the open market or in negotiated transactions. For the six months ended June 30, 2007, the Company purchased 11,801 shares pursuant to the repurchase program. For the six month periods ended June 30, 2007 and June 30, 2006 , the Company purchased 71,109 and 30,900 shares, respectively, through its deferred compensation plans.

| Period | Total <br> Number of <br> Shares <br> Purchased | Average Price Paid per Share | Total Number of Shares <br> Purchased as Part of Publicly <br> Announced Plans or Programs | Maximum Number <br> of Shares That May <br> Yet Be Purchased under Publicly <br> Announced Plans or Programs (2) |
| :---: | :---: | :---: | :---: | :---: |
| January 2007 | 14,460(1) | \$16.25 | -- | -- |
| February 2007 | 42,049(1) | \$15.30 | -- | -- |
| March 2007 | 3,680 (1) | \$13.12 | -- | 560,000 |
| April 2007 | 14,801 (3) | \$15.00 | 11,801 | 548,199 |
| May 2007 | 6,620 (1) | \$16.62 | -- | 548,199 |
| June 2007 | 1,300(1) | \$17.15 | -- | 548,199 |
| Total | 82,910 | \$15.45 | 11,801 | 548,199 |

1. The Company purchased these shares other than through a publicly announced plan or program.
2. The Company had a previously authorized repurchase plan, of which 48,024 shares have yet to be purchased.

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3. The Company purchased 3,000 of these shares other than through a publicly announced plan or program.

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

At the Company's Annual Meeting of Shareholders conducted on May 16, 2007, the Company's shareholders re-elected seven incumbent members (J. Dwane Baumgardner, Avrum Gray, James R. Henderson, Glen M. Kassan, Warren G. Lichtenstein, James A. Risher and Mark E. Schwarz) to the Company's Board of Directors. The votes cast for all nominees were as follows:

| NOMINEES | FOR | WITHHOLD AUTHORITY |
| :---: | :---: | :---: |
| J. Dwane Baumgardner | 4,853,009 | 118,156 |
| Avrum Gray | 4,780,171 | 190,994 |
| James R. Henderson | 4,882,356 | 88,809 |
| Glen M. Kassan | 4,504,817 | 466,348 |
| Warren G. Lichtenstein | 4,853,090 | 118,075 |
| James A. Risher | 4,882,306 | 88,859 |
| Mark E. Schwarz | 4,516,282 | 454,883 |

The votes cast for, against, and withheld for the ratification of the appointment of Grant Thornton LLP as the Company's independent auditors for the fiscal year ending December 31, 2007 were as follows:

| FOR | AGAINST | ABSTAIN |
| :---: | :---: | :---: |
| --------------160 | 67,111 | 1,894 |

ITEM 5. OTHER INFORMATION

Pursuant to Section 10A(i) (2) of the Exchange Act, the Company is responsible for listing the non-audit services performed by Grant Thornton, the Company's external auditor, in the first six months of 2007 , as approved by its Audit Committee. During the first six months of 2007 , there were no non-audit services performed by Grant Thornton.

ITEM 6. EXHIBITS
31.1 Certification by Principal Executive Officer pursuant to Rule 13a-15(e) or $15(d)-15(e)$ of the Securities Exchange Act of 1934 , as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (transmitted herewith).
31.2 Certification by Principal Financial Officer pursuant to Rule 13a-15(e) or $15(d)-15(e)$ of the Securities Exchange Act of 1934 , as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (transmitted herewith).
32.1 Certification by Principal Executive Officer pursuant to Rule 13a or 15 (d) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (transmitted herewith).
32.2 Certification by Principal Financial Officer pursuant to Rule 13a or 15 (d) of the Securities Exchange Act of 1934 , as amended, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (transmitted herewith).

## SIGNATURES

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

Date: August 9, 2007

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SL INDUSTRIES, INC.
    (Registrant)
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By: /s/ James C. Taylor

James C. Taylor
Chief Executive Officer
(Principal Executive Officer)

By: /s/ David R. Nuzzo
David R. Nuzzo
Chief Financial Officer
(Principal Accounting Officer)

