PERKINELMER INC
Form 10-K
March 17, 2006
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-K

(Mark One)

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

For the fiscal year ended January 1, 2006

or

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

Commission file number 001-5075

PerkinElmer, Inc.

(Exact name of registrant as specified in its charter)

Massachusetts	**04-2052042**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
45 William Street, Wellesley, Massachusetts	**02481**
(Address of Principal Executive Offices)	*(Zip Code)*

Registrant s telephone number, including area code:

(781) 237-5100

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $1 Par Value	New York Stock Exchange

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

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Exchange Act of 1934. Yes þ No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes ¨ No þ

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 þ No ¨

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

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 12b-2 of the Exchange Act.

Large accelerated filer þ Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in 12b-2 of the Exchange Act). Yes ¨ No þ

The aggregate market value of the common stock, $1 par value per share, held by nonaffiliates of the registrant on July 1, 2005, was $2,308,540,529 based upon the last reported sale of the common stock on that date.

As of March 14, 2006, there were outstanding 126,722,858 million shares of common stock, $1 par value per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of PerkinElmer, Inc. s Definitive Proxy Statement for its Annual Meeting of Shareholders to be held on April 25, 2006 are incorporated by reference into Part III of this Form 10-K.

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PART I

Item 1. *Business*

Overview

We are a leading provider of scientific instruments, consumables and services to the pharmaceutical, biomedical, environmental testing and general industrial markets, commonly referred to as the health sciences and photonics markets. We design, manufacture, market and service products and systems within two businesses, each constituting one reporting segment:

- *Life and Analytical Sciences.* We are a leading provider of drug discovery and development, genetic screening, and environmental and chemical analysis tools, including instruments, reagents, consumables and services.

- *Optoelectronics.* We provide a broad range of digital imaging, sensor and specialty lighting components used in biomedical, consumer products and other specialty end markets.

The health sciences markets include all of the businesses in our Life and Analytical Sciences reporting segment and the medical imaging business, as well as elements of the medical sensors and lighting businesses in our Optoelectronics reporting segment. The photonics markets include the remaining businesses in our Optoelectronics reporting segment.

In fiscal 2005, we had $1,473.8 million in sales from continuing operations.

We are a Massachusetts corporation, founded in 1947. Our headquarters are in Wellesley, Massachusetts, and we market our products and systems in more than 125 countries. As of January 1, 2006, we had approximately 8,000 employees. Our common stock is listed on the New York Stock Exchange, and we are a component of the S&P 500 Index.

We maintain a website with the address http://www.perkinelmer.com/. We are not including the information contained in our website as part of, or incorporating it by reference into, this annual report on Form 10-K. We make available free of charge through our website our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file these materials with, or otherwise furnish them to, the Securities and Exchange Commission.

Significant Developments

As part of our efforts to focus and grow our core businesses, we have taken the following significant measures in recent years:

Unsecured Credit Facility. In October 2005, we entered into a $350 million unsecured senior revolving credit facility with a term of five years. The facility replaced our previous $100 million facility and will be used for general corporate purposes which may include fulfilling working capital needs, refinancing existing indebtedness, making capital expenditures, repurchasing shares, or consummating acquisitions and strategic alliances.

Tender Offer. In October 2005, we commenced a cash tender offer and consent solicitation for any and all of our outstanding 8 $^{7}/8$% senior subordinated notes due 2013 (the Senior Subordinated Notes). On November 14, 2005, as part of an initial settlement under the tender offer, we repurchased $269.9 million of the $270 million outstanding Senior Subordinated Notes.

Share Repurchase Program. On October 21, 2005 our Board of Directors reaffirmed our authority to repurchase up to 10,000,000 shares of our common stock, which we publicly disclosed on November 14, 2005 (the Program). This Program will expire on October 21, 2008, unless it is earlier terminated by our Board of Directors. During the fourth quarter of 2005, we repurchased in the open market under this program 1,096,000 shares of our common stock at an aggregate cost of $24.4 million. We believe that the share repurchase program benefits our shareholders by increasing earnings per share by reducing the number of shares outstanding and that we are likely to have adequate financial flexibility to fund additional share repurchases given current cash and debt levels.

Acquisition of Elcos AG. In February 2005, we acquired Elcos AG, a leading European designer and manufacturer of custom light emitting diode, or LED, solutions for biomedical and industrial applications. Consideration for the transaction was approximately $15.4 million in cash at the time of closing, $0.3 million of additional payments in 2005 and approximately $1.1 million due through fiscal 2007. Also, we estimate that under an earn out provision in the acquisition agreement we will make an additional cash payment of approximately $3.1 million in 2006 to reflect the performance of the business in 2005, with the potential for additional earn out payments being made in 2007 and 2008 based on the performance of the business in 2006 and 2007, respectively.

American Jobs Creation Act. The homeland investment provisions of the American Jobs Creation Act of 2004, enacted on October 22, 2004, provided us with an opportunity during 2005 to repatriate earnings from our foreign subsidiaries at a substantially reduced tax cost and to increase the amount of cash available to fund our operations in the United States. During 2005, we repatriated cash of approximately $535 million of which over $470 million qualified as domestic reinvestment plan repatriations under the homeland investment provisions of the American Jobs Creation Act. While such repatriation carried with it reduced tax costs, it also required that we still recognize incremental tax obligations. It has been a general policy in the past to not provide for taxes on earnings that we did not intend to repatriate; accordingly, any incremental tax would have a negative impact on our current tax rates. In 2005, we recognized $15.5 million of tax expense for qualified repatriation. During 2006 and 2007, we will continue to invest the qualified earnings in permitted uses pursuant to the domestic reinvestment plans approved by our Board.

Tax Audit. We are under regular examination by tax authorities in jurisdictions in which we have significant business operations. The tax years under examination vary by jurisdiction. We regularly assess the likelihood of additional assessments in each of the taxing jurisdictions resulting from these examinations. Tax reserves have been established, which we believe to be adequate in relation to the potential for additional assessments. Once established, we adjust these reserves as information becomes available and when an event occurs requiring a change to the reserves. We do not expect the examination process and resolution of tax matters to have a material effect on our consolidated financial position, although future adjustments or settlements could have a material impact on our income tax expense, effective tax rate, cash flow, and consolidated statement of income for a particular future period. As a result of concluding the federal, state and foreign audits during 2005, we recognized a benefit of $27.5 million.

Restructuring and Integration Charges. Total restructuring and integration charges for 2005 were $22.1 million. During the second and fourth quarters of 2005, our management approved separate plans to terminate employees in several locations as we shift into geographic regions and product lines that are more consistent with our growth strategy. As a result of these plans of termination, we incurred pre-tax restructuring charges of approximately $9.9 million. Substantially all of this pre-tax restructuring charge will result in cash expenditures that we expect will be paid within the next 12 months. Also, as part of our planned effort to consolidate our Canadian operations, we closed one of our properties in the Montreal area. As a result, we recorded an additional pre-tax restructuring charge during fiscal 2005 of approximately $6.1 million which consisted primarily of an impairment charge related to the facility in Montreal. In addition, due to a soft sublease market, we increased our reserves for our financial obligations under several leases associated with previous restructurings in 2001 and 2002. As a result, we recorded an additional pre-tax restructuring charge during fiscal 2005 of approximately $6.1 million which is expected to be paid through 2014.

Fluid Sciences Business Segment Divestiture. In September 2005, our Board of Directors approved a plan to divest our Fluid Sciences business segment to increase our strategic focus on higher growth markets within our

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Life and Analytical Sciences and Optoelectronics businesses. The Fluid Sciences business segment consisted of three businesses Aerospace, Fluid Testing and Semiconductor. We have reflected this segment as a discontinued operation for all periods presented in this annual report on Form 10-K. In November 2005, we sold the Fluid Testing business to Caleb Brett USA Inc. for approximately $34.5 million, resulting in a net pre-tax gain of $30.3 million. In December 2005, we sold the Aerospace business to Eaton Corporation for approximately $333 million, resulting in a net pre-tax gain of $250.6 million. We recognized these gains during fiscal 2005 as gains on the disposition of discontinued operations. We received total cash proceeds in these transactions of approximately $360 million. On February 27, 2006, we sold substantially all of the assets of our Semiconductor business to an entity affiliated with Tara Capital, Inc. for approximately $26.5 million (subject to a net working capital adjustment) plus additional contingent consideration that could bring the total proceeds received to more than $30 million. We are currently in the process of computing the gain on the transaction and will record such amount in the first quarter of 2006.

Lithography Divestiture and Fiber Optics Test Equipment Shutdown. In 2005, as part of our continued efforts to focus on higher growth opportunities, our Board of Directors also approved separate plans to sell our Lithography business and to shutdown our Fiber Optics Test Equipment businesses. We have reflected these businesses as discontinued operations for all periods presented in this annual report on Form 10-K. Upon the sale of the Lithography business in December 2005, we received proceeds of $0.5 million and recognized a pre-tax loss of $3.3 million as loss on the disposition of discontinued operations. The shutdown of the Fiber Optics Test Equipment business in June 2005 resulted in a $5.2 million loss related to lease and severance costs and the reduction of fixed assets and inventory to net realizable value. In August 2005, certain assets that were previously written down were subsequently sold resulting in a gain of $0.1 million. We recognized the pre-tax net loss of $5.2 million as a loss on the disposition of discontinued operations.

Other Operations Classified as Discontinued. Included in this Form 10-K are the financial results of other operations that were discontinued or sold prior to fiscal 2005. These include our Computer-To-Plate and Electroformed Products businesses which were approved for shutdown by our Board of Directors in September 2004 and June 2004, respectively, and our Ultraviolet Lighting business which was sold in June 2004. These also include our Telecommunications Component and Entertainment Lighting businesses which were approved for shutdown by our Board of Directors in June 2002, our Security and Detection Systems business which was sold in June 2002, and our Technical Services Business which was sold in August 1999. We have reflected these businesses as discontinued operations for all periods presented in this annual report on Form 10-K.

Life and Analytical Sciences

Our Life and Analytical Sciences business unit is a leading provider of biopharmaceutical, genetic screening and analytical sciences solutions, including instruments, reagents, software, applications and services. Our instruments are used in daily applications for scientific research and clinical applications. Our research products provide the fundamental tools necessary for a variety of applications that are critical to the development of many of our customers new products and academic projects. In fiscal 2005, our Life and Analytical Sciences business generated sales of $1,081.1 million.

For drug discovery and development, we offer a wide range of systems comprised of instrumentation, software and consumables, including reagents, based on our core expertise in proteomics and genomics, fluorescence, chemiluminescence, radioactive labeling and the detection of nucleic acids and proteins.

For genetic screening and clinical laboratories, we provide instrumentation, software, reagents and analytical tools to test for various inherited disorders in newborns and to monitor risk factors during pregnancy. These clinical screening programs help by identifying women at risk during pregnancy and newborn babies at risk from inherited metabolic or endocrinological disorders. We sell our genetic screening solutions to public health authorities and private health care organizations around the world.

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For environmental and chemical analysis, we offer analytical tools employing technologies such as molecular and atomic spectroscopy, high performance liquid chromatography, gas chromatography and thermal analysis. Our instruments and related application solutions measure a range of substances from biomolecular matter to organic and inorganic chemicals. We sell these products to pharmaceutical manufacturers and customers in the environmental, food and beverage, and chemical markets. These customers use our instruments in various applications to verify the identity, quality or composition of the materials they examine.

For service and support, we offer customers a range of products including service plans, first-year warranties, training, and preventative maintenance. OneSource®, our managed maintenance service plan, helps customers consolidate the essential maintenance and equipment management needs of their laboratory(s).

Principal Products. The principal products of our Life and Analytical Sciences business include:

Chemical and biological reagents, such as LANCE and AlphaScreen assay technologies, fluorescent labeled probes and cloned receptors. These reagents are used in and support a broad and flexible range of assays used in high throughput screening for drug discovery, functional genomics, proteomics, and genotyping.

DELFIA® Xpress is a complete solution for prenatal screening. It has a continuous loading system supported by kits for both first and second trimester analytes, and clinically validated LifeCycle software.

The prOTOF 2000 MALDI O-TOF mass spectrometer. This instrument features MALDI-TOF technology for the identification and characterization of proteins.

The LABWORKS v5.9 laboratory information management system (LIMS). This robust information management system enables scientists to store, share and create reports on laboratory data in both small and large laboratory environments.

The EnVision, a multilabel reader used in a wide range of high-throughput screening applications. It features two detectors enabling simultaneous dual wavelength reading, below emission reading, barcode readers, a high speed light source and adjustment of measurement height function. The instrument is fully configurable, accepting microplates from 96 to 1536 wells, and can be integrated into robotic systems.

The UltraVIEW ERS confocal imaging system. This fully automated, high-resolution, live cell imaging system allows for the observation and measurement of cellular and molecular processes.

The Spectrum Spotlight FT-IR imaging system. This system enables rapid extraction and analysis of data on molecular composition from a wide range of materials. The Spectrum s speed and ability to complement other imaging techniques improves problem solving time and extends infrared, or IR, analysis to many applications.

ViewLux. This ultra high throughput microplate imager offers high sensitivity and fast measurement of light from fluorescence polarization, fluorescence intensity, time-resolved fluorescence, luminescence and absorbance assays.

The PerkinElmer® family of inorganic analysis instrumentation, including the AAnalyst series of atomic absorption spectrometers, the Optima family of inductively coupled plasma, or ICP, spectrometers and the ELAN® family of ICP mass spectrometers. These instruments are used in the environmental and chemical industries, among others, to determine the elemental content of a sample.

The Clarus® 500 gas chromatograph, mass spectrometer and TurboMatrix family of sample-handling equipment. These instruments are used for compound identification and quantitation in applications such as environmental, petrochemical, forensics, food, pharmaceutical and semiconductor.

New Products. New product releases in 2005 by our Life and Analytical Sciences business include:

The NeoGram MS/MS AAAC *in vitro* diagnostic kit to support detection of metabolic disorders in newborns by tandem mass spectrometry.

The AutoDELFIA® toxoplasma-screen kit for screening newborns for congenital toxoplasmosis, an infection that can be passed from mother to fetus through the bloodstream.

Evolution precision pipetting platform with Modular Dispense Technology (MDT), a precision dispense and microplate handling system for liquid handling automation. This system provides the ability to automate assay protocols and sample preparation with high-precision pipetting and labware movement.

The JANUS automated workstation, an automation and liquid handling system consisting of a modular platform that enables one pipetting arm with different tip configurations as well as a one-plate movement arm on a single workstation. JANUS is designed for the efficient automation of sample preparation procedures utilized in pharmaceutical, biotech, and research applications.

The BioXPRESSION biomarker discovery platform with Proteomic Signature Technology (PST). This platform gives researchers the ability to screen thousands of samples and obtain accurate results for population segmentation, pre-clinical trials and disease profiling.

The LumiLux cellular screening platform, which enables luminescent ultra-high throughput cellular screening with all types of cells in 1536-well format, and features an integrated cell stirrer.

The Spectrum 100 Series of infrared (IR) spectrometers, which includes a Universal Attenuated Total Reflectance (UATR) accessory, fiber optic near infrared (NIR) probe, and an enhanced version of PerkinElmer s Spectrum and AssureID software packages.

The new family of TurboMatrix thermal desorbers, which provide sample-handling solutions that simplify and speed a wide range of gas chromatography applications, including environmental, occupational health and safety, materials testing, and flavors and fragrances.

Chromera, an application-specific software system that integrates all components of a speciation measurement system. Chromera software features a single-user interface that coordinates operation of an ICP mass spectrometer, control of a liquid chromatograph and quantitative measurements into a single software package.

Brand Names. Our Life and Analytical Sciences reporting segment offers additional products under various brand names, including Wallac, Packard, NEN®, OneSource®, Pyris, CellLux, ProXPRESSION, MultiPROBE®, FlashBlue, ScanArray and Victor.

Optoelectronics

Our Optoelectronics business unit provides a broad range of digital imaging, sensor and specialty lighting components used in biomedical, consumer products, and other specialty end markets. For fiscal 2005, our Optoelectronics business unit generated sales of $392.7 million.

We are a leading supplier of amorphous silicon digital x-ray detectors, a technology for diagnostic medical imaging and radiation therapy. Amorphous silicon digital x-ray detectors replace film and produce improved image resolution and diagnostic capability for use in radiography, angiography, cardiac and cancer treatment. The amorphous silicon technology is important to medical imaging applications as well as to industrial nondestructive testing for defect recognition within automated manufacturing lines.

We have significant expertise in optical sensor technologies, with products used in a variety of applications. Some of the applications in which our optical sensors are used include sample detection in life sciences instruments, x-ray luggage screening, safety and security applications such as smoke detectors, HVAC controls, document handling/sorting, smart weaponry and non-contact temperature measurements for applications such as ear thermometers and consumer appliances.

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Our specialty lighting technologies include xenon flashtubes, ceramic xenon light sources, intense pulsed light, laser pump sources, and LEDs. These products are used in a variety of applications including mobile phones, digital still and analog cameras, medical endoscopy equipment, home theater projectors, aesthetic applications including hair removal, skin rejuvenation and acne treatment, and laser machine tools.

Principal Products. The principal products of our Optoelectronics business include:

Health Sciences

- Amorphous silicon digital x-ray detectors, an enabling technology for digital x-ray imaging that replaces film and produces improved image resolution and diagnostic capability in applications such as radiography, cardiology, angiography and cancer treatments.
- Cermax® Xenon short arc lamps and fiber optic light sources used in diagnostic and surgical endoscopes, surgical headlamps, microscopes and phototherapy systems.
- A wide range of optical detectors and light sources used in analytical instruments, drug discovery tools and clinical diagnostic systems. The detectors include charge coupled devices, avalanche photodiodes, photodiode arrays, channel photo multipliers, and our unique single photon counting module. The light sources include our Cermax® Xenon short arc lamps described above as well as our line of guided arc xenon flash lamps. We also produce ultraviolet-visible range spectrometer sub-systems based on the above components.
- Thermopile temperature sensors used in digital ear thermometers.
- LED light sources coupled with photodiodes for signal detection, used in sensor modules for hand-held blood glucose meters. The sensing module represents the optical detection unit of the system. An additional product incorporated into the blood glucose meter is an LED-based reflective sensor to read out tracking information on the consumables.
- IR-absorption-based real-time gas analyzers for measuring anesthesia gases delivered in operating rooms; digital sidestream benches for measuring CO_2 levels in neonatal, pediatric and adult respiration.

Photonics

- Xenon flashtubes for use in mobile phone cameras, digital still cameras, 35mm compact cameras and single use cameras.
- Optical sensors used in a variety of safety and security applications, including x-ray luggage screening and smoke alarms, consumer applications such as laser printers, copiers, HVAC systems and monitoring of harmful gases in households, various automotive applications, and smart weaponry.
- Linear xenon and argon flashlamps used in solid state lasers in machine tools and other industrial applications.

Charge-coupled device cameras, which are used to detect defects in manufacturing processes, pilot vision systems and document sorting.

A range of products used in military and aerospace applications including lighting, detonators, power supplies and other specialty components.

Cermax® Xenon lamps utilized in front projection and rear projection applications for home theater and larger venues such as conference rooms and auditoriums due to Cermax s ability to deliver the required brightness while minimizing sacrifices in color performance.

LED-based products used as light sources in various applications including film scanners, aircraft navigation lights, and specialty and architectural displays.

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New Products. New product releases in 2005 by our Optoelectronics business include:

1620 and 1640 AN amorphous silicon flat panel detectors, which offer improved imaging performance and higher frame rates without sacrificing image resolution. The amorphous flat panel detector is a digital x-ray detector using a glass substrate, and is used in image guided radiation therapy product lines and non-destructive industrial testing to deliver advanced, high-quality images.

New amorphous silicon flat panel detectors for General Electric Health Care diagnostic X-Ray systems including the following products: a cardiac detector for improved sensitivity for low dose fluoroscopic applications; a portable radiography detector for bedside patient exams; and a new higher performance radiography detector to support applications such as tomographic 3-D imaging.

CERMAX® Gen 3 , a new generation of Cermax Xenon technology for video projection in home theater applications. Gen 3 offers an improved combination of thermal characteristics, lifetime, price and a higher efficacy for 6500º K color temperature video images.

ACULED (All Color Ultrabright LED), a compact, high power light emitting diode that incorporates multi chip-on-board technology. The RGB platform is designed to provide high brightness for operation in a variety of specialty applications including medical lighting, mood lighting, and architectural lighting.

EPI-Cavity Laser, a new single-chip high power pulse laser which provides reliable high power output from a small beam size in a compact package. The laser is suitable for integration into a variety of range finding applications.

Next generation, further miniaturized photoflash technology High quality and more compact xenon flash lamps and modules are being designed into mobile phones and other digital cameras. The xenon flash technology provides significant improvements over LEDs in increased light output and brightness levels, improved color temperature, reduced shutter speeds and lower cost.

Custom high performance Avalanche Photodiode (APD) modules for use in OEM Molecular Imaging equipment. These optical detection modules are designed into unique Positron Emission Tomography (PET) scanners that generate high resolution images of living subjects for pre-clinical and medical applications.

Brand Names. Our Optoelectronics business offers its products under various brand names, including Cermax®, Heimann, ColdBlue, MultiBlue, ACULED, Power Systems, Amorphous Silicon and Reticon®.

Marketing

All of our businesses market their products and services directly through their own specialized sales forces. As of January 1, 2006, we employed approximately 2,500 sales and service representatives operating in approximately 35 countries, and marketing products and services in approximately 125 countries. In addition, in geographic regions where we do not have a sales and service presence, we utilize distributors to sell our products.

Raw Materials and Supplies

Each of our businesses uses raw materials and supplies that are generally readily available in adequate quantities from domestic and foreign sources. We typically do not have long-term contracts with any of our suppliers. In some cases, we may rely on a single supplier for particular items, although we generally believe that we could obtain these items from alternative suppliers, if necessary.

Intellectual Property

We own numerous United States and foreign patents and have patent applications pending in the United States and abroad. We also license intellectual property rights to and from third parties, some of which bear royalties and are terminable in specified circumstances. In addition to our patent portfolio, we possess a wide array of unpatented proprietary technology and know-how. We also own numerous United States and foreign trademarks and trade names for a variety of our product names, and have applications for the registration of trademarks and trade names pending in the United States and abroad. We believe that patents and other proprietary rights are important to the development of both of our reporting segments, but we also rely upon trade secrets, know-how, continuing technological innovations and licensing opportunities to develop and maintain the competitive position of both of our reporting segments. We do not believe that the loss of any one patent or other proprietary right would have a material adverse effect on our overall business or on any of our reporting segments.

In some cases, we may participate in litigation or other proceedings to defend against or assert claims of infringement, to enforce our patents or our licensors patents, to protect our trade secrets, know-how or other intellectual property rights, or to determine the scope and validity of our or third parties intellectual property rights. Litigation of this type could result in substantial cost to us and diversion of our resources. An adverse outcome in any litigation or proceeding could subject us to significant liabilities or expenses, require us to cease using disputed intellectual property or cease the sale of a product, or require us to license the disputed intellectual property from third parties. We are currently involved in several lawsuits involving claims of violation of intellectual property rights. See Item 3. Legal Proceedings for a discussion of these matters.

Backlog

We believe that backlog is not a meaningful indicator of future business prospects for any of our business units due to the short lead time required on a majority of our sales. Therefore, we believe that backlog information is not material to an understanding of our business.

Competition

Because of the wide range of our products and services, we face many different types of competition and competitors. This affects our ability to sell our products and services and the prices at which these products and services are sold. Our competitors range from large foreign and domestic organizations that produce a comprehensive array of goods and services and that may have greater financial and other resources than we do, to small firms producing a limited number of goods or services for specialized market segments.

In our Life and Analytical Sciences reporting segment, we compete on the basis of service level, price, technological innovation, product differentiation, product availability, and quality and reliability. Competitors range from multinational organizations with a wide range of products to specialized firms that in some cases have well-established market niches. We expect the proportion of large competitors in this reporting segment to increase through the continued consolidation of competitors.

We do not believe any single competitor competes directly with our Optoelectronics reporting segment across its full product range. However, we do compete with specialized manufacturing companies in the manufacturing and sale of specialty flashtubes and ultraspecialty lighting sources, photodetectors and photodiodes, and switched power supplies. Competition is based on price, technological innovation, operational efficiency, and product reliability and quality.

We believe we compete effectively in each of the areas in which our businesses experience competition.

Research and Development

Research and development expenditures were approximately $87.4 million during fiscal 2005, approximately $82.4 million during fiscal 2004, and approximately $76.8 million during fiscal 2003.

We directed our research and development efforts in both 2005 and 2004 primarily toward genetic screening, biopharmaceutical, and environmental and chemical end markets within our Life and Analytical Sciences reporting segment, and medical digital imaging and Cermax Lighting within our Optoelectronics reporting segment. In 2003 we directed our research and development efforts toward genetic screening and biopharmaceutical end markets within our Life and Analytical Sciences reporting segment, and medical digital imaging and Cermax Lighting within our Optoelectronics reporting segment.

Environmental Matters

Our operations are subject to various foreign, federal, state and local environmental and safety laws and regulations. These requirements include those governing emissions and discharges of hazardous substances, the remediation of contaminated soil and groundwater, the regulation of radioactive materials, and the health and safety of our employees.

We may have liability under the Comprehensive Environmental Response Compensation and Liability Act, and comparable state statutes that impose liability for investigation and remediation of contamination without regard to fault, in connection with materials that we or our former businesses sent to various third-party sites. We have incurred, and expect to incur, costs pursuant to these statutes.

We are conducting a number of environmental investigations and remedial actions at current and former locations and, along with other companies, have been named a potentially responsible party (PRP) for specific waste disposal sites. We accrue for environmental issues in the accounting period in which our responsibility is established and when the cost can be reasonably estimated. We have accrued $3.7 million as of January 1, 2006, representing management s estimate of the total cost for the ultimate disposition of known environmental matters. This amount is not discounted and does not reflect the potential recovery of any amounts through insurance or indemnification arrangements. These cost estimates are subject to a number of variables, including the stage of the environmental investigations, the magnitude of the possible contamination, the nature of the potential remedies, possible joint and several liability, the timeframe over which remediation may occur, and the possible effects of changing laws and regulations. For sites where we are named a PRP, management does not currently anticipate any additional liability to result from the inability of other significant named parties to contribute. We expect that these accrued amounts could be paid out over a period of up to ten years. As assessment and remediation activities progress at each individual site, we review these liabilities and adjust them to reflect additional information as it becomes available. There have been no environmental problems to date that have had or that we expect to have a material effect on our financial position, results of operations or cash flows. While it is reasonably possible that a material loss exceeding the amounts recorded may have been incurred, the potential exposure is not expected to be materially different than the amounts recorded.

We may become subject to new or unforeseen environmental costs or liabilities. Compliance with new or more stringent laws or regulations, stricter interpretations of existing laws, or the discovery of new contamination could cause us to incur additional costs.

Employees

As of January 1, 2006, we employed approximately 8,000 employees. Several of our subsidiaries are parties to contracts with labor unions and workers councils. As of January 1, 2006, we employed an aggregate of approximately 1,800 union and workers council employees. We consider our relations with employees to be satisfactory.

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Financial Information About Reporting Segments

The table below sets forth sales and operating profit (loss) by reporting segment for the 2005, 2004 and 2003 fiscal years:

	2005	2004	2003
		(In thousands)	
Life and Analytical Sciences			
Sales	$ 1,081,104	$ 1,062,767	$ 1,003,711
Operating profit	110,228	103,609	94,745
Optoelectronics			
Sales	392,727	366,322	340,829
Operating profit	58,405	59,096	52,671
Other			
Operating loss	(27,682)	(25,029)	(20,461)
Continuing operations			
Sales	1,473,831	1,429,089	1,344,540
Operating profit	140,951	137,676	126,955

Discontinued operations have not been included in the preceding table.

Additional information relating to our reporting segments for the 2005, 2004, and 2003 fiscal years is as follows:

	Depreciation and Amortization Expense			Capital Expenditures		
	2005	2004	2003	2005	2004	2003
			(In thousands)			
Life and Analytical Sciences	$ 46,217	$ 47,645	$ 47,938	$ 12,650	$ 6,747	$ 9,841
Optoelectronics	19,712	18,717	21,177	11,798	7,556	5,353
Other	1,069	1,237	1,335	603	1,515	430
Continuing operations	$ 66,998	$ 67,599	$ 70,450	$ 25,051	$ 15,818	$ 15,624
Discontinued operations	$ 7,272	$ 9,506	$ 9,700	$ 3,065	$ 3,143	$ 1,348

	Total Assets	
	January 1, 2006	January 2, 2005

	(In thousands)	
Life and Analytical Sciences	$ 1,994,502	$ 2,112,322
Optoelectronics	290,676	256,618
Other	380,636	71,025
Net current and long-term assets of discontinued operations	27,647	135,542
	$ 2,693,461	$ 2,575,507

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Financial Information About Geographic Areas

The following geographic area information for continuing operations includes sales based on location of external customer and net long-lived assets based on physical location:

	Sales		
	2005	2004	2003
	(In thousands)		
U.S.	$ 569,906	$ 580,040	$ 543,741
International:			
United Kingdom	98,419	99,767	98,603
Germany	95,279	103,751	90,725
Japan	81,568	92,089	88,079
France	71,154	87,834	77,229
Italy	66,065	76,589	46,165
Other International	491,440	389,019	399,998
Total International	903,925	849,049	800,799
	$ 1,473,831	$ 1,429,089	$ 1,344,540

	Net Long-Lived Assets	
	January 1, 2006	January 2, 2005
	(In thousands)	
U.S.	$ 1,291,444	$ 1,320,472
International:		
Singapore	154,317	175,935
Germany	96,070	85,039
Netherlands	37,276	42,270
United Kingdom	32,004	36,575
Canada	24,776	31,817
Finland	20,757	22,506
Other International	15,833	24,075
Total International	381,033	418,217
	$ 1,672,477	$ 1,738,689

Each of our reporting segments conducts business in, and derives substantial revenue from, various countries outside the United States. During fiscal 2005, we had $903.9 million in sales from our international operations, representing approximately 61% of our total sales. During fiscal 2005, we derived approximately 77% of our international sales from our Life and Analytical Sciences reporting segment, and approximately

23% of our international sales from our Optoelectronics reporting segment. We anticipate that sales from international operations will continue to represent a substantial portion of our total sales in the future.

We are exposed to the risks associated with international operations, including exchange rate fluctuations, regional and country-specific political and economic conditions, foreign receivables collection concerns, trade protection measures and import or export licensing requirements, tax risks, staffing and labor law concerns, intellectual property protection risks and differing regulatory requirements.

Item 1A. ***Risk Factors***

The following important factors affect our business and operations generally or affect multiple segments of our business and operations:

If we do not introduce new products in a timely manner, we may lose market share and be unable to achieve revenue growth targets.

We sell many of our products in industries characterized by rapid technological change, frequent new product and service introductions, and evolving customer needs and industry standards. Many of the businesses competing with us in these industries have significant financial and other resources to invest in new technologies, substantial intellectual property portfolios, substantial experience in new product development, regulatory expertise, manufacturing capabilities and the distribution channels to deliver products to customers. Our products could become technologically obsolete over time, or we may invest in technology that does not lead to revenue growth or continue to sell products for which the demand from our customers is declining, in which case we may lose market share or not achieve our revenue growth targets. The success of our new product offerings will depend upon several factors, including our ability to:

- accurately anticipate customer needs,
- innovate and develop new technologies and applications,
- successfully commercialize new technologies in a timely manner,
- price our products competitively and manufacture and deliver our products in sufficient volumes and on time, and
- differentiate our offerings from our competitors offerings.

Many of our products are used by our customers to develop, test and manufacture their products. Therefore, we must anticipate industry trends and develop products in advance of the commercialization of our customers products. In developing new products, we may be required to make significant investments before we can determine the commercial viability of the new product. If we fail to accurately foresee our customers needs and future activities, we may invest heavily in research and development of products that do not lead to significant sales.

In addition, some of our licensed technology is subject to contractual restrictions, which may limit our ability to develop or commercialize products for some applications. For example, some of our license agreements are limited to the field of life sciences research, and exclude clinical diagnostics applications.

We may not be able to successfully execute acquisitions or license technologies, integrate acquired businesses or licensed technologies into our existing business, or make acquired businesses or licensed technologies profitable.

We have in the past, and may in the future, supplement our internal growth by acquiring businesses and licensing technologies that complement or augment our existing product lines, such as our acquisition of Elcos AG in February 2005. However, we may be unable to identify or complete promising acquisitions or license transactions for many reasons, including:

- competition among buyers and licensees,
- the high valuations of businesses and technologies,
- The need for regulatory an other approval, and
- Our inability to raise capital to fund these acquisitions.

Some of the businesses we may seek to acquire may be unprofitable or marginally profitable. Accordingly, the earnings or losses of acquired businesses may dilute our earnings. For these acquired businesses to achieve acceptable levels of profitability, we must improve their management, operations, products and market penetration. We may not be successful in this regard and may encounter other difficulties in integrating acquired businesses into our existing operations, such as incompatible management, information or other systems or cultural differences.

To finance our acquisitions, we may have to raise additional funds, either through public or private financings. We may be unable to obtain such funds or may be able to do so only on terms unacceptable to us.

We may not be successful in adequately protecting our intellectual property.

Patent and trade secret protection is important to us because developing new products, processes and technologies gives us a competitive advantage, although it is time-consuming and expensive. We own many United States and foreign patents and intend to apply for additional patents. Patent applications we file, however, may not result in issued patents or, if they do, the claims allowed in the patents that issue may be narrower that what is needed to protect fully our products, processes and technologies. Similarly, applications to register our trademarks may not be granted in all countries in which they are filed. For our intellectual property that is protected by keeping it secret, such as trade secrets and know-how, we may not use adequate measures to protect this intellectual property.

Third parties may also challenge the validity of our issued patents, may circumvent or design around our patents and patent applications, or may claim that our products, processes or technologies infringe their patents. In addition, third parties may assert that our product names infringe their trademarks. We may incur significant expense in legal proceedings to protect our intellectual property against infringement by third parties or to defend against claims of infringement by third parties. Claims by third parties in pending or future lawsuits could result in awards of substantial damages against us or court orders that could effectively prevent us from manufacturing, using, importing or selling our products in the United States or other countries.

If we are unable to renew our licenses or otherwise lose our licensed rights, we may have to stop selling products or we may lose competitive advantage.

We may not be able to renew our existing licenses, or licenses we may obtain in the future, on terms acceptable to us, or at all. If we lose the rights to a patented or other proprietary technology, we may need to stop selling products incorporating that technology and possibly other products, redesign our products or lose a competitive advantage. Potential competitors could in-license technologies that we fail to license and potentially erode our market share.

Our licenses typically subject us to various economic and commercialization obligations. If we fail to comply with these obligations we could lose important rights under a license, such as the right to exclusivity in a market. In some cases, we could lose all rights under the license. In addition, rights granted under the license could be lost for reasons out of our control. For example, the licensor could lose patent protection for a number of reasons, including invalidity of the licensed patent, or a third party could obtain a patent that curtails our freedom to operate under one or more licenses.

If we do not compete effectively, our business will be harmed.

We encounter aggressive competition from numerous competitors in many areas of our business. We may not be able to compete effectively with all of these competitors. To remain competitive, we must develop new products and periodically enhance our existing products. We anticipate that we may also have to adjust the prices of many of our products to stay competitive. In addition, new competitors, technologies or market trends may emerge to threaten or reduce the value of entire product lines.

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Our quarterly operating results could be subject to significant fluctuation, and we may not be able to adjust our operations to effectively address changes we do not anticipate.

Given the nature of the markets in which we participate, we cannot reliably predict future sales and profitability. Changes in competitive, market and economic conditions may require us to adjust our operations, and we may not be able to make those adjustments or to make them quickly enough to adapt to changing conditions. A high proportion of our costs are fixed, due in part to our research and development, and manufacturing costs. Thus, small declines in sales could disproportionately affect our operating results in a quarter. Factors that may affect our quarterly operating results include:

- demand for and market acceptance of our products,
- competitive pressures resulting in lower selling prices,
- adverse changes in the level of economic activity in regions in which we do business,
- adverse changes in industries, such as pharmaceutical and biomedical, on which we are particularly dependent,
- changes in the portions of our sales represented by our various products and customers,
- delays or problems in the introduction of new products,
- our competitors announcement or introduction of new products, services or technological innovations,
- increased costs of raw materials or supplies, and
- changes in the volume or timing of product orders.

If we are unable to produce an adequate quantity of products, particularly of our digital x-ray detectors, to meet our customers demands, our revenue growth may be adversely affected.

We have an established global manufacturing base with facilities in multiple locations around the world. Each of these facilities faces risks to its production capacity that may relate to natural disasters, labor relations or regulatory compliance. In addition, in any of these facilities, particularly our Optoelectronics amorphous silicon facility in Santa Clara, California, we may not manage the manufacturing or production processes at expected levels, we may fail to anticipate or act on the need to increase the production capacity, or we may be unable to quickly resolve technical manufacturing issues that arise from time to time. Any of these risks could cause our revenue growth to be adversely affected.

If we fail to maintain satisfactory compliance with the regulations of the United States Food and Drug Administration and other governmental agencies, we may be forced to recall products and cease their manufacture and distribution, and we could be subject to civil or criminal penalties.

Some of the products produced by our Life and Analytical Sciences segment are subject to regulation by the United States Food and Drug Administration (FDA) and similar international agencies. These regulations govern a wide variety of product activities, from design and development to labeling, manufacturing, promotion, sales, resales and distribution. If we fail to comply with those regulations or those of similar international agencies, we may have to recall products, cease their manufacture and distribution, and may be subject to fines or criminal prosecution.

Changes in governmental regulations may reduce demand for our products or increase our expenses.

We compete in markets in which we or our customers must comply with federal, state, local and foreign regulations, such as environmental, health and safety, and food and drug regulations. We develop, configure and market our products to meet customer needs created by these regulations. Any significant change in these regulations could reduce demand for our products or increase our costs of producing these products.

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Economic, political and other risks associated with foreign operations could adversely affect our international sales.

Because we sell our products worldwide, our businesses are subject to risks associated with doing business internationally. Our sales originating outside the United States represented the majority of our total sales in the fiscal year ended January 1, 2006. We anticipate that sales from international operations will continue to represent a substantial portion of our total sales. In addition, many of our manufacturing facilities, employees and suppliers are located outside the United States. Accordingly, our future results of operations could be harmed by a variety of factors, including:

- changes in foreign currency exchange rates,
- changes in a country s or region s political or economic conditions, particularly in developing or emerging markets,
- longer payment cycles of foreign customers and difficulty of collecting receivables in foreign jurisdictions,
- trade protection measures and import or export licensing requirements,
- differing tax laws and changes in those laws,
- difficulty in staffing and managing widespread operations,
- differing labor laws and changes in those laws,
- differing protection of intellectual property and changes in that protection, and
- differing regulatory requirements and changes in those requirements.

If we do not retain our key personnel, our ability to execute our business strategy will be limited.

Our success depends to a significant extent upon the continued service of our executive officers and key management and technical personnel, particularly our experienced engineers, and on our ability to continue to attract, retain, and motivate qualified personnel. The competition for these employees is intense. The loss of the services of one or more of our key personnel could have a material adverse effect on our operating results. In addition, there could be a material adverse effect on us should the turnover rates for engineers and other key personnel increase significantly or if we are unable to continue to attract qualified personnel. We do not maintain any key person life insurance policy on any of our officers or employees.

Restrictions in our senior unsecured credit facility may limit our activities.

Our senior unsecured credit facility contains, and future debt instruments to which we may become subject may contain, restrictive covenants that limit our ability to engage in activities that could otherwise benefit our company. Our new senior unsecured credit facility includes restrictions on our ability and the ability of our subsidiaries to:

- pay dividends on, redeem or repurchase our capital stock,
- sell assets,
- incur obligations that restrict their ability to make dividend or other payments to us,
- guarantee or secure indebtedness,
- enter into transactions with affiliates, and
- consolidate, merge or transfer all or substantially all of our assets and the assets of our subsidiaries on a consolidated basis.

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We are also required to meet specified financial ratios under the terms of our senior unsecured credit facility. Our ability to comply with these financial restrictions and covenants is dependent on our future performance, which is subject to prevailing economic conditions and other factors, including factors that are beyond our control such as foreign exchange rates, interest rates, changes in technology and changes in the level of competition.

Our failure to comply with any of these restrictions in our senior unsecured credit facility may result in an event of default under that facility, which could permit acceleration of the debt under that facility, and require us to prepay that debt before its scheduled due date.

Our results of operations will be adversely affected if we fail to realize the full value of our intangible assets.

As of January 1, 2006, our total assets included $1.4 billion of net intangible assets. Net intangible assets consist principally of goodwill associated with acquisitions and costs associated with securing patent rights, trademark rights and technology licenses, net of accumulated amortization. We test certain of these items specifically all of those that are considered non-amortizing on an annual basis for potential impairment by comparing the carrying value to the fair market value of the reporting unit to which they are assigned. All of our amortizing intangible assets are evaluated for impairment should discrete events occur that call into question the recoverability of the intangible.

Adverse changes in our business or the failure to grow our Life and Analytical Sciences business may result in impairment of our intangible assets which could adversely affect our results of operations.

Item 1B. ***Unresolved Staff Comments***

Not applicable.

Item 2. ***Properties***

As of January 1, 2006, our continuing operations occupied approximately 2,434,000 square feet. We own approximately 717,000 square feet of this space and lease the balance. Our headquarters occupies 53,000 square feet of leased space in Wellesley, Massachusetts. We conduct our other operations in manufacturing and assembly plants, research laboratories, administrative offices and other facilities located in 6 states and 35 foreign countries.

Facilities outside of the United States account for approximately 1,322,000 square feet of our owned and leased property, or approximately 54% of our total occupied space.

Our real property leases are both short-term and long-term. We believe that our properties are well-maintained and are adequate for our present requirements.

The following table indicates, as of January 1, 2006, the approximate square footage of real property owned and leased attributable to the continuing operations of each of our reporting segments:

	Owned	Leased	Total
		(In square feet)	
Life and Analytical Sciences	398,000	1,106,000	1,504,000
Optoelectronics	319,000	558,000	877,000
Corporate offices		53,000	53,000
Continuing operations	717,000	1,717,000	2,434,000

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Item 3. ***Legal Proceedings***

In papers dated October 23, 2002, Enzo Biochem, Inc. and Enzo Life Sciences, Inc. (Enzo) filed a complaint in the United States District Court for the Southern District of New York, Civil Action No. 02-8448, against Amersham PLC, Amersham BioSciences, PerkinElmer, Inc., PerkinElmer Life Sciences, Inc., Sigma-Aldrich Corporation, Sigma Chemical Company, Inc., Molecular Probes, Inc., and Orchid BioSciences, Inc. The complaint alleges that we have breached our distributorship and settlement agreements with Enzo, infringed Enzo s patents, engaged in unfair competition and fraud, and committed torts against Enzo by, among other things, engaging in commercial development and exploitation of Enzo s patented products and technology, separately and together with the other defendants. Enzo seeks injunctive and monetary relief. On May 28, 2003, the Court severed the lawsuit and ordered Enzo to serve individual complaints against the five defendants. Enzo served its new complaint on July 16, 2003, and we subsequently filed an answer denying the substantive allegations and including a counterclaim alleging that several of Enzo s patents are invalid. During the last half of 2005, fact discovery was largely completed and a Markman hearing was conducted regarding the construction of the claims in Enzo s patents. The court has not yet issued its decision regarding claim construction or set a date for trial.

On October 17, 2003, Amersham Biosciences Corp. filed a complaint, which was subsequently amended, in the United States District Court for New Jersey, Civil Action No. 03-4901, against one of our subsidiaries alleging that our ViewLux and certain of our Image FlashPlates infringe three of Amersham s patents related to high-throughput screening (the NJ case). On August 18, 2004, Amersham Plc filed a complaint against two of our United Kingdom-based subsidiaries in the Patent Court of the English High Court of Justice, Case No. 04C02688, alleging that the same products infringe Amersham s European (United Kingdom) patent granted in August 2004 (the UK case). Amersham seeks injunctive and monetary relief in both cases. We subsequently filed answers in both cases denying the substantive allegations and including affirmative defenses and counterclaims. On October 29, 2003, we filed a complaint, which was subsequently amended, against Amersham Biosciences Corp. in the United States District Court for Massachusetts, Civil Action No. 03-12098, alleging that Amersham s IN Cell Analyzer, LEADseeker Multimodality Imaging system and certain Cyclic AMP and IP3 assays infringe two of our patents related to high-throughput screening (the MA case). We seek injunctive and monetary relief. Amersham subsequently filed an answer denying the substantive allegations and including affirmative defenses and counterclaims. Trial in the UK case was completed in December 2005. In February 2006, the court ruled that Amersham s patent in question was invalid in the United Kingdom and awarded costs to us. In the NJ case, discovery regarding issues of liability, which have been bifurcated from issues of damages, has largely been completed, and a Markman hearing on claim construction is anticipated in early 2006. No trial date has been set. In the MA case, discovery is ongoing.

We believe we have meritorious defenses to these lawsuits and other proceedings, and we are contesting the actions vigorously in all of the above matters. We are currently unable, however, to reasonably estimate the amount of loss, if any, that may result from the resolution of these matters or to determine whether resolution of any of these matters will have a material adverse impact on our consolidated financial statements included in this annual report on Form 10-K.

We are also subject to various other claims, legal proceedings and investigations covering a wide range of matters that arise in the ordinary course of our business activities. Each of these matters is subject to uncertainties, and it is possible that some of theses matters may be resolved unfavorably to us. In the opinion of our management, based on its review of the information available at this time, the total cost of resolving these other contingencies at January 1, 2006 should not have a material adverse effect on our consolidated financial statements included in this annual report on Form 10-K.

We and certain of our officers were named as defendants in a purported class action lawsuit filed in July 2002 in the United States District Court for the District of Massachusetts, *In re PerkinElmer, Inc. Securities Litigation*, Civil Action No. 02-11314 GAO, on behalf of purchasers of our common stock between July 15, 2001 and April 11, 2002. The lawsuit claimed violations of Sections 10(b) and 20(a) of, and Rule 10b-5 under, the

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Securities Exchange Act of 1934, alleging various statements made during the putative class period by us and our management were misleading with respect to our future operating results. A purported derivative action was filed in June 2004 in the United States District Court for the District of Massachusetts, Jaroslawicz v. Summe et al., Civil Action no. 04-cv-11469-GAO, against certain of our officers and four of our directors, and nominal defendant PerkinElmer, which purported to make claims of breach of fiduciary duty, gross negligence, breach of contract, breach of duty of loyalty and unjust enrichment, based in part on allegations similar to those in the purported class action lawsuit. On November 7, 2005, the plaintiffs in both actions filed, and the court approved, stipulations of dismissal with prejudice of all claims in both lawsuits. As part of these stipulations, the plaintiffs waived their right to appeal the dismissals. The resolution of these claims did not have a material impact on our financial statements.

Our subsidiary, EG&G Rocky Flats, Inc., and two other companies were served with a complaint in January 2000 naming EG&G Rocky Flats, Inc. as a defendant in a civil false claim action pending in the United States District Court for the District of Colorado, involving alleged false claims arising out of security issues at the United States Department of Energy s Rocky Flats Plant. In response to a motion filed by the United States Department of Justice, the District Court dismissed the case. In February 2004, the United States Court of Appeals for the Tenth Circuit affirmed the District Court s dismissal of the case. The United States Supreme Court declined to accept any further appeal of the case in October 2005.

Item 4. ***Submission of Matters to a Vote of Security Holders***

Not applicable.

EXECUTIVE OFFICERS OF THE REGISTRANT

Listed below are our executive officers as of March 17, 2006. No family relationship exists between any one of these officers and any of the other executive officers or directors.

Name	Position	Age
Gregory L. Summe	Chairman of the Board, Chief Executive Officer and President	49
Robert F. Friel	Vice Chairman and President Life and Analytical Sciences	50
Jeffrey D. Capello	Senior Vice President, Chief Financial Officer and Chief Accounting Officer	41
Katherine A. O Hara	Senior Vice President, General Counsel and Secretary	47
Richard F. Walsh	Senior Vice President and Chief Administrative Officer	53
John A. Roush	Senior Vice President, President Optoelectronics	40

*Gregory L. Summe***,** *49.* Mr. Summe was named our Chief Executive Officer effective January 1, 1999 and Chairman effective April 27, 1999. He was appointed President and Chief Operating Officer and elected to our board of directors in February 1998. From 1993 to 1998, Mr. Summe held several management positions with AlliedSignal, Inc., now Honeywell International: President of the Automotive Products Group, President of Aerospace Engines, and President of General Aviation Avionics. Prior to joining AlliedSignal, he worked at General Electric, and was a partner at McKinsey & Company, where he worked from 1983 to 1992. Mr. Summe is a director of State Street Corporation. He holds a Bachelor of Science and a Master of Science degree in electrical engineering from the University of Kentucky and the University of Cincinnati, respectively, and a Master of Business Administration degree from the Wharton School at the University of Pennsylvania.

Robert F. Friel, 50. Mr. Friel joined us in February 1999 as our Senior Vice President and Chief Financial Officer. In 2005 he was named Executive Vice President and Chief Financial Officer with responsibility for business development and information technology, in addition to his oversight of the finance functions. In January 2006 he was named our Vice Chairman, President of Life and Analytical Sciences and elected to our

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Board of Directors. From 1980 to 1999 he held several positions at AlliedSignal Inc. (now Honeywell International) including Corporate Vice President and Treasurer from 1997 to 1999 and Vice President, Finance and Administration of Aerospace Engines from 1992 to 1996. He holds a Bachelor of Arts degree in economics from Lafayette College and a Master of Science degree in taxation from Fairleigh Dickinson University. Mr. Friel is a Director of Millennium Pharmaceuticals, Inc. and Fairchild Semiconductor, Inc.

Jeffrey D. Capello, 41. Mr. Capello joined us in June 2001 as our Vice President of Finance and was named Chief Accounting Officer in April 2002. In January 2006, he was named Senior Vice President and Chief Financial Officer. From 1991 to June 2001, he held various positions including that of partner at PricewaterhouseCoopers LLP, a public accounting firm, initially in the United States and later in the Netherlands. He holds a Bachelor of Science degree in business administration from the University of Vermont and a Master of Business Administration degree from the Harvard Business School.

Katherine A. O Hara, 47. Ms. O Hara joined us in May 2005 as Senior Vice President, General Counsel and Secretary of PerkinElmer, Inc. Prior to joining PerkinElmer in May 2005, Ms. O Hara served as Vice President and Associate General Counsel for Avon Products, Inc. During her 11 years with Avon, she held responsibilities in the areas of legal and regulatory compliance, corporate finance and corporate governance. Before joining Avon, Ms. O Hara had been an associate at Davis Polk & Wardwell, focusing on capital markets transactions for global clients. Previously, she had been Assistant Vice President at Morgan Guaranty Trust Company of New York, responsible for the Argentine business unit. Ms. O Hara holds a Bachelor of Arts degree from Duke University and a J.D. from the Columbia University School of Law.

Richard F. Walsh, 53. Mr. Walsh joined us in July 1998 as our Senior Vice President of Human Resources and in January 2006 was also named our Chief Administrative Officer. From 1995 to 1998, he served as Senior Vice President of Human Resources of ABB Americas, Inc., the United States subsidiary of an international engineering company. Prior to that, Mr. Walsh held a number of managerial positions in human resources with ABB starting in 1989. His prior employment was with Unilever where he spent nine years in human resource management. Mr. Walsh holds a Bachelor of Science degree in marketing and a Master of Business Administration degree from LaSalle University, and a Master of Art in counseling from Villanova University.

John Roush, 40. John Roush was named Vice President of PerkinElmer and President of our Optoelectronics business in November 2004. In January of 2006, Mr. Roush was named Senior Vice President of PerkinElmer and remains President of our Optoelectronics business. Mr. Roush first joined us in 1999 as General Manager of a specialty lighting division within our Optoelectronics business, and subsequently held several additional roles within Optoelectronics. From 2001 to 2002, he served as Vice President & General Manager of the Sensors business, and from 2002 to 2004, he held the role of Vice President of Sales & Product Management. Before joining PerkinElmer, Mr. Roush held leadership positions with General Electric, Allied Signal (now Honeywell International), and McKinsey & Company. Mr. Roush holds a Bachelor of Science degree in electrical engineering from Tufts University and a Master of Business Administration degree from the Harvard Business School.

PART II

Item 5. *Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Market Price of Common Stock

Our common stock is listed and traded on the New York Stock Exchange. The following table sets forth the high and low per share sale prices for our common stock on that exchange for each fiscal quarter in 2005 and 2004.

	2005 Fiscal Quarters			
	First	Second	Third	Fourth
High	$ 23.66	$ 20.80	$ 21.55	$ 23.86
Low	19.81	18.01	19.17	20.60

	2004 Fiscal Quarters			
	First	Second	Third	Fourth
High	$ 21.74	$ 22.32	$ 20.04	$ 22.89
Low	16.95	17.82	15.74	16.82

As of March 14, 2006, we had approximately 8,012 holders of record of our common stock.

Stock Repurchase Program

The following table provides information with respect to the shares of common stock repurchased by us for the periods indicated.

	Issuer Repurchases of Equity Securities			
Period	Total Number of Shares Purchased[1]	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 3, 2005 October 30, 2005	0	$ 0.00	0	10,000,000
October 31, 2005 November 27, 2005	1,066,100	22.22	1,066,100	8,933,900
November 28, 2005 January 1, 2006	29,900	22.50	29,900	8,904,000

Total	1,096,000	$ 22.23	1,096,000	8,904,000

(1) On October 21, 2005 our Board of Directors reaffirmed our authority to repurchase up to 10,000,000 shares of our common stock, which we publicly disclosed on November 14, 2005 (the Program). This Program will expire on October 21, 2008, unless it is earlier terminated by our Board of Directors. During the fourth quarter of 2005, we repurchased 1,096,000 shares of our common stock in the open market under the Program at an aggregate cost of $24.4 million.

Dividends

During the 2005 and 2004 fiscal years, we declared regular quarterly cash dividends on our common stock. The table below sets forth the cash dividends per share that we declared on our common stock during each of those fiscal years, by quarter.

	2005 Fiscal Quarters				2005 Total
	First	Second	Third	Fourth	
Cash dividends per common share	$ .07	$ .07	$ .07	$ .07	$.28

	2004 Fiscal Quarters				2004 Total
	First	Second	Third	Fourth	
Cash dividends per common share	$ .07	$ .07	$ .07	$ .07	$.28

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For further information related to our stockholders equity, refer to Note 18 included in our notes to consolidated financial statements included in this annual report on Form 10-K.

Item 6. ***Selected Financial Data***

The following table sets forth selected historical financial information as of and for each of the fiscal years in the five-year period ended January 1, 2006. We derived the selected historical financial information as of and for each of the fiscal years in the three-year period ended January 1, 2006 from our audited consolidated financial statements which are included elsewhere in this annual report on Form 10-K. We derived the selected historical financial information as of and for the fiscal years ended December 29, 2002 and December 30, 2001 from our audited consolidated financial statements which are not included in this annual report on Form 10-K. As with our financial statements for the fiscal years ended January 1, 2006, January 2, 2005 and December 28, 2003, we adjusted the information in the financial statements for the fiscal years ended December 29, 2002 and December 30, 2001, where appropriate, to account for our discontinued operations.

Our historical financial information may not be indicative of our results of operations or financial position that you should expect in the future.

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You should read the following selected historical financial information together with our Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements, including the related notes, included elsewhere in this annual report on Form 10-K.

	Fiscal Year Ended				
	January 1, 2006	January 2, 2005	December 28, 2003	December 29, 2002	December 30, 2001
	(In thousands, except per share data)				
Income Statement Data:					
Sales	$ 1,473,831	$ 1,429,089	$ 1,344,540	$ 1,296,829	$ 1,256,116
Operating income	140,951	137,676	126,955	10,998	60,831
Other expense, net[1]	74,291	38,332	53,513	29,786	23,674
Income (loss) from continuing operations before taxes[2][3]	66,660	99,344	73,442	(18,788)	37,157
Income (loss) from continuing operations, net of income taxes[4]	66,532	75,879	50,755	(10,404)	1,401
Income (loss) from discontinued operations, net of income taxes	15,214	20,659	2,652	(10,274)	30,737
Gain (loss) on dispositions of discontinued operations, net of income taxes[5][6]	186,362	(495)	(448)	(13,460)	2,367
Net income (loss) before effect of accounting change	268,108	96,043	52,959	(34,138)	34,505
Effect of accounting change, net of income tax[7]				(117,800)	
Net income (loss)	$ 268,108	$ 96,043	$ 52,959	$ (151,938)	$ 34,505
Basic earnings (loss) per share:					
Continuing operations	$ 0.51	$ 0.60	$ 0.40	$ (0.08)	$ 0.01
Discontinued operations	1.56	0.16	0.02	(0.19)	0.32
Effect of accounting change, net of income tax				(0.94)	
Net income (loss)	$ 2.07	$ 0.75	$ 0.42	$ (1.21)	$ 0.33
Diluted earnings (loss) per share:					
Continuing operations	$ 0.51	$ 0.59	$ 0.40	$ (0.08)	$ 0.01
Discontinued operations	1.54	0.16	0.02	(0.19)	0.31
Effect of accounting change, net of income tax				(0.94)	
Net income (loss)	$ 2.04	$ 0.74	$ 0.41	$ (1.21)	$ 0.32
Weighted-average common shares outstanding:					
Basic:	129,267	127,345	126,363	125,439	103,687
Diluted:	131,140	129,429	127,741	125,439	107,259
Cash dividends per common share	$ 0.28	$ 0.28	$ 0.28	$ 0.28	$ 0.28

	As of				
	January 1, 2006	January 2, 2005	December 28, 2003	December 29, 2002	December 30, 2001
Balance Sheet Data:					

Total assets	$ 2,693,461	$ 2,575,507	$ 2,607,727	$ 2,825,482	$ 2,969,938
Short-term debt	1,131	9,714	5,167	191,408	125,741
Long-term debt	243,282	364,874	544,307	614,053	598,125
Stockholders equity	1,650,513	1,460,085	1,349,050	1,252,344	1,363,557
Common shares outstanding	130,109	129,059	126,909	125,854	124,188

(1) In 2005, we incurred $54.9 million in fees associated with the extinguishment of our Senior Subordinated Notes offset by gains on the sales of investments of $5.8 million.
(2) We incurred restructuring charges and (reversals), net of $22.1 million in 2005, $0 in 2004, $(2.8) million in 2003, $36.6 million in 2002 and $9.5 million in 2001. The 2002 restructuring charge primarily related to the combination of our Life Science and Analytical Instruments businesses into Life and Analytical Sciences.
(3) In 2001 we had an in-process R&D charge of $71.5 million primarily related to the Packard acquisition. This was partially offset by net gains on dispositions of $33.2 million, which resulted principally from the gain on the sale of the Instruments for Research and Applied Sciences business, previously part of the Life and Analytical Sciences segment .
(4) The 2005 effective tax rate on continuing operations of 0.19% was largely due to a $27.5 million benefit related to the settlement of federal, state and foreign income tax audits and an additional accrual of $15.5 million related to the homeland investment provisions of the American Jobs Creation Act.
(5) In 2005, we sold the Aerospace and Fluid Testing segments of our Fluid Sciences division for a net pre-tax gain of $280.9 million. Net pre-tax losses of $8.5 million related to the sale of the Lithography Business and Fiber Optic Test Equipment Business were partially offset by other pre-tax gains of $1.4 million that related to multiple discontinued operations.
(6) In 2002 we sold the Security and Detection Systems business for a net pre-tax gain on the sale of $15.0 million. We also approved separate plans to shut down our Telecommunications Component and sell our Entertainment Lighting businesses with related losses recorded to reduce the assets to the amount estimated to be fair value less cost to sell Entertainment Lighting business of $2.1 million and Telecommunications Component business of $18.4 million.
(7) We adopted SFAS No. 142 in 2002. We completed our transitional implementation of the impairment of testing provisions of SFAS No. 142, which resulted in a $117.8 million after-tax charge for goodwill associated with the lighting reporting unit within the Optoelectronics business unit.

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

This annual report on Form 10-K, including the following management s discussion and analysis, contains forward-looking information that you should read in conjunction with the consolidated financial statements and notes to consolidated financial statements that we have included elsewhere in this annual report on Form 10-K. For this purpose, any statements contained in this report that are not statements of historical fact may be deemed to be forward-looking statements. Words such as believes, plans, anticipates, expects, will and similar expressions are inten to identify forward-looking statements. Our actual results may differ materially from the plans, intentions or expectations we disclose in the forward-looking statements we make. We have included important factors below under the heading Risk Factors in Item 1A above that we believe could cause actual results to differ materially from the forward-looking statements we make. We are not obligated to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

Overview

We are a leading provider of scientific instruments, consumables and services to the pharmaceutical, biomedical, environmental testing and general industrial markets. We design, manufacture, market, and service products and systems within two businesses, each constituting one reporting segment:

Life and Analytical Sciences. We are a leading provider of drug discovery and development, genetic screening and environmental and chemical analysis tools, including instruments, reagents, consumables and services.

Optoelectronics. We provide a broad range of digital imaging, sensor and specialty lighting components used in the biomedical, consumer products and other specialty end markets.

Accounting Period

Our fiscal year ends on the Sunday nearest December 31. We report fiscal years under a 52/53 week format. Under this method, certain years will contain 53 weeks. The fiscal year ended January 1, 2006 included 52 weeks. The fiscal year ended January 2, 2005 included 53 weeks. The fiscal year ended December 28, 2003 included 52 weeks. In fiscal 2004, the fourth quarter average weekly sales were approximately $29.4 million.

Consolidated Results of Continuing Operations

Sales

2005 Compared to 2004. Sales for 2005 were $1,473.8 million, versus $1,429.1 million during 2004, an increase of $44.7 million, or 3%. Acquisitions increased 2005 sales by $12.1 million over 2004, whereas changes in foreign exchange rates had an immaterial impact on sales on a year over year basis. Fiscal 2005 had 52 weeks compared to 53 weeks in fiscal 2004. In the fourth quarter of fiscal 2004, an average week s sales represented $29.4 million. The following analysis compares significant sales for 2005 as compared to 2004 and includes the effect of foreign exchange rate fluctuations and the previously mentioned extra week during 2004. The overall increase in sales reflects an $18.3 million, or 2%, increase in our Life and Analytical Sciences segment sales, which grew from $1,062.8 million in 2004 to $1,081.1 in 2005. Our Optoelectronics segment sales grew $26.4 million, or 7%, from $366.3 million in 2004 to $392.7 million in 2005.

2004 Compared to 2003. Sales for 2004 were $1,429.1 million, versus $1,344.5 million during 2003, an increase of $84.6 million, or 6%. Changes in foreign exchange rates increased sales by $45.7 million over 2003. Fiscal 2004 had 53 weeks compared to 52 weeks in fiscal 2003. In the fourth quarter of fiscal 2004, an average week s sales represented $29.4 million. The following analysis compares significant sales for 2004 as compared to 2003 and includes the previously mentioned extra week during 2004. The overall increase in sales reflects a $59.1 million, or 6%, increase in our Life and Analytical Sciences segment sales, which grew from $1,003.7 million in 2003 to $1,062.8 in 2004, and reflects approximately $39.2 million in sales attributable to favorable changes in foreign exchange rates, as compared to 2003. Our Optoelectronics segment sales grew $25.5 million, or 7%, from $340.8 million in 2003 to $366.3 million in 2004, including approximately $6.5 million in sales attributable to favorable changes in foreign exchange rates, as compared to 2003.

Cost of Sales

2005 Compared to 2004. Cost of sales for 2005 was $859.3 million, versus $846.3 million for 2004, an increase of $13.0 million, or 2%. As a percentage of sales, cost of sales decreased to 58.3% in 2005 from 59.2% in 2004, resulting in an increase in gross margin of 90 basis points from 40.8% in 2004 to 41.7% in 2005. The increase in gross margin was largely attributable to higher sales volume enabling better leveraging of fixed costs and increased manufacturing productivity, offset somewhat by a higher contribution of Optoelectronics revenue as a percentage of overall sales. While Optoelectronics does have lower gross margins than Life and Analytical Sciences, it also has lower operating expenses as a percentage of sales.

2004 Compared to 2003. Cost of sales for 2004 was $846.3 million, versus $781.1 million for 2003, an increase of $65.2 million, or 8%. As a percentage of sales, cost of sales increased to 59.2% in 2004 from 58.1% in 2003, resulting in a decrease in gross margin of 110 basis points from 41.9% in 2003 to 40.8% in 2004. The decrease in gross margin was partially attributable to greater revenue contribution, as a percentage of overall sales, from Optoelectronics versus Life and Analytical Sciences.

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Research and Development Expenses

2005 Compared to 2004. Research and development expenses for 2005 were $87.4 million versus $82.4 million in 2004, an increase of $5.0 million, or 6%. As a percentage of sales, research and development expenses increased to 5.9% in 2005 from 5.8% in 2004. We directed research and development efforts during 2005 and 2004 primarily toward genetic screening, biopharmaceutical, and environmental and chemical end markets within our Life and Analytical Sciences reporting segment, and medical digital imaging and Cermax lighting within our Optoelectronics reporting segment. We expect our research and development spending to increase on both an absolute and percentage of sales basis in 2006 and to continue to emphasize the health sciences end markets.

2004 Compared to 2003. Research and development expenses for 2004 were $82.4 million versus $76.8 million in 2003, an increase of $5.6 million, or 7%. As a percentage of sales, research and development expenses increased to 5.8% in 2004 from 5.7% in 2003. We directed research and development efforts during 2004 and 2003 primarily toward genetic screening and biopharmaceutical end markets within our Life and Analytical Sciences reporting segment, and medical digital imaging and Cermax lighting within our Optoelectronics reporting segment.

Selling, General and Administrative Expenses

2005 Compared to 2004. Selling, general and administrative expenses for 2005 were $365.5 million, versus $362.3 million for 2004, an increase of $3.2 million, or 1%. As a percentage of sales, selling, general and administrative expenses decreased 60 basis points to 24.8% in 2005 from 25.4% in 2004. The decrease as a percentage of sales of 60 basis points in 2005 was primarily due to net productivity improvements and cost reductions in both our Life and Analytical Sciences and Optoelectronics reporting segments.

2004 Compared to 2003. Selling, general and administrative expenses for 2004 were $362.3 million, versus $365.0 million for 2003, a decrease of $2.7 million, or 1%. As a percentage of sales, selling, general and administrative expenses decreased 170 basis points to 25.4% in 2004 from 27.1% in 2003. The decrease as a percentage of sales of 170 basis points in 2004 was primarily due to net productivity improvements and cost reductions in our Life and Analytical Sciences reporting segment.

Restructuring (Reversals) and Integration Charges, Net

2005 Compared to 2004. Restructuring and integration charges for 2005 were $22.1 million versus zero for 2004. The following table summarizes our restructuring accrual balances and related activity by restructuring plan during 2005, 2004 and 2003:

	Balance at 12/29/2002	2003 Charges	2003 Amounts paid and incurred	2003 Changes in Estimates	Balance at 12/28/2003	2004 Amounts paid	Balance at 1/02/2005	2005 Charges	2005 Amounts paid and incurred	2005 Changes in Estimates	Balance at 1/1/2006
					(In thousands)						
Q4 2001 plan	$ 4,075	$	$ (3,434)	$ 1,830	$ 2,471	$ (965)	$ 1,506	$	$ (401)	$	$ 1,105
Q1 2002 plan	1,152		(52)	(1,000)	100	(100)					
Q4 2002 plan	22,662		(12,868)	(5,494)	4,300	(3,330)	970		(1,543)	5,632	5,059

Q2 2003 plan		2,251	(1,582)	(381)	288	(86)	202			(202)	
Q2 2005 plan								8,251	(5,510)	(403)	2,338
Q4 2005 plan								8,223	(6,077)		2,146
Restructuring	27,889	2,251	(17,936)	(5,045)	7,159	(4,481)	2,678	16,474	(13,531)	5,027	10,648
Integration	4,020		(3,146)		874	(507)	367	564	(337)		594
Total Restructuring and Integration	$ 31,909	$ 2,251	$ (21,082)	$ (5,045)	$ 8,033	$ (4,988)	$ 3,045	$ 17,038	$ (13,868)	$ 5,027	$ 11,242

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Q4 2005 Plan:

During the fourth quarter of 2005, we incurred an $8.2 million restructuring charge in Life and Analytical Sciences and Optoelectronics, which we refer to as our Q4 2005 Plan. The principal actions in the Q4 2005 Plan included planned workforce reductions resulting from our resource shift towards product lines that are more consistent with our growth strategy, as well the closure of manufacturing and administrative facilities in order to consolidate certain operations in our North American and European territories.

As part of our Q4 2005 Plan, we reduced headcount by 44. We anticipate that all remaining Q4 2005 Plan actions will be completed by December 2006.

We recorded restructuring charges by segment for the Q4 2005 Plan as follows:

(In millions)	Life and Analytical Sciences	Optoelectronics	Total
Severance	$2.1	$0.1	$2.2
Abandonment of Excess Facilities	0.2	5.8	6.0
Total	$2.3	$5.9	$8.2

Q2 2005 Plan:

During the second quarter of 2005, we recognized an $8.2 million restructuring charge in Life and Analytical Sciences and Optoelectronics, which we refer to as our Q2 2005 Plan. The purpose of these restructuring actions was to shift resources into geographic regions and product lines that were more consistent with our growth strategy. The principal actions in the Q2 2005 Plan comprised headcount reductions resulting from reorganization activities. During the fourth quarter of 2005, we recorded a pre-tax restructuring reversal of $0.4 million relating to this plan due to lower than expected employee separation costs associated with the Life and Analytical Sciences segment.

As part of our Q2 2005 Plan, we reduced headcount by 228. We anticipate that all remaining severance costs will be paid by the end of the second quarter in 2006.

The following table summarizes the Q2 2005 restructuring charges recognized in 2005 by segment:

(In millions)	Life and Analytical Sciences	Optoelectronics	Total
Severance	$5.3	$2.9	$8.2

Q2 2003 Plan:

During 2003, we incurred a $2.3 million restructuring charge in Life and Analytical Sciences and Optoelectronics, which we refer to as our Q2 2003 Plan. The purpose of the restructuring was to further improve performance and take advantage of synergies between our former Life Sciences and Analytical Instruments businesses which we began integrating in the fourth quarter of 2002. The principal actions in this restructuring plan included lower headcount due to the continued integration of the Life and Analytical Sciences business in a European manufacturing and customer care center, as well as headcount reduction at one of the Optoelectronics manufacturing facilities to reflect recent declining demand for several product lines. We planned to reduce headcount by 120. We recorded restructuring charges by segment for 2003 as follows:

(In millions)	Life and Analytical Sciences	Optoelectronics	Total
Q2 2003 Plan	$2.0	$0.3	$2.3

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This restructuring charge was primarily recorded in the second quarter of 2003. However, we recorded additional charges of $0.5 million and $0.1 million in the third and fourth quarters of 2003, as required by SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, as some employees who were notified of their employment termination in the second quarter were required to work for a period of time prior to receiving their severance. In addition, in the fourth quarter of 2003, we recorded a pre-tax restructuring reversal of $0.4 million due to 30 fewer employee terminations as a result of higher attrition rates in several countries prior to ultimate termination, and accordingly, lower severance costs.

Q4 2002 Plan:

In connection with our decision to combine our Life Sciences and Analytical Instruments businesses in order to reduce costs and achieve operational efficiencies, we recorded a pre-tax restructuring charge of $26.0 million during the fourth quarter of 2002, which we refer to as our Q4 2002 Plan. The Q4 2002 Plan allowed us to combine many business functions worldwide, with the intention to better serve our customers and more fully capitalize on the strengths of the businesses sales, service, and research and development organizations. The principal actions in the Q4 2002 Plan included planned workforce reductions of 546 people, closure of approximately 20 facilities, and disposal of underutilized assets.

The Q4 2002 Plan resulted in the integration of our United States Life and Analytical Sciences sales, service and customer care centers, the integration of European customer care and finance centers, the merging of a former Life Sciences European manufacturing facility with a former Analytical Instruments European manufacturing facility, and the merging of a portion of a former Life Sciences research and development facility in Europe with a former Analytical Instruments facility in Europe.

During 2003, we expended $12.9 million to execute these actions. In addition, we recorded a reversal of $5.5 million in the Q4 2002 Plan due to 182 fewer terminations as a result of higher than expected employee attrition rates in several countries prior to ultimate termination and lower severance costs for actual terminations.

During 2004, we expended an additional $3.3 million to execute these actions. During 2005, we expended $1.5 million to execute these actions. In addition, we recorded a restructuring charge of $5.6 million in the Q4 2002 Plan due to higher than expected costs associated with the closure of facilities, primarily in Europe. The remaining liability associated with the Q4 2002 Plan represents severance related to 2 employees and ongoing lease commitments. We expect to settle the remaining severance liability by the end of the first quarter of 2006. Our current estimate is that our lease commitments on unoccupied buildings extend until 2014.

Q1 2002 Plan:

During the first quarter of 2002, our management developed a plan to restructure several businesses and we recorded a restructuring charge of $9.2 million. We refer to these activities as our Q1 2002 Plan. The principal actions in the Q1 2002 Plan included planned workforce and overhead reductions resulting from reorganization activities, including the closure of a manufacturing facility, disposal of underutilized assets, and general cost reductions. Total headcount was reduced by 276.

During 2003, we recorded a restructuring reversal of $1.0 million in the Q1 2002 Plan primarily due to lower than expected employee separation costs associated with our Optoelectronics segment.

Q4 2001 Plan:

During the fourth quarter of 2001, in connection with the integration of Packard BioScience Company and a restructuring of our sales offices in Europe, we recorded a restructuring charge of $9.2 million in our Life and

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Analytical Sciences segment and incurred $1.6 million in charges in 2002. We refer to these activities as our Q4 2001 Plan. The principal actions in the Q4 2001 Plan included the closing or consolidation of several leased sales and services offices in Europe, as well as costs associated with the closure of a manufacturing facility in Europe, the closure of leased manufacturing facilities in the United States, and the disposal of related assets.

In 2003, we recorded an additional pre-tax restructuring charge associated with the Q4 2001 Plan of $1.8 million. This charge was primarily due to additional severance and severance related benefits of the previously identified employees associated with the closure of our European manufacturing facility in the Life and Analytical Sciences segment.

In 2004, we expended $1.0 million to execute the actions associated with the Q4 2001 Plan. We expect to pay the remaining balance in 2006 for previously identified employees associated with the closure of our European manufacturing facility in the Life and Analytical Sciences segment.

Integration:

In November 2001, we completed our acquisition of Packard BioScience Company. The integration activities are complete with the exception of $0.6 million in remaining payments due on leased facilities exited in 2001 that will be paid through 2011.

The following table summarizes integration reserve activity during 2005 and 2004 related to the acquisition of Packard BioScience Company:

	Abandonment of Excess Facilities	**Total Cash Charges**
	(In millions)	
Packard Integration Plan		
Balance at December 28, 2003	$ 874	$ 874
Amounts paid	(507)	(507)
Balance at January 2, 2005	$ 367	$ 367
Provision	564	564
Amounts paid	(337)	(337)
Balance at January 1, 2006	$ 594	$ 594

Gains (Losses) on Dispositions

2005 Compared to 2004. Dispositions resulted in a net gain of $1.5 million in 2005 versus a net loss of $0.4 million in 2004. Gain on dispositions in 2005 included a $2.0 million gain from an insurance reimbursement due to fire damage in certain manufacturing facilities offset by a $0.5 million loss on disposal of fixed assets due to a facilities upgrade. Loss on dispositions in 2004 included a $0.7 million loss from the sale of a business and was partially offset by a $0.3 million gain from the sale of facilities.

2004 Compared to 2003. Dispositions resulted in a net loss of $0.4 million in 2004 versus a net gain of $2.5 million in 2003. Gains on dispositions in 2003 included $2.2 million from sales of facilities and $0.5 million from post closing adjustments associated with the resolution of contingencies related to the sale of our Instruments for Research and Applied Sciences business, which we refer to as IRAS.

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Interest and Other Expense, Net

Interest and other expense, net consisted of the following:

	2005	2004	2003
		(In thousands)	
Interest income	$ (3,321)	$ (2,401)	$ (2,479)
Interest expense	27,291	36,203	50,213
(Gains) losses on sale of investments, net	(5,844)	300	2,391
Extinguishment of debt	54,886	4,143	1,953
Other	1,279	87	1,435
	$ 74,291	$ 38,332	$ 53,513

2005 Compared to 2004. Interest and other expense, net for 2005 was $74.3 million versus $38.3 million for 2004, an increase of $36.0 million or 94%. The increase in interest and other expense, net in 2005 as compared to 2004, was due primarily to the fees associated with the extinguishment of approximately $300 million of our Senior Subordinated Notes, which included premium fees of $36.3 million, an $8.9 million accelerated amortization of term loan and Senior Subordinated Notes issuance fees, and $8.5 million in charges associated with terminating interest rate swaps. The increase was partially offset by a corresponding decrease in interest expense on our Senior Subordinated Notes that were purchases pursuant to our tender offer in the fourth quarter of 2005, as well as a lower average outstanding term loan balance (which was approximately $120 million). In addition, we recognized a gain on sale of investments of $5.8 million associated with the liquidation of an investment. We anticipate that interest expense will decrease in 2006 as compared to 2005 due to the repayment of the Senior Subordinate Notes in 2005. A more complete discussion of our liquidity is set forth below under the heading, Liquidity and Capital Resources.

2004 Compared to 2003. Interest and other expense, net for 2004 was $38.3 million versus $53.5 million for 2003, a decrease of $15.2 million or 28%. The decrease in interest and other expense, net in 2004 as compared to 2003, was due primarily to a lower average outstanding term loan balance, by about $100 million. Interest and other expense also declined as a result of lower interest rates applicable to our term loan which are attributable to an amendment of our credit facility in the fourth quarter of 2003. The remaining decrease in interest and other expense was the result of (i) swapping $100 million of our Senior Subordinated Notes from fixed rate debt to a floating rate based on six-month USD Libor in January 2004, resulting in a $2.2 million decrease in interest expense, and (ii) $2.3 million of net interest expense not incurred in 2004 as it was related to our zero coupon convertible debentures which we redeemed in 2003. The decrease in interest and other expense was partially offset by our increased acceleration of debt issuance costs of $4.1 million resulting from partial prepayments of our term debt during 2004, versus $1.9 million in 2003.

Provision/Benefit for Income Taxes

2005 Compared to 2004. The 2005 provision for income taxes from continuing operations was $0.1 million, versus a provision of $23.5 million in 2004. The 2005 effective tax rate from continuing operations was 0.19% as compared to the 2004 effective tax rate of 23.6%. The reduction in the effective tax rate between the years was due to (i) an incremental $17 million benefit associated with the conclusion of audits with the Internal Revenue Service and Revenue Canada with respect to the years 1999 through 2002; and (ii) the use in 2005 of federal, state, and foreign tax attributes (current year state and foreign net operating losses, federal current year research and experimental credits, and state current year income tax credits) enabled by the sale of our Fluid Science s business unit. These benefits were partially offset by an incremental accrual of $6.8 million for the tax cost of the domestic reinvestment plan repatriation calculated in accordance with the homeland investment provisions of the American Jobs Creation Act of 2004.

2004 Compared to 2003. The 2004 provision for income taxes was $23.5 million, versus a provision of $22.7 million in 2003. The 2004 effective tax rate was 23.6% as compared to the 2003 effective tax rate of

30.9%. The reduction to the effective tax rate was primarily due to a $10.4 million benefit associated with the resolution of an appeal of Internal Revenue Service audit findings with respect to our 1997 and 1998 taxes; additional benefits resulting from the conclusion of tax audits in Canada and the U.K.; reduction of our state tax expense; and the use of existing foreign net operating losses. These benefits were partially offset by an accrual of $8.7 million for the estimated U.S. tax cost of repatriation calculated in accordance with the homeland investment provisions of the American Jobs Creation Act of 2004.

Discontinued Operations

We recorded the following gains and losses, which we report as the gain (loss) on dispositions of discontinued operations, during the years ended January 1, 2006 and January 2, 2005:

	2005	2004	2003
		(In thousands)	
Gain on the sale of Aerospace business	$ 250,638	$	$
Gain on the sale of Fluid Testing business	30,281		
Loss on the sale of Fiber Optics Test Equipment business	(5,184)		
Loss on the sale of Lithography business	(3,307)		
Gain on the resolution of contingencies associated with the Technical Services business	900	1,487	6,535
Gain (loss) on other discontinued businesses	497	(2,303)	(6,757)
Net gain (loss) on disposition of discontinued operations before income taxes	273,825	(816)	(222)
Provision (benefit) for income taxes	87,463	(321)	226
Gain (loss) on disposition of discontinued operations, net of income taxes	$ 186,362	$ (495)	$ (448)

In September 2005, our Board of Directors approved a plan to divest our Fluid Sciences business segment to increase our strategic focus on our higher growth markets within the Life and Analytical Sciences and Optoelectronics businesses. The Fluid Sciences business segment consisted of three businesses Aerospace, Fluid Testing and Semiconductor. In November 2005 we sold the Fluid Testing business to Caleb Brett USA Inc. for approximately $34.5 million, resulting in a net pre-tax gain of $30.3 million. In December 2005, we sold the Aerospace business to Eaton Corporation for approximately $333 million, resulting in a net pre-tax gain of $250.6 million. We recognized these gains during fiscal 2005. We received total cash proceeds in these transactions of approximately $360 million. On February 27, 2006, we sold substantially all of the assets of our Semiconductor business to an entity affiliated with Tara Capital, Inc. for approximately $26.5 million (subject to a net working capital adjustment) and additional contingent consideration that could bring the total proceeds received to more than $30 million. We are currently in the process of computing the gain on the transaction and will record such amount in the first quarter of 2006.

As part of our continued efforts to focus on higher growth markets, in December 2005, our Board of Directors also approved a plan to sell our Lithography business. We received proceeds of $0.5 million upon the sale of the business and recognized a pre-tax loss of $3.3 million. We previously had reported the results of this business as part of the Optoelectronics reporting segment.

In June 2005, our Board of Directors approved a plan to shut down our Fiber Optics Test Equipment business as part of our continued efforts to focus on higher growth opportunities. We previously had reported the results of this business as part of the Optoelectronics reporting segment. The shut down of this business resulted in a $5.2 million loss related to lease and severance costs and the reduction of fixed assets and inventory to net realizable value. In August 2005, certain assets that were previously written down were subsequently sold resulting in a gain of $0.1 million.

As part of our continued efforts to focus on higher growth opportunities, in June 2004, our Board of Directors approved a plan to shut down our Electroformed Products business and sell our Ultraviolet Lighting business. In September 2004, our Board of Directors approved a plan to shut down our Computer-To-Plate business. We previously had reported the results of all three of these businesses as part of the Optoelectronics reporting segment. The net assets of the Electroformed Products business were written off resulting in a $1.6 million pre-tax loss for the year ended January 2, 2005. We sold the fixed assets and inventory of the Ultraviolet Lighting business in July 2004 for their approximate book value. The abandonment of the Computer-To-Plate business resulted in a $1.0 million write-down of fixed assets and inventory.

During 2005 and 2004, we settled various claims under certain long-term contracts and transition services with our Technical Services business, which we sold in August 1999. The net settlement and the reversal of certain previously established contingencies resulted in pre-tax gains of $0.9 million in 2005 and $1.5 million in 2004.

Summary operating results of the discontinued operations were as follows:

	2005	2004	2003
		(In thousands)	
Sales	$ 223,997	$ 261,535	$ 194,899
Costs and expenses	200,156	225,045	187,276
Operating income from discontinued operations	23,841	36,490	7,623
Other expense	1,314	1,778	2,600
Income from discontinued operations before income taxes	22,527	34,712	5,023
Provision for income taxes	7,313	14,053	2,371
Income from discontinued operations, net of income taxes	$ 15,214	$ 20,659	$ 2,652

Acquisitions

In February 2005, we acquired Elcos AG, a leading European designer and manufacturer of custom light emitting diode, or LED, solutions for biomedical and industrial applications. Consideration for the transaction was approximately $15.4 million in cash at the time of closing, $0.3 million of additional payments in 2005 and approximately $1.1 million due through fiscal 2007. Also, we estimate that under an earn out provision in the acquisition agreement we will make an additional cash payment of approximately $3.1 million in 2006 to reflect the performance of the business in 2005, with the potential for additional earn out payments being made in 2007 and 2008 based on the performance of the business in 2006 and 2007, respectively.

Contingencies, Including Tax Matters

We are conducting a number of environmental investigations and remedial actions at our current and former locations and, along with other companies, have been named a potentially responsible party for certain waste disposal sites. We accrue for environmental issues in the accounting period that our responsibility is established and when the cost can be reasonably estimated. We have accrued $3.7 million as of January 1, 2006, representing our management s estimate of the total cost of ultimate disposition of known environmental matters. This amount is not discounted and does not reflect any recovery of any amounts through insurance or indemnification arrangements. These cost estimates are subject to a number of variables, including the stage of the environmental investigations, the magnitude of the possible contamination, the nature of the potential remedies, possible joint and several liability, the timeframe over which remediation may occur, and the possible effects of changing laws and regulations. For sites where we have been named a potentially responsible party, our management does not currently anticipate any additional liability to result from the inability of other significant named parties to contribute. We expect that such accrued amounts could be paid out over a period of up to ten years. As assessment and remediation activities progress at each individual site, these liabilities are reviewed and adjusted to reflect additional information as it becomes available. There have been no environmental problems to date that have had or are expected to have a material adverse effect on our financial position or results of operations. While it is possible that a material loss exceeding the amounts recorded may be incurred, we do not expect the potential exposure to be materially different from the amounts we recorded.

In papers dated October 23, 2002, Enzo Biochem, Inc. and Enzo Life Sciences, Inc. (Enzo) filed a complaint in the United States District Court for the Southern District of New York, Civil Action No. 02-8448, against Amersham PLC, Amersham BioSciences, PerkinElmer, Inc., PerkinElmer Life Sciences, Inc., Sigma-Aldrich Corporation, Sigma Chemical Company, Inc., Molecular Probes, Inc., and Orchid BioSciences, Inc. The complaint alleges that we have breached our distributorship and settlement agreements with Enzo, infringed Enzo s patents, engaged in unfair competition and fraud, and committed torts against Enzo by, among other things, engaging in commercial development and exploitation of Enzo s patented products and technology, separately and together with the other defendants. Enzo seeks injunctive and monetary relief. On May 28, 2003, the Court severed the lawsuit and ordered Enzo to serve individual complaints against the five defendants. Enzo served its new complaint on July 16, 2003, and we subsequently filed an answer denying the substantive allegations and including a counterclaim alleging that several of Enzo s patents are invalid. During the last half of 2005, fact discovery was largely completed and a Markman hearing was conducted regarding the construction of the claims in Enzo s patents. The court has not yet issued its decision regarding claim construction or set a date for trial.

On October 17, 2003, Amersham Biosciences Corp. filed a complaint, which was subsequently amended, in the United States District Court for New Jersey, Civil Action No. 03-4901, against one of our subsidiaries alleging that our ViewLux and certain of our Image FlashPlates infringe three of Amersham s patents related to high-throughput screening (the NJ case). On August 18, 2004, Amersham Plc filed a complaint against two of our United Kingdom-based subsidiaries in the Patent Court of the English High Court of Justice, Case No. 04C02688, alleging that the same products infringe Amersham s European (United Kingdom) patent granted in August 2004 (the UK case). Amersham seeks injunctive and monetary relief in both cases. We subsequently filed answers in both cases denying the substantive allegations and including affirmative defenses and counterclaims. On October 29, 2003, we filed a complaint, which was subsequently amended, against Amersham Biosciences Corp. in the United States District Court for Massachusetts, Civil Action No. 03-12098, alleging that Amersham s IN Cell Analyzer, LEADseeker Multimodality Imaging system and certain Cyclic AMP and IP3 assays infringe two of our patents related to high-throughput screening (the MA case). We seek injunctive and monetary relief. Amersham subsequently filed an answer denying the substantive allegations and including affirmative defenses and counterclaims. Trial in the UK case was completed in December 2005. In February 2006, the court ruled that Amersham s patent in question was invalid in the United Kingdom and awarded costs to us. In the NJ case, discovery regarding issues of liability, which have been bifurcated from issues of damages, has largely been completed and a Markman hearing on claim construction is anticipated in early 2006. No trial date has been set. In the MA case, discovery is ongoing.

We believe we have meritorious defenses to these lawsuits and other proceedings, and we are contesting the actions vigorously in all of the above matters. We are currently unable, however, to reasonably estimate the amount of loss, if any, that may result from the resolution of these matters or to determine whether resolution of any of these matters will have a material adverse impact on our consolidated financial statements.

In 2005, we resolved certain claims, including the securities litigation described in Part I of this annual report on Form 10-K under Item 3. Legal Proceedings. The resolution of these claims did not have a material impact on our financial statements.

During 2005, the Internal Revenue Service concluded its audit of federal income taxes for the years 1999 through 2002. We have agreed to all matters with the exception of one, and have filed a single issue protest with the Appeals Division of the Internal Revenue Service, and expect to resolve the matter in 2006. Regardless of the outcome of this matter, we do not expect final resolution to significantly impact our financial position, results of operations or cash flows in 2006.

We are under regular examination by the Internal Revenue Service and other tax authorities in the United States and other countries, such as Germany, the United Kingdom, and states in which we have significant business operations, such as California and New York. The tax years under examination vary by jurisdiction; with the most significant one being that undertaken by the German tax authority for the years 1999 through 2003.

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During the year, in addition to the IRS audit described above, we concluded audits concerning income tax matters affecting certain of our subsidiaries with Texas, Illinois, the United Kingdom, Canada, and Belgium.

As a result of concluding the federal, state, and foreign audits during 2005, we recognized a benefit of $27.5 million.

We regularly assess the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years examinations. Tax reserves have been established, which we believe to be adequate in relation to the potential for additional assessments. Once established, reserves are adjusted as information becomes available and when an event occurs requiring a change to the reserves. The resolution of current tax audits is not expected to have a material effect on our consolidated financial condition, although adjustments related to the examination process or audit settlement could have a material impact on our income tax expense, cash flow, and consolidated statement of income for a particular future period.

We are also subject to various other claims, legal proceedings and investigations covering a wide range of matters that arise in the ordinary course of our business activities. Each of these matters is subject to uncertainties, and it is possible that some of theses matters may be resolved unfavorably to us. In the opinion of our management, based on its review of the information available at this time, the total cost of resolving these other contingencies at January 1, 2006 should not have a material adverse effect on our consolidated financial statements.

Reporting Segment Results of Continuing Operations

Life and Analytical Sciences

2005 Compared to 2004. Sales for 2005 were $1,081.1 million, versus $1,062.8 million in 2004, an increase of $18.3 million, or 2%. Changes in foreign exchange rates had an immaterial impact on sales and operating profit. Fiscal 2005 had 52 weeks compared to 53 weeks in fiscal 2004. In the fourth quarter of fiscal 2004, an average week s sales represented $22.3 million. The following analysis compares significant sales by market and product type for 2005, as compared to 2004, and includes the effect of foreign exchange rate fluctuations and the previously mentioned extra week during 2004: sales to genetic screening customers increased $17.1 million, OneSource service sales increased by $15.1 million, sales to environmental and chemical analysis customers increased $5.5 million, and sales to biopharmaceutical customers decreased $19.4 million. Sales by type of product included increases in sales of instruments of $9.0 million, service of $15.1 million, offset by decreases in consumables of $5.8 million.

Operating profit for 2005 was $110.2 million, versus $103.6 million in 2004, an increase of $6.6 million or 6%. Increases in operating profit resulting from increased sales volume, productivity initiatives and restructuring activities were offset by a restructuring charge of $12.9 million and a $1.7 million increase in research and development spending. Amortization of intangibles was $26.2 million for the year ended January 1, 2006, versus $26.4 million for the year ended January 2, 2005.

2004 Compared to 2003. Sales for 2004 were $1,062.8 million, versus $1,003.7 million in 2003, an increase of $59.1 million, or 6%. Changes in foreign exchange rates increased sales by $39.2 million over 2003. Fiscal 2004 had 53 weeks compared to 52 weeks in fiscal 2003. In the fourth quarter of fiscal 2004, an average week s sales represented $22.3 million. The following analysis compares significant sales by market and product type for 2004, as compared to 2003, and includes the effect of foreign exchange rate fluctuations and the previously mentioned extra week during 2004. Sales to environmental and chemical analysis customers increased $24.8 million, OneSource service sales increased by $20.4

million, sales to genetic screening customers increased $11.4 million, and sales to biopharmaceutical customers increased $2.5 million. Sales by type of product included increases in sales of instruments of $33.5 million, service of $20.4 million, and consumables of $5.2 million.

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Operating profit for 2004 was $103.6 million, versus $94.7 million in 2003, an increase of $8.9 million or 9%. Research and development increased $3.5 million in 2004, as compared to 2003. Contributing to the increase were net cost savings associated with various productivity initiatives, including our restructuring and integration activities which resulted in a reduction of employees and the elimination of excess facilities. Offsetting these net cost savings were a $1.9 million restructuring reversal in 2003 for which there was no similar reversal in 2004, and dispositions which created a $0.8 million loss in 2004 versus dispositions which created a $1.6 million gain in 2003. Amortization of intangibles was $26.4 million for the year ended January 2, 2005, versus $26.0 million for the year ended December 28, 2003.

Optoelectronics

2005 Compared to 2004. Sales for 2005 were $392.7 million, versus $366.3 million for 2004, an increase of $26.4 million, or 7%. Acquisitions increased 2005 sales by $12.1 million over 2004. Changes in foreign exchange rates had an immaterial impact on sales and operating profit. Fiscal 2005 had 52 weeks compared to 53 weeks in fiscal 2004. In the fourth quarter of fiscal 2004, an average week s sales represented $7.1 million. The following analysis of significant sales by product line for 2005, as compared to 2004, includes the effects of changes in foreign exchange rates and the previously mentioned extra week during 2004. Sales of specialty lighting products increased by $10.2 million, sales of digital imaging products increased by $9.4 million due to increased sales of diagnostic and radiotherapy digital x-ray products, and sales of sensors increased $6.8 million.

Operating profit for 2005 was $58.4 million, versus $59.1 million for 2004, a decrease of $0.7 million, or 1%. The decrease in operating profit was primarily the result of increases in operating profit from increased sales volume, net productivity improvements and cost reduction actions, which were more than offset by pricing reductions and a $9.2 million restructuring charge. Amortization of intangible assets increased to $2.6 million in 2005 from $1.2 million in 2004 due to the acquisition of Elcos in the beginning of 2005.

2004 Compared to 2003. Sales for 2004 were $366.3 million, versus $340.8 million for 2003, an increase of $25.5 million, or 7%. Changes in foreign exchange rates increased sales by $6.5 million over 2003. Fiscal 2004 had 53 weeks compared to 52 weeks in fiscal 2003. In the fourth quarter of fiscal 2004, an average week s sales represented $7.1 million. The following analysis of significant sales by product line for 2004, as compared to 2003, includes the effects of changes in foreign exchange rates and the previously mentioned extra week during 2004. Sales of digital imaging products increased by $21.4 million due to increased sales of diagnostic and radiotherapy digital x-ray products. Sales of sensors increased $8.6 million, and sales of specialty lighting products decreased by $4.5 million due to lower photoflash sales into single-use cameras.

Operating profit for 2004 was $59.1 million, versus $52.7 million for 2003, an increase of $6.4 million or 12%. The increase in operating profit was primarily the result of increased sales volume and net productivity improvements and cost reduction actions, offset in part by pricing reductions. Amortization of intangible assets was $1.2 million for both 2004 and 2003.

Liquidity and Capital Resources

We require cash to pay our operating expenses-including funding our research and development, make capital expenditures, service our debt and other long-term liabilities, and pay dividends on our common stock. Our principal sources of funds are from our operations and the capital markets, particularly the debt markets. In the near term, we anticipate that our operations will generate sufficient cash to fund our operating expenses, capital expenditures, interest payments on our debt, and dividends on our common stock. In the long-term, we expect to use internally generated funds and external sources to satisfy our debt and other long-term liabilities.

Principal factors that could affect the availability of our internally generated funds include:

- deterioration of sales due to weakness in markets in which we sell our products and services, and
- changes in our working capital requirements.

Principal factors that could affect our ability to obtain cash from external sources include:

- financial covenants contained in our borrowings that limit our total borrowing capacity,
- increases in interest rates applicable to our outstanding variable rate debt,
- a ratings downgrade that would limit our ability to borrow under our accounts receivable facility and our overall access to the corporate debt market,
- volatility in the markets for corporate debt,
- a decrease in the market price for our common stock, and
- volatility in the public equity markets.

Cash Flows

Fiscal Year 2005

Operating Activities. Net cash generated by continuing operations operating activities was $193.4 million in 2005. Contributing to the generation of cash from operating activities during 2005 were net income from continuing operations of $66.5 million, amortization of deferred debt issuance costs, accretion of discounts and extinguishment of debt of $57.4 million, depreciation and amortization of $67.0 million, non-cash restructuring expense of $22.1 million, stock-based compensation of $9.8 million and a decrease in working capital accounts of $12.5 million, offset by $27.8 million from the resolution of prior year tax contingencies and $13.5 million from accrued expenses and other. Contributing to the decrease in working capital accounts in 2005 was an increase in accounts payable of $23.2 million, offset by increases in accounts receivable of $10.4 million and inventory of $0.3 million. There was no incremental use of our accounts receivable securitization facility during 2005. The outstanding amount under this facility totaled $45.0 million at both January 1, 2006 and January 2, 2005. As discussed under Off-Balance Sheet Arrangements , we had approximately $20 million of undrawn capacity available under the facility at January 1, 2006.

Investing Activities. Investing activities related to continuing operations contributed $333.3 million in 2005. In 2005, we received $366.6 million from the disposition of businesses, primarily comprising Fluid Sciences proceeds of $359.1 million. We also received $9.4 million from dispositions of property, plant and equipment. Also in 2005, we made capital expenditures of $25.1 million, mainly for tooling and productivity improvements and for system and facility costs. In addition, we used $17.6 million for acquisitions and investments, primarily for our acquisition of Elcos for $13.2 million and the settlement of earn outs for $1.8 million.

Financing Activities. In 2005, we used $217.6 million of net cash in continuing operations financing activities. Debt reductions during 2005 totaled $374.7 million, primarily comprising $300.0 million used to repay our senior subordinated debt, and $70.0 million to repay our term loan. In addition, we paid $36.3 million of premium related to the prepayment of our senior subordinated debt and $8.5 million to settle interest rate swaps on this debt. We also paid $36.3 million in dividends and $24.4 million to purchase our common stock pursuant to a stock repurchase program we implemented in 2005. We borrowed $244.3 million related to the repatriation of funds under the American Jobs Creation Act and received $19.4 million from the exercise of employee stock options.

Fiscal Year 2004

Operating Activities. Net cash generated by continuing operations operating activities was $173.0 million in 2004. Contributing to the generation of cash from operating activities during 2004 was net income from continuing operations of $75.9 million, depreciation and amortization of $67.6 million, a net change in deferred taxes of $21.9 million, stock-based compensation of $8.4 million, amortization of deferred debt issuance costs,

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accretion of discounts and extinguishment of debt of $8.1 million, and a decrease in working capital accounts of $9.1 million, offset by a decrease of $10.8 million in accrued expenses and other and a net change of $8.0 million from the resolution of prior year tax contingencies. Contributing to the decrease in working capital in 2004 were decreases in accounts receivable of $18.0 million and inventory of $5.6 million, offset by a decrease in accounts payable of $14.4 million. In general, accounts receivable collections increased due primarily to our focus on improved processes and collections, whereas inventory balances decreased primarily due to improved logistics and inventory management processes. Accounts payable decreased primarily due to timing of payments. There was no incremental use of our accounts receivable securitization facility during 2004.

Investing Activities. Investing activities related to continuing operations used $9.2 million in 2004. In 2004, we made capital expenditures of $15.8 million, mainly for tooling and productivity improvements and for system and facility costs. We derived $3.4 million from sales of a building and equipment and $2.8 million from the settlement of an escrow related to an entity acquired in 2000.

Financing Activities. In 2004, we used $195.7 million of net cash in financing activities related to continuing operations. Debt reductions during 2004 totaled $175.0 million, comprised of $175.0 million used to repay a portion of our term loan. We also paid $35.8 million in dividends and received net cash proceeds from the exercise of employee stock options of $15.0 million in 2004.

Current Borrowing Arrangements

Senior Unsecured Credit Facility. On October 31, 2005, we entered into a new $350 million five-year senior unsecured revolving credit facility. This facility replaced our existing $100 million five-year revolving credit facility. Letters of credit in the aggregate amount of approximately $15 million, originally issued under our previous credit agreement, will be treated as issued under this new agreement. The new senior unsecured credit facility will be used for general corporate purposes which may include fulfilling working capital needs, refinancing existing indebtedness, making capital expenditures, repurchasing shares, or consummating acquisitions and strategic alliances. The interest rates under the senior unsecured credit facility are based on the Eurocurrency rate at the time of borrowing plus a margin, or the base rate from time to time. The base rate is the higher of (1) the corporate base rate announced from time to time by Bank of America, N.A. and (2) the Federal funds rate plus 50 basis points. We may allocate all or a portion of our indebtedness under the senior credit facility to interest based upon the Eurocurrency rate plus a margin or the base rate. The Eurocurrency margin as of January 1, 2006 was 60 basis points; the weighted average Eurocurrency rate was 2.51%. There were approximately $243 million of borrowings under the facility as of January 1, 2006 with interest based on the above described Eurocurrency rate. At year end, the borrowings were undertaken by certain foreign subsidiaries of ours and the funds were borrowed in the subsidiaries functional currencies of Euro (EUR), Canadian Dollars (CAD) and Japanese Yen (JPY). The effective rates of the borrowings as of January 1, 2006 were as follows: EUR: 3.04%; CAD: 3.97% and JPY: .67%.

Our senior credit facility contains covenants that require us to maintain specific financial ratios, including:

- A minimum interest coverage ratio, and
- A maximum total leverage ratio.

At all times during 2005, we were in compliance with all applicable covenants.

Prior to the fourth quarter of 2005, we had a number of borrowings from a number of different sources. These included our:

Senior Secured Credit Facility which was established in December 2002. This facility was the predecessor to the Senior Unsecured Credit Facility described above and was terminated in October 2005. This facility comprised a six-year term loan in the amount of $315.0 million and a $100.0 million five-year secured revolving credit facility. In 2005, prior to the above described refinancing, we made $70.0 million of principal payments on the term loan.

Interest rates under the senior credit facility applicable to the term loan and to the revolving credit facility were determined as a margin over either the Eurodollar rate or the base rate. The base rate was the higher of (1) the corporate base rate announced from time to time by Bank of America, N.A. and (2) the Federal Funds rate plus 50 basis points. The applicable margins for the term loan and the revolving credit facility varied based upon our leverage ratio at the end of the prior quarter. In October 2004, we amended the senior credit facility to allow greater flexibility regarding acquisitions, stock repurchases, debt reduction and cash repatriation.

Our prior revolving credit facility was available to us through December 2007 for our working capital needs. At no point in fiscal 2005, nor at any other time, did we have any outstanding principal balance under this prior revolving credit facility.

Our senior credit facility which terminated in October 2005 contained covenants that required us to maintain specific financial ratios, including:

- a minimum interest coverage ratio,
- a minimum fixed charge coverage ratio, and
- a maximum senior leverage ratio.

At all times during 2005, we were in compliance with all applicable covenants.

Senior Subordinated Notes issued in December 2002. These were ten-year senior subordinated notes issued at a rate of 8 $^{7}/8$% with a face value of $300.0 million (the Senior Subordinated Notes). In the second quarter of 2005, we repurchased $30.0 million of this debt. The Senior Subordinated Notes had an outstanding balance as of October 2, 2005 of $270 million. In the fourth quarter of 2005, we commenced and substantially completed a cash tender offer and consent solicitation for any and all of our outstanding Senior Subordinated Notes. On November 14, 2005, as part of an initial settlement under the tender offer, we repurchased $269.9 million of the Senior Subordinated Notes. We completed the tender offer and repurchased all but $25 thousand of these notes as of November 23, 2005. The source of funds for the tender offer was comprised of proceeds from the sale of our Fluid Testing business, our cash and cash equivalents, and our new unsecured credit facility. In connection with the tender offer, we solicited consents to amend the indenture under which the Senior Subordinated Notes were issued and removed most of the restrictive covenants from the indenture.

In January 2004, we swapped the fixed rate on $100 million of the Senior Subordinated Notes to a floating rate using swap instruments which reset semi-annually in arrears based upon six-month USD LIBOR and an applicable spread as defined in the swap agreements. In January 2005, we swapped an additional $100 million of these notes from fixed rate to floating rate at similar terms to the January 2004 swap, and therefore we were obligated to pay the applicable six-month USD LIBOR rate, plus the applicable spread, on $200 million of our obligations represented by the notes. On November 10, 2005, we terminated the interest rate swaps in conjunction with our tender of the Senior Subordinated Notes at a cost of $8.5 million.

6.8% Notes issued by one of our acquired companies. In December 2002, we initiated a tender offer for all of our outstanding 6.8% notes. We completed the tender offer and repurchased all but $4.7 million of these notes as of December 26, 2002. The remaining principal balance of $4.7 million matured and was paid in the fourth quarter of 2005.

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Off-Balance Sheet Arrangements

Receivables Securitization Facility

Through a wholly owned consolidated subsidiary, we purchase, on a revolving basis, certain of our accounts receivable balances and simultaneously sell an undivided interest in this pool of receivables to a financial institution. The total funding capacity under this facility is $65.0 million. Amounts funded under this facility were $45.0 million at both January 1, 2006 and January 2, 2005. As of January 1, 2006, we had approximately $20 million of undrawn capacity available under the facility. The facility had an effective interest rate of approximately LIBOR plus 53 basis points as of January 1, 2006. The facility includes conditions that require us to maintain a senior unsecured credit rating of BB or above, as defined by Standard & Poor s Rating Services, and Ba2 or above, as defined by Moody s Investors Service. At January 1, 2006, we had a senior unsecured credit rating of BBB- with a stable outlook from Standard & Poor s Rating Services, and of Baa3 with a stable outlook from Moody s Investors Service. The facility expires on January 26, 2007.

Dividends

Our Board of Directors declared regular quarterly cash dividends of seven cents per share in each quarter of 2005 and 2004, resulting in an annual dividend rate of 28 cents per share.

Contractual Obligations

The following table summarizes our contractual obligations at January 1, 2006:

	Operating Leases	Sr. Unsecured Credit Facility Maturing 2010	8.875% Sr. Subordinated Notes due 2013	Other Revolving Debt Facilities	Total
			(In thousands)		
2006	$ 30,568	$	$	$ 1,131	$ 31,699
2007	22,399				22,399
2008	18,752				18,752
2009	15,652				15,652
2010	13,732	243,257			256,989
2011 and beyond	61,637		25		61,662
Total	$ 162,740	$ 243,257	$ 25	$ 1,131	$ 407,153

Because the credit facility borrowings are considered to carry variable interest rates, the above table does not contemplate interest obligations.

Capital Expenditures

During 2006, we expect to make capital expenditures of approximately $35 million to $45 million primarily to introduce new products, to improve our operating processes, to shift the production capacity to lower cost locations, to relocate certain administrative facilities, and to capitalize expenses related to internally developed information technology. We expect to use our available cash and internally generated funds to fund these expenditures.

Other Potential Liquidity Considerations

In February 2005, we acquired Elcos AG, a leading European designer and manufacturer of custom light emitting diode, or LED, solutions for biomedical and industrial applications. The transaction combines Elcos visible LED technology platform and strong customer and application base with our global sales, application and support organization, therefore expanding the sales growth opportunities for the Elcos technology. We paid approximately $15.4 million in cash at the time of closing, $0.3 million in additional payments in 2005, and are required to make future cash payments of approximately $1.1 million through fiscal 2007. Also, we estimate that under an earn out provision in the acquisition agreement we will make an additional cash payment of approximately $3.1 million in 2006 to reflect the performance of the business in 2005, with the potential for additional earn out payments being made in 2007 and 2008 based on the performance of the business in 2006 and 2007, respectively.

On October 21, 2005 our Board of Directors reaffirmed our authority to repurchase up to 10.0 million shares of our common stock, which we publicly disclosed on November 14, 2005 (the Program). This Program will expire on October 21, 2008, unless it is earlier terminated by our Board of Directors. During the fourth quarter of 2005, we repurchased 1.1 million shares of our common stock in the open market under the Program at an aggregate cost of $24.4 million. Subsequent to year end, we repurchased 5.0 million shares of our common stock in the open market under the Program at an average cost of $23.25 per share.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS No. 95, Statement of Cash Flows. This statement addressed the accounting for share-based payments to employees, including grants of employee stock options. Under the new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB Opinion No. 25. Instead, companies will be required to account for such transactions using a fair-value method and recognize the related expense associated with share-based payments in the statement of operations. SFAS 123R is effective for us as of January 1, 2006. We historically accounted for share-based payments to employees under APB Opinion No. 25 s intrinsic value method. As such, we have not recognized compensation expense for options granted to employees. We will adopt the provisions of SFAS 123R under the modified prospective method, in which compensation cost for all share-based payments granted or modified after the effective date is recognized based upon the requirements of SFAS 123R, and compensation cost for all awards granted to employees prior to the effective date that are unvested as of the effective date of SFAS 123R is recognized based on SFAS 123. Tax benefits will be recognized related to the cost for share-based payments to the extent the equity instrument would ordinarily result in a future tax deduction under existing law. Tax expense will be recognized to write off excess deferred tax assets when the tax deduction upon settlement of a vested option is less than the expense recorded in the statement of operations (to the extent not offset by prior tax credits for settlements where the tax deduction was greater than the fair value cost). Our current estimates associated with 2006 indicate that we will recognize stock option compensation expense of approximately 6 cents per share. This amount is subject to revisions as we finalize certain assumptions related to 2006, including the size and nature of awards and forfeiture rates. SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost be reported as a financial cash flow rather than as operating cash flow as was required. We cannot estimate what the future tax benefits will be as the amounts depend on, among other factors, future employee stock option exercises.

In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 regarding the Staff s interpretation of SFAS 123R. This interpretation provides the Staff s views regarding interactions between SFAS 123R and certain SEC rules and regulations, and provides interpretations of the valuation of share-based payments for public companies. The interpretive guidance is intended to assist companies in applying the provisions of SFAS 123R, and investors and users of the financial statements in analyzing the information provided. We will follow the guidance prescribed in SAB No. 107NT>5,502,027 5,760,906

2007

3,887,761 4,078,885 1,276,399 1,291,888

2008

31,122 7,672

Total real estate loans	$14,639,145	$15,506,529	$11,385,998	$11,901,324

(1) Average LTV/CLTV at loan origination and average estimated current LTV/CLTV at December 31, 2007 is not shown as the data is not readily available.

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Allowance for Loan Losses

The allowance for loan losses is management s estimate of credit losses inherent in our loan portfolio as of the balance sheet date. The estimate of the allowance for loan losses is based on a variety of factors, including the composition and quality of the portfolio; delinquency levels and trends; probable expected losses for the next twelve months; current and historical charge-off and loss experience; current industry charge-off and loss experience; the condition of the real estate market and geographic concentrations within the loan portfolio; the interest rate climate; the overall availability of housing credit; and general economic conditions. Determining the adequacy of the allowance is complex and requires judgment by management about the effect of matters that are inherently uncertain. Subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the allowance for loan losses in future periods. We believe our allowance for loan losses at March 31, 2008 is representative of probable losses inherent in the loan portfolio at the balance sheet date.

In determining the allowance for loan losses, we allocate a portion of the allowance to various loan products based on an analysis of individual loans and pools of loans. However, the entire allowance is available to absorb credit losses inherent in the total loan portfolio as of the balance sheet date.

The following table presents the allowance for loan losses by major loan category (dollars in thousands):

	One- to Four-Family		Home Equity		Consumer and Other		Total	
	Allowance	Allowance as a % of Loans Receivable[1]	Allowance	Allowance as a % of Loans Receivable[1]	Allowance	Allowance as a % of Loans Receivable[1]	Allowance	Allowance as a % of Loans Receivable[1]
March 31, 2008	$ 41,403	0.28%	$ 490,831	4.23%	$ 33,674	1.24%	$ 565,908	1.95%
December 31, 2007	$ 18,831	0.12%	$ 459,167	3.79%	$ 30,166	1.05%	$ 508,164	1.66%

(1) Allowance as a percentage of loans receivable is calculated based on the gross loans receivable for each respective category.

During the three months ended March 31, 2008, the allowance for loan losses increased by $57.7 million from the level at December 31, 2007. This increase was driven primarily by the increase in the allowance allocated to the home equity loan portfolio, which began to deteriorate during the second half of 2007. During the first quarter of 2008, we also observed deterioration in the performance of our one- to four-family loan portfolio. We believe the deterioration in both of these portfolios was caused by several factors, including: home price depreciation in key markets; growing inventories of unsold homes; rising foreclosure rates; significant contraction in the availability of credit; and a general decline in economic growth. In addition, the combined impact of home price depreciation and the reduction of available credit made it increasingly difficult for borrowers to refinance existing loans. We believe these factors will cause the provision for loan losses to continue at historically high levels in future periods.

The following table provides an analysis of the net charge-offs for the three months ended March 31, 2008 and 2007 (dollars in thousands):

	Charge-offs	Recoveries	Net Charge-offs	% of Average Loans (Annualized)
Three months ended March 31, 2008				
One- to four-family	$ (15,058)	$ 455	$ (14,603)	0.38 %
Home equity	(150,128)	762	(149,366)	5.02 %
Recreational vehicle	(11,470)	3,266	(8,204)	1.73 %
Marine	(3,085)	1,335	(1,750)	1.35 %
Credit card	(2,511)	195	(2,316)	10.58 %
Other	(160)	272	112	(0.16)%
Total	$ (182,412)	$ 6,285	$ (176,127)	2.36 %
Three months ended March 31, 2007				
One- to four-family	$ (674)	$	$ (674)	0.02 %
Home equity	(11,941)	422	(11,519)	0.37 %
Recreational vehicle	(7,487)	3,373	(4,114)	0.72 %
Marine	(2,612)	1,238	(1,374)	0.85 %
Credit card	(3,569)	194	(3,375)	11.21 %
Other	(355)	586	231	(0.31)%
Total	$ (26,638)	$ 5,813	$ (20,825)	0.30 %

Loan losses are recognized when it is probable that a loss will be incurred. Our policy is to charge-off closed-end consumer loans when the loan is 120 days delinquent or when we determine that collection is not probable. For credit cards, our policy is to charge-off loans when collection is not probable or the loan has been delinquent for 180 days. Our policy for one- to four-family loan charge-offs prior to January 1, 2008 was to recognize a charge-off when we foreclosed on the property. For home equity loans, our policy prior to January 1, 2008 was to charge-off loans when we foreclosed on the property or when the loan had been delinquent for 180 days. As of January 1, 2008, we adjusted our charge-off policy mainly for loans in the process of foreclosure. Our updated policy for both one- to four-family and home equity loans is to assess the value of the property when the loan has been delinquent for 180 days, regardless of whether or not the property is in foreclosure, and charge-off the amount of the loan balance in excess of the estimated current property value. As a result of this change, we recorded additional charge-offs of $8.3 million on one- to four-family loans and $21.7 million on home equity loans during the first quarter of 2008.

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Net charge-offs for the three months ended March 31, 2008 compared to the same period in 2007 increased by $155.3 million. The overall increase was primarily due to higher net charge-offs on home equity loans, which was driven mainly by the same factors as described above. The continued pressure in the residential real estate market, specifically home price depreciation combined with tighter mortgage lending guidelines, will likely lead to a higher level of charge-offs in future periods. The following graph illustrates the net charge-offs by quarter:

Nonperforming Assets

We classify loans as nonperforming when they are 90 days past due. The following table shows the comparative data for nonperforming loans and assets (dollars in thousands):

	March 31, 2008	December 31, 2007
One- to four-family[1]	$ 292,165	$ 181,315
Home equity	285,074	229,523
Consumer and other loans	7,141	7,604
Total nonperforming loans	584,380	418,442
Real estate owned (REO) and other repossessed assets, net	60,852	45,895
Total nonperforming assets, net	$ 694,232	$ 464,337
Nonperforming loans receivable as a percentage of gross loans receivable	2.02%	1.37%
One- to four-family allowance for loan losses as a percentage of one- to four-family nonperforming loans	14.17%	10.39%
Home equity allowance for loan losses as a percentage of home equity nonperforming loans	172.18%	200.05%
Consumer and other allowance for loan losses as a percentage of consumer and other nonperforming loans	471.56%	396.71%
Total allowance for loan losses as a percentage of total nonperforming loans	96.84%	121.44%

(1) One- to four-family excludes held-for-sale loans of $0.3 million and $0.1 million at March 31, 2008 and December 31, 2007, respectively. Loans held-for-sale are accounted for at lower of cost or market value with adjustments recorded in the gain (loss) on loans and securities, net line item and are not considered in the allowance for loan losses.

During the three months ended March 31, 2008, our nonperforming assets, net increased $229.9 million from $464.3 million at December 31, 2007. The increase was attributed primarily to an increase in nonperforming one- to four-family loans of $110.9 million and home equity loans of $55.6 million for the three months ended March 31, 2008 when compared to December 31, 2007. We expect nonperforming loan levels to increase over time due to the weak conditions in the residential real estate and credit markets.

The following graph illustrates the nonperforming loans by quarter:

The allowance as a percentage of total nonperforming loans receivable, net decreased from 121% at December 31, 2007 to 97% at March 31, 2008. This decrease was driven primarily by an increase in one- to four-family non-performing loans, which have a significantly lower level of expected loss when compared to home equity loans.

In addition to nonperforming assets in the table above, we monitor loans where a borrower s past credit history casts doubt on their ability to repay a loan (Special Mention loans). We classify loans as Special Mention when they are between 30 and 89 days past due. The following table shows the comparative data for Special Mention loans (dollars in thousands):

	March 31, 2008	December 31, 2007
One- to four-family[1]	$ 363,389	$ 296,764
Home equity	276,790	291,675
Consumer and other loans	22,912	23,800
Total Special Mention loans	$ 663,091	$ 612,239
Special Mention loans receivable as a percentage of gross loans receivable	2.29%	2.00%

(1) One- to four-family excludes held-for-sale loans of $0.1 million and $0.4 million at March 31, 2008 and December 31, 2007, respectively. Loans held-for-sale are accounted for at lower of cost or market value with adjustments recorded in the gain (loss) on loans and securities, net line item and are not considered in the allowance for loan losses.

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The trend in Special Mention loan balances are generally indicative of the expected trend for charge-offs in future periods, as these loans have a greater propensity to migrate into nonaccrual status and ultimately charge- off. One- to four-family loans are generally secured, in a first lien position, by real estate assets, reducing the potential loss when compared to an unsecured loan. Our home equity loans are generally secured by real estate assets; however, the majority of these loans are secured in a second lien position which substantially increases the potential loss when compared to a first lien position.

While our total Special Mention loans increased during the period, our home equity Special Mention loans, which we believe represent our most significant exposure to future credit losses, declined by $14.9 million to $276.8 million.

The following graph illustrates the Special Mention loans by quarter:

Securities

We focus primarily on security type and credit rating to monitor credit risk in our securities portfolios. We believe our asset-backed securities portfolio, which we sold in the fourth quarter of 2007, represented our highest concentration of credit risk within the securities portfolio. Subsequent to the sale of that portfolio, we believe our highest concentration of remaining credit risk, while dramatically lower than the credit risk inherent in asset-backed securities, is our CMO portfolio. The table below details the amortized cost by average credit ratings and type of asset as of March 31, 2008 and December 31, 2007 (dollars in thousands):

March 31, 2008	**AAA**	**AA**	**A**	**BBB**	**Below Investment Grade and Non-Rated**	**Total**
Mortgage-backed securities backed by U.S. Government sponsored and Federal agencies	$ 7,553,314	$	$	$	$	$ 7,553,314
CMOs and other	1,003,619	126,188	413			1,130,220
Municipal bonds, corporate bonds, preferred stock and FHLB stock	311,232	396,977	14,311			722,520
Total	$ 8,868,165	$ 523,165	$ 14,724	$	$	$ 9,406,054

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December 31, 2007	AAA	AA	A	BBB	Below Investment Grade and Non-Rated	Total
Mortgage-backed securities backed by U.S. Government sponsored and Federal agencies	$ 9,697,723	$	$	$	$	$ 9,697,723
CMOs and other	1,066,290	132,330	469			1,199,089
Asset-backed securities					122	122
Municipal bonds, corporate bonds, preferred stock and FHLB stock	675,058	596,047	8,342			1,279,447
Total	$ 11,439,071	$ 728,377	$ 8,811	$	$ 122	$ 12,176,381

While the vast majority of this portfolio is AAA-rated, we continue to monitor these securities for impairment. During the three months ended March 31, 2008, we identified approximately $183 million of CMOs that showed a possibility of future loss. As a result, $95 million of these securities were written down to their estimated fair market value by recording a $26.6 million impairment during the first quarter of 2008. Further declines in the performance of our CMO portfolio could result in additional impairments in future periods.

During the three months ended March 31, 2008, we sold certain of our mortgage-backed securities, which is the primary reason for the decline in our securities balance compared to the balance as of December 31, 2007.

SUMMARY OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of our financial condition and results of operations requires us to make judgments and estimates that may have a significant impact upon the financial results of the Company. We believe that of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management, which can materially impact reported results: allowance for loan losses and uncollectible margin loans; classification and valuation of certain investments; valuation and accounting for financial derivatives; estimates of effective tax rate; deferred taxes and valuation allowances; and valuation of goodwill and other intangibles. These are more fully described in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2007.

Classification and Valuation of Certain Investments

Effective January 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), which defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Company determines the fair values of its financial instruments and for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis in accordance with SFAS No. 157. The Company will not adopt this statement until January 1, 2009 for nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis. Examples of nonfinancial assets and nonfinancial liabilities for which the Company has not applied the provisions of SFAS No. 157 include reporting units, nonfinancial assets and nonfinancial liabilities and indefinite-lived intangible assets measured at fair value in impairment tests under SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142), nonfinancial long-lived assets measured at fair value for an impairment assessment under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144) as well as nonfinancial liabilities for exit or disposal activities initially measured at fair value under SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146).

In determining fair value, the Company uses various valuation approaches, including market, income and/or cost approaches. The fair value hierarchy established in SFAS No. 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is a market-based measure considered from the perspective of a market participant. As such, even when market assumptions are not readily available, the Company s own assumptions reflect those that market participants would use in pricing the asset or liability at the measurement date. The standard describes three levels of inputs that may be used to measure fair value and are as follows:

Level 1 Quoted prices in active markets for identical assets or liabilities. Examples of assets and liabilities utilizing Level 1 inputs include actively traded equity securities.

Level 2 Quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly. Examples of assets and liabilities utilizing Level 2 inputs include mortgage-backed securities backed by U.S. Government sponsored and Federal agencies, certain CMOs, most investment securities and most over-the-counter (OTC) derivatives.

Level 3 Unobservable inputs that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. Examples of assets and liabilities utilizing significant Level 3 inputs or those that require significant management judgment include most CMOs, servicing rights, retained interest in securitizations, certain other mortgage-backed securities, and certain OTC derivatives. In certain securities, including a portion of the CMO portfolio, where there has been limited activity or less transparency around inputs to the valuation, securities are classified as Level 3 even though the Company believes that Level 2 inputs could likely be obtainable in a more active market.

The availability of observable inputs can vary from instrument to instrument and in certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an instrument s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company s assessment of the significance of a particular input to the fair value measurement of an instrument requires judgment and consideration of factors specific to the instrument.

Fair Value Option

Effective January 1, 2008, the Company elected to carry investments in Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) preferred stock at fair value through earnings under SFAS No. 159. The Company elected to carry the investment in preferred stock at fair value through earnings to allow the Company to economically hedge the portfolio without the burden of complying with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133), as amended. The impact of this adoption was an after-tax decrease to opening retained earnings as of January 1, 2008 of approximately $86.9 million. As of December 31, 2007, the Company s investment in preferred stock was reported in the balance sheet line item available-for-sale mortgage-backed and investment securities. In accordance with SFAS No. 159, as a result of the fair value election the investment in preferred stock is reported in the balance sheet line item trading securities as of March 31, 2008. Realized and unrealized gains and losses on securities classified as trading are included in the gain (loss) on loans and securities, net line item. During the first quarter of 2008, the Company used equity put options and credit default swaps as economic hedges against potential declines in the value of the preferred stock. Derivatives used as economic hedges but not designated in a hedging relationship for accounting purposes are included in derivative assets or derivative liabilities. The mark on the net hedged position is recognized in gain (loss) on loans and securities, net.

Valuation Techniques

The fair value for certain financial instruments is derived using pricing models and other valuation techniques that in involve significant management judgment. The price transparency of financial instruments is a key determinant of the degree of judgment involved in determining the fair value of the Company s financial instruments. Financial instruments for which actively quoted prices or pricing parameters are available will generally have a higher degree of price transparency than financial instruments that are thinly traded or not quoted.

SFAS No. 157 states that the fair value measurement of a liability must reflect the nonperformance risk of the entity. The Company manages credit risk by following an established credit approval process, which includes monitoring credit limits based on counterparty credit rating, as well as by enforcing collateral requirements through credit support agreements which reduce risk by permitting the netting of transactions with the same counterparty upon occurrence of certain events. During the three months ended March 31, 2008, the consideration of credit risk did not result in a material adjustment to the valuation of OTC derivative contracts.

Mortgage-backed Securities Backed by U.S. Government Sponsored and Federal Agencies

Mortgage-backed securities backed by U.S. government sponsored and federal agencies include to be announced (TBA) securities and mortgage pass-through certificates. The fair value of TBA securities is determined using quoted market prices. The fair value of mortgage pass-through certificates is determined using quoted market prices, price activity and spread data for similar instruments. Mortgage-backed securities backed by U.S. government sponsored and federal agencies are generally categorized in Level 2 of the fair value hierarchy.

Collateralized Mortgage Obligations

CMOs, generally non-agency mortgage-backed securities, are typically valued using external price activity and spread data for similar instruments. The valuations of CMOs reflect the Company s best estimate of what market participants would consider in pricing the financial instruments. The Company considers the price transparency for these financial instruments to be a key determinant of the degree of judgment involved in determining the fair value. Due to the limited activity and low level of transparency around inputs to the valuation, a portion of these securities are classified as Level 3 even though the Company believes that Level 2 inputs could likely be obtainable in a more active market.

Investment Securities

Investment securities includes preferred stock, municipal bonds and corporate bonds. The fair value of preferred stock is typically estimated using market price quotations and the investment is generally categorized in Level 2 of the fair value hierarchy. The fair value of municipal bonds is estimated using pricing information based on bond characteristics, such as credit quality, maturity, coupon as well as where bonds with similar characteristics have traded. Municipal bonds are generally categorized in Level 2 of the fair value hierarchy. The fair value of corporate bonds is estimated using market price quotes corroborated by recently executed transactions observable in the market. Corporate bonds are generally categorized in Level 2 of the fair value hierarchy.

Derivative Financial Instruments

Derivative financial instruments include OTC swaps and option contracts related to interest rates, credit standing of reference entities or equity prices. The majority of the Company s derivative financial instruments, interest rate swap and option contracts, are valued with pricing models commonly used by the financial services industry using market observable pricing inputs. The Company does not consider these models to involve significant judgment on the part of management. The majority of the Company s derivative financial instruments are categorized in Level 2 of the fair value hierarchy.

Securities Owned and Securities Sold, Not Yet Purchased

Proprietary securities transactions entered into by broker-dealer subsidiaries for trading or investment purposes are included in Securities owned and Securities sold, not yet purchased in the Company s SFAS

No. 157 disclosures. The fair value of securities owned and securities sold, not yet purchased is determined using observable market price quotes from recently executed transactions and are generally categorized in Level 1 or Level 2 of the fair value hierarchy.

Servicing Rights

On January 1, 2008, the Company elected to account for servicing rights under the fair value measurement method in accordance with SFAS No. 156, *Accounting for Servicing Financial Assets, an Amendment of SFAS No. 140* (SFAS. No. 156). The fair value of the servicing rights is determined using models that include observable inputs, if available. To the extent observable inputs are not available, the Company estimates fair value based on the present value of expected future cash flows using its best estimate of the key assumptions, including anticipated loan prepayments and discount rates. Servicing rights are categorized as Level 3 in the fair value hierarchy when unobservable inputs are significant to the fair value measurements.

Retained Interests in Securitization

The fair value of the retained interests in securitizations is determined using models that include observable inputs, if available. To the extent observable inputs are not available, the Company estimates fair value based on the present value of expected future cash flows using its best estimate of the key assumptions, including forecasted credit losses, prepayments rates and discount rates. Retained interests in securitizations are categorized as Level 3 in the fair value hierarchy when unobservable inputs are significant to the fair value measurements.

GLOSSARY OF TERMS

Active Trader The customer segment that includes those who execute 30 or more trades per quarter.

Adjusted total assets Bank-only assets composed of total assets plus/(less) unrealized losses (gains) on available-for-sale securities, less deferred tax assets, goodwill and certain other intangible assets.

Average commission per trade Total retail segment commission revenue divided by total number of retail trades.

Average equity to average total assets Average total shareholders equity divided by average total assets.

Bank ETB Holdings, Inc. (ETBH), the entity that is our bank holding company and parent to E*TRADE Bank.

Basis point One one-hundredth of a percentage point.

Cash flow hedge A financial derivative instrument designated in a hedging relationship that mitigates exposure to variability in expected future cash flows attributable to a particular risk.

Charge-off The result of removing a loan or portion of a loan from an entity s balance sheet because the loan is considered to be uncollectible.

Compensation and benefits as a percentage of revenue Total compensation and benefits expense divided by total net revenue.

Contract for difference (CFDs) A derivative based on an underlying stock or index that covers the difference between the nominal value at the opening of a trade and at the close of a trade. A CFD is researched and traded in the same manner as a stock.

Corporate investments Primarily equity investments held at the parent company level that are not related to the ongoing business of the Company s operating subsidiaries.

Customer cash and deposits Deposits (excluding brokered certificates of deposit), customer payables and money market balances, including those held by third parties.

Daily average revenue trades (DARTs) Total revenue trades in a period divided by the number of trading days during that period.

Derivative A financial instrument or other contract, the price of which is directly dependent upon the value of one or more underlying securities, interest rates or any agreed upon pricing index. Derivatives cover a wide assortment of financial contracts, including forward contracts, options and swaps.

*E*TRADE Complete* An integrated trading, investing and banking product that allows customers to manage their relationships with the Company through one account. E*TRADE Complete helps customers optimize cash and credit by utilizing tools designed to inform them of whether or not they are receiving the most appropriate rates for their cash and paying the most appropriate rates for credit.

Enterprise interest-bearing liabilities Liabilities such as customer deposits, repurchase agreements, other borrowings and advances from the FHLB, certain customer credit balances and stock loan programs on which the Company pays interest; excludes customer money market balances held by third parties.

Enterprise interest-earning assets Consists of the primary interest-earning assets of the Company and includes: loans receivable, mortgage-backed and available-for-sale securities, margin receivables, stock borrow balances, and cash required to be segregated under regulatory guidelines that earn interest for the Company.

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Enterprise net interest income The taxable equivalent basis net operating interest income excluding corporate interest income and corporate interest expense, stock conduit interest income and expense and interest earned on customer cash held by third parties.

Enterprise net interest spread The taxable equivalent rate earned on average enterprise interest-earning assets less the rate paid on average enterprise interest-bearing liabilities, excluding corporate interest-earning assets and liabilities, stock conduit and cash held by third parties.

Exchange-traded funds A fund that invests in a group of securities and trades like an individual stock on an exchange.

Fair value The exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

Fair value hedge A financial derivative instrument designated in a hedging relationship that mitigates exposure to changes in the fair value of a recognized asset or liability or a firm commitment.

Generally Accepted Accounting Principles (GAAP) Accounting principles generally accepted in the United States of America.

Interest rate cap An options contract that puts an upper limit on a floating exchange rate. The writer of the cap has to pay the holder of the cap the difference between the floating rate and the upper limit when that upper limit is breached. There is usually a premium paid by the buyer of such a contract.

Interest rate floor An options contract that puts a lower limit on a floating exchange rate. The writer of the floor has to pay the holder of the floor the difference between the floating rate and the lower limit when that lower limit is breached. There is usually a premium paid by the buyer of such a contract.

Interest rate swaps Contracts that are entered into primarily as an asset/liability management strategy to reduce interest rate risk. Interest rate swap contracts are exchanges of interest rate payments, such as fixed-rate payments for floating-rate payments, based on notional principal amounts.

Main Street Investor The customer segment that includes those who execute less than 30 trades per quarter and hold less than $50,000 in assets in combined retail accounts.

Margin debt The extension of credit to brokerage customers of the Company, on and off balance sheet, where the loan is secured with securities owned by the customer.

Mass Affluent The customer segment that includes those who hold $50,000 or more in assets in combined retail accounts.

Net Present Value of Equity (NPVE) The present value of expected cash inflows from existing assets, minus the present value of expected cash outflows from existing liabilities, plus the expected cash inflows and outflows from existing derivatives and forward commitments. This calculation is performed for E*TRADE Bank.

Nonperforming assets Assets that do not earn income, including those originally acquired to earn income (delinquent loans) and those not intended to earn income (REO). Loans are classified as nonperforming when full and timely collection of interest and principal becomes uncertain or when the loans are 90 days past due.

Notional amount The specified dollar amount underlying a derivative on which the calculated payments are based.

Operating expenses Total expense excluding interest, as shown on the Company s consolidated statement of income (loss).

Operating margin Income (loss) before other income (expense) and income taxes.

Operating margin (%) Percentage of net revenue that goes to income (loss) before other income (expense) and income taxes. It is calculated by dividing our income (loss) before other income (expense) and income taxes, by our total net revenue.

Option adjustable-rate mortgage (ARM) loan An adjustable-rate mortgage loan that provides the borrower with the option to make a fully-amortizing, interest-only, or minimum payment each month. The minimum payment on an Option ARM loan is usually based on the interest rate charged during the introductory period. This introductory rate is usually significantly below the fully-indexed rate for loans with short duration introductory periods.

Options Contracts that grant the purchaser, for a premium payment, the right, but not the obligation, to either purchase or sell the associated financial instrument at a set price during a period or at a specified date in the future.

Organic Business related to new and existing customers as opposed to acquisitions.

Principal transactions Transactions that primarily consist of revenue from market-making activities.

Real-estate owned repossessed assets (REO) Ownership of real property by the Company, generally acquired as a result of foreclosure.

Repurchase agreement An agreement giving the seller of an asset the right or obligation to buy back the same or similar securities at a specified price on a given date. These agreements are generally collateralized by mortgage-backed or investment-grade securities.

Retail customer assets Market value of all customer assets held by the Company including security holdings, customer cash and deposits and vested unexercised options.

Retail deposits Balances of retail customer cash held at the Bank; excludes brokered certificates of deposit.

Return on average total assets Annualized net income from continuing operations divided by average assets.

Return on average total shareholders equity Annualized net income from continuing operations divided by average shareholders equity.

Revenue growth The difference between the current and prior comparable period total net revenue divided by the prior comparable period total net revenue.

Risk-weighted assets Primarily computed by the assignment of specific risk-weightings assigned by the OTS to assets and off-balance sheet instruments for capital adequacy calculations. This calculation is for E*TRADE Bank only.

Stock conduit The borrowing of shares from a Broker-Dealer and subsequently lending the same shares to another Broker-Dealer netting a fee.

Sweep deposit accounts Accounts with the functionality to transfer brokerage cash balances to and from an FDIC-insured money market account at the Bank.

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Taxable equivalent interest adjustment The operating interest income earned on certain assets is completely or partially exempt from federal and/or state income tax. As such, these tax-exempt instruments typically yield lower returns than a taxable investment. To provide more meaningful comparison of yields and margins for all interest-earning assets, the interest income earned on tax exempt assets is increased to make it fully equivalent to interest income on other taxable investments. This adjustment is done for the analytic purposes in the net enterprise interest income/spread calculation and is not made on the consolidated statement of income (loss), as that is not permitted under GAAP.

Tier 1 Capital Adjusted equity capital used in the calculation of capital adequacy ratios at E*TRADE Bank as required by the OTS. Tier 1 capital equals: total shareholder s equity at E*TRADE Bank, plus/(less) unrealized losses (gains) on available-for-sale securities and cash flow hedges, less deferred tax assets, goodwill and certain other intangible assets.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The following discussion about our market risk disclosure includes forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of certain factors, including, but not limited to, those set forth in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007 and as updated in this report. Market risk is our exposure to changes in interest rates, foreign exchange rates and equity and commodity prices. Our exposure to interest rate risk is related primarily to interest-earning assets and interest-bearing liabilities.

Interest Rate Risk

The management of interest rate risk is essential to profitability. Interest rate risk is our exposure to changes in interest rates. In general, we manage our interest rate risk by balancing variable-rate and fixed-rate assets and liabilities and we utilize derivatives in a way that reduces our overall exposure to changes in interest rates. In recent years, we have managed our interest rate risk to achieve a minimum to moderate risk profile with limited exposure to earnings volatility resulting from interest rate fluctuations. Exposure to interest rate risk requires management to make complex assumptions regarding maturities, market interest rates and customer behavior. Changes in interest rates, including the following, could impact interest income and expense:

- Interest-earning assets and interest-bearing liabilities may re-price at different times or by different amounts creating a mismatch.
- The yield curve may flatten or change shape affecting the spread between short- and long-term rates. Widening or narrowing spreads could impact net interest income.
- Market interest rates may influence prepayments resulting in maturity mismatches. In addition, prepayments could impact yields as premium and discounts amortize.

Exposure to market risk is dependent upon the distribution and composition of interest-earning assets, interest-bearing liabilities and derivatives. The differing risk characteristics of each product are managed to mitigate our exposure to interest rate fluctuations. At March 31, 2008, 89% of our total assets were enterprise interest-earning assets.

At March 31, 2008, approximately 65% of our total assets were residential real estate loans and available-for-sale mortgage-backed securities. The values of these assets are sensitive to changes in interest rates, as well as expected prepayment levels. As interest rates increase, fixed rate residential mortgages and mortgage-backed securities tend to exhibit lower prepayments. The inverse is true in a falling rate environment.

When real-estate loans prepay, unamortized premiums are written off. Depending on the timing of the prepayment, the write-offs of unamortized premiums may result in lower than anticipated yields. The ALCO reviews estimates of the impact of changing market rates on loan production volumes and prepayments. This information is incorporated into our interest rate risk management strategy.

Our liability structure consists of transactional deposit relationships, such as money market and savings accounts; certificates of deposit; securities sold under agreements to repurchase; customer payables; other borrowings; and corporate debt. Our transactional deposit accounts and customer payables tend to be less rate-sensitive than wholesale borrowings. Agreements to repurchase securities re-price as interest rates change. Money market and savings accounts re-price at management s discretion. Certificates of deposit re-price over time depending on maturities. FHLB advances and corporate debt generally have fixed rates.

Derivative Financial Instruments

We use derivative financial instruments to help manage our interest rate risk. Interest rate swaps involve the exchange of fixed-rate and variable-rate interest payments between two parties based on a contractual underlying notional amount, but do not involve the exchange of the underlying notional amounts. Option products are utilized primarily to decrease the market value changes resulting from the prepayment dynamics of the mortgage portfolio, as well as to protect against increases in funding costs. The types of options employed include Cap Options (Caps) and Floor Options (Floors), Payor Swaptions and Receiver Swaptions. Caps mitigate the market risk associated with increases in interest rates while Floors mitigate the risk associated with decreases in market interest rates. Similarly, Payor and Receiver Swaptions mitigate the market risk associated with the respective increases and decreases in interest rates. See derivative financial instruments discussion at Note 6 Accounting for Derivative Financial Instruments and Hedging Activities in Item 1. Consolidated Financial Statements.

Scenario Analysis

Scenario analysis is an advanced approach to estimating interest rate risk exposure. Under the Net Present Value of Equity (NPVE) approach, the present value of all existing assets, liabilities, derivatives and forward commitments are estimated and then combined to produce a NPVE figure. The sensitivity of this value to changes in interest rates is then determined by applying alternative interest rate scenarios, which include, but are not limited to, instantaneous parallel shifts up 100, 200 and 300 basis points and down 100 and 200 basis points. The NPVE method is used at the E*TRADE Bank level and not for the Company.

E*TRADE Bank has 95% and 96% of our enterprise interest-earning assets at March 31, 2008 and December 31, 2007, respectively, and holds 96% and 96% of our enterprise interest-bearing liabilities at March 31, 2008 and December 31, 2007, respectively. The sensitivity of NPVE at March 31, 2008 and December 31, 2007 and the limits established by E*TRADE Bank s Board of Directors are listed below (dollars in thousands):

	Change in NPVE				
	March 31, 2008		December 31, 2007		
Parallel Change in Interest Rates (basis points)	Amount	Percentage	Amount	Percentage	Board Limit
+300	$ (398,125)	(17)%	$ (434,303)	(17)%	(55)%
+200	$ (355,206)	(15)%	$ (323,193)	(12)%	(30)%
+100	$ (211,769)	(9)%	$ (174,280)	(7)%	(20)%
-100	$ 217,930	9%	$ 99,245	4%	(20)%
-200[1]	$	%	$ (63,785)	(2)%	(30)%

[1] On March 31, 2008, the yield on the three-month Treasury bill was 1.38%. As a result, the OTS temporarily modified the requirements of the NPV Model, resulting in removal of the minus 200 basis points scenario for the quarter ended March 31, 2008.

Under criteria published by the OTS, E*TRADE Bank s overall interest rate risk exposure at March 31, 2008 was characterized as minimum. We actively manage our interest rate risk positions. As interest rates change, we will re-adjust our strategy and mix of assets, liabilities and derivatives to optimize our position. For example, a 100 basis points increase in rates may not result in a change in value as indicated above. The ALCO monitors E*TRADE Bank s interest rate risk position.

Other Market Risk

Equity Security Risk

Equity securities risk is the risk of potential loss from investing in public and private equity securities including foreign currency exchange risk. We hold equity securities for corporate investment purposes and in trading securities for market-making purposes. The foreign currency exchange risk associated with these investments is not material to the Company. For corporate investment purposes, we currently hold publicly traded equity securities, in which we had an estimated fair value of $1.3 million as of March 31, 2008. See the corporate investments line item in the publicly traded equity securities discussion at Note 4 Available-for-Sale Mortgage-Backed and Investment Securities in Item 1. Consolidated Financial Statements.

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PART I FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INCOME (LOSS)

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31, 2008	2007
Revenue:		
Operating interest income	$ 710,737	$ 829,795
Operating interest expense	(377,966)	(439,209)
Net operating interest income	332,771	390,586
Provision for loan losses	(233,871)	(21,186)
Net operating interest income after provision for loan losses	98,900	369,400
Commission	129,764	158,993
Fees and service charges	62,612	59,498
Principal transactions	20,495	30,082
Gain (loss) on loans and securities, net	(9,145)	17,375
Other revenue	13,610	9,650
Total non-interest income	217,336	275,598
Total net revenue	316,236	644,998
Expense excluding interest:		
Compensation and benefits	128,777	123,782
Clearing and servicing	48,579	67,252
Advertising and market development	60,472	45,592
Communications	27,439	26,156
Professional services	24,347	24,985
Depreciation and amortization	22,071	19,383
Occupancy and equipment	22,003	23,579
Amortization of other intangibles	10,910	10,268
Facility restructuring and other exit activities	10,492	733
Other	17,523	32,675
Total expense excluding interest	372,613	374,405
Income (loss) before other income (expense) and income taxes	(56,377)	270,593
Other income (expense):		
Corporate interest income	2,426	1,705
Corporate interest expense	(95,241)	(37,791)
Gain on sales of investments, net	502	19,756
Loss on early extinguishment of debt	(2,851)	
Equity in income of investments and venture funds	4,699	8,095

Total other income (expense)	(90,465)	(8,235)
Income (loss) before income taxes	(146,842)	262,358
Income tax expense (benefit)	(55,649)	92,948
Net income (loss)	$ (91,193)	$ 169,410
Basic earnings (loss) per share	$ (0.20)	$ 0.40
Diluted earnings (loss) per share	$ (0.20)	$ 0.39
Shares used in computation of per share data:		
Basic	460,857	423,786
Diluted	460,857	437,535

See accompanying notes to consolidated financial statements

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E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(In thousands, except share amounts)

(Unaudited)

	March 31, 2008	December 31, 2007
ASSETS		
Cash and equivalents	$ 3,061,987	$ 1,778,244
Cash and investments required to be segregated under Federal or other regulations	427,918	334,831
Trading securities	422,941	130,018
Available-for-sale mortgage-backed and investment securities (includes securities pledged to creditors with the right to sell or repledge of $8,032,306 at March 31, 2008 and $10,074,082 at December 31, 2007)	8,402,077	11,255,048
Margin receivables	6,655,659	7,179,175
Loans, net (net of allowance for loan losses of $565,908 at March 31, 2008 and $508,164 and December 31, 2007)	28,444,165	30,139,382
Investment in FHLB stock	241,392	338,585
Property and equipment, net	324,940	355,433
Goodwill	1,950,682	1,933,368
Other intangibles, net	419,105	430,007
Other assets	2,846,084	2,971,846
Total assets	$ 53,196,950	$ 56,845,937
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Deposits	$ 27,467,227	$ 25,884,755
Securities sold under agreements to repurchase	7,109,716	8,932,693
Customer payables	5,413,283	5,514,675
Other borrowings	5,242,921	7,446,504
Corporate debt	3,156,699	3,022,698
Accounts payable, accrued and other liabilities	2,091,765	3,215,547
Total liabilities	50,481,611	54,016,872
Shareholders equity:		
Common stock, $0.01 par value, shares authorized: 600,000,000; shares issued and outstanding: 468,335,796 at March 31, 2008 and 460,897,875 at December 31, 2007	4,683	4,609
Additional paid-in capital (APIC)	3,507,223	3,463,220
Accumulated deficit	(425,170)	(247,368)
Accumulated other comprehensive loss	(371,397)	(391,396)
Total shareholders equity	2,715,339	2,829,065
Total liabilities and shareholders equity	$ 53,196,950	$ 56,845,937

See accompanying notes to consolidated financial statements

E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

(Unaudited)

	Three Months Ended March 31, 2008	2007
Net income (loss)	$ (91,193)	$ 169,410
Other comprehensive loss		
Available-for-sale securities:		
Unrealized gains, net	1,761	6,889
Reclassification into earnings, net	8,058	(11,168)
Net change from available-for-sale securities	9,819	(4,279)
Cash flow hedging instruments:		
Unrealized losses, net	(78,157)	(1,124)
Reclassification into earnings, net	2,393	188
Net change from cash flow hedging instruments	(75,764)	(936)
Foreign currency translation losses	(950)	(2,863)
Other comprehensive loss	(66,895)	(8,078)
Comprehensive income (loss)	$ (158,088)	$ 161,332

See accompanying notes to consolidated financial statements

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E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(In thousands)

(Unaudited)

	Common Stock		Additional		Accumulated Other	Total
	Shares	Amount	Paid-in Capital	Accumulated Deficit	Comprehensive Loss	Shareholders Equity
Balance, December 31, 2007	460,898	$ 4,609	$ 3,463,220	$ (247,368)	$ (391,396)	$ 2,829,065
Cumulative effect of adoption of SFAS No. 156				285		285
Cumulative effect of adoption of SFAS No. 159				(86,894)	86,894	
Adjusted balance	460,898	4,609	3,463,220	(333,977)	(304,502)	2,829,350
Net loss				(91,193)		(91,193)
Other comprehensive loss					(66,895)	(66,895)
Exchange of debt for common stock	4,500	45	17,640			17,685
Exercise of stock options and purchase plans, including tax benefit	272	3	(1,306)			(1,303)
Issuance of restricted stock	8					
Cancellation of restricted stock	(14)					
Retirement of restricted stock to pay taxes	(77)	(1)	(415)			(416)
Amortization of deferred share-based compensation to APIC under SFAS No. 123(R)			13,989			13,989
Additional purchase consideration[(1)]	2,749	27	9,405			9,432
Other			4,690			4,690
Balance, March 31, 2008	468,336	$ 4,683	$ 3,507,223	$ (425,170)	$ (371,397)	$ 2,715,339

	Common Stock		Additional		Accumulated Other	Total
	Shares	Amount	Paid-in Capital	Retained Earnings	Comprehensive Loss	Shareholders Equity
Balance, December 31, 2006	426,304	$ 4,263	$ 3,184,290	$ 1,209,289	$ (201,472)	$ 4,196,370
Cumulative effect of adoption of FIN 48				(14,903)		(14,903)
Adjusted balance	426,304	4,263	3,184,290	1,194,386	(201,472)	4,181,467
Net income				169,410		169,410
Other comprehensive loss					(8,078)	(8,078)
Exercise of stock options and purchase plans, including tax benefit	1,240	12	18,975			18,987
Repurchases of common stock	(1,030)	(10)	(23,012)			(23,022)
Issuance of restricted stock	615	6	(6)			
Retirement of restricted stock to pay taxes	(64)	(1)	(1,518)			(1,519)
Amortization of deferred share-based compensation to APIC under SFAS No. 123(R)			11,567			11,567
Other	97	2	2,212			2,214
Balance, March 31, 2007	427,162	$ 4,272	$ 3,192,508	$ 1,363,796	$ (209,550)	$ 4,351,026

See accompanying notes to consolidated financial statements

(1) Amounts represent additional contingent consideration paid in connection with prior acquisitions.

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E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Cash flows from operating activities:		
Net income (loss)	$ (91,193)	$ 169,410
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Provision for loan losses	233,871	21,186
Depreciation and amortization (including discount amortization and accretion)	77,649	70,018
(Gain) loss on loans and securities, net and (gain) loss on sales of investments, net	8,643	(37,131)
Equity in income of investments and venture funds	(4,699)	(8,095)
Gain on sale of corporate aircraft related assets	(23,715)	
Loss on early extinguishment of debt	2,851	
Non-cash facility restructuring costs and other exit activities	3,041	(850)
Share-based compensation	13,989	11,567
Tax benefit from tax deductions in excess of compensation expense	2,582	(8,432)
Other	(4,349)	674
Net effect of changes in assets and liabilities:		
Increase in cash and investments required to be segregated under Federal or other regulations	(101,419)	(128,944)
Decrease (increase) in margin receivables	534,831	(125,168)
(Decrease) increase in customer payables	(68,725)	130,480
Proceeds from sales, repayments and maturities of loans held-for-sale	165,529	451,037
Purchases and originations of loans held-for-sale	(85,754)	(368,552)
Proceeds from sales, repayments and maturities of trading securities	695,676	343,993
Purchases of trading securities	(621,058)	(306,961)
Decrease (increase) in other assets	199,526	(400,590)
Increase (decrease) in accounts payable, accrued and other liabilities	(1,234,456)	371,573
Facility restructuring liabilities	(3,894)	(2,943)
Net cash (used in) provided by operating activities	(301,074)	182,272
Cash flows from investing activities:		
Purchases of available-for-sale mortgage-backed and investment securities	(1,070,770)	(7,324,763)
Proceeds from sales, maturities of and principal payments on available-for-sale mortgage-backed and investment securities	3,994,007	4,823,918
Net decrease (increase) in loans receivable	1,029,897	(3,347,604)
Purchases of property and equipment	(25,226)	(43,427)
Proceeds from sale of corporate aircraft related assets	69,250	
Cash used in business acquisitions, net	(7,883)	(2,688)
Net cash flow from derivatives hedging assets	(37,116)	4,473
Other	(14,348)	(25,778)
Net cash provided by (used in) investing activities	$ 3,937,811	$ (5,915,869)

See accompanying notes to consolidated financial statements

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E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (Continued)

(In thousands)

(Unaudited)

	Three Months Ended March 31, 2008	2007
Cash flows from financing activities:		
Net increase in deposits	$ 1,579,545	$ 2,183,771
Net increase (decrease) in securities sold under agreements to repurchase	(1,803,041)	2,332,036
Net increase (decrease) in other borrowed funds	(4,400)	39,627
Advances from other long-term borrowings	600,000	3,386,000
Payments on advances from other long-term borrowings	(2,810,694)	(2,229,934)
Proceeds from issuance of springing lien notes	150,000	
Proceeds from issuance of subordinated debentures and trust preferred securities		40,000
Proceeds from issuance of common stock from employee stock transactions	1,279	10,555
Tax benefit from tax deductions in excess of compensation expense recognition	(2,582)	8,432
Repurchases of common stock		(23,022)
Net cash flow from derivatives hedging liabilities	(57,834)	(30,419)
Other	4,458	
Net cash (used in) provided by financing activities	(2,343,269)	5,717,046
Effect of exchange rates on cash	(9,725)	(702)
Increase (decrease) in cash and equivalents	1,283,743	(17,253)
Cash and equivalents, beginning of period	1,778,244	1,212,234
Cash and equivalents, end of period	$ 3,061,987	$ 1,194,981
Supplemental disclosures:		
Cash paid for interest	$ 432,698	$ 569,847
Cash paid for income taxes	$ 9,574	$ 10,789
Non-cash investing and financing activities:		
Transfers from loans to other real estate owned and repossessed assets	$ 58,735	$ 22,095
Reclassification of loans held-for-sale to loans held-for-investment	$ 1,630	$ 8,973
Issuance of common stock to retire debentures	$ 17,685	$

See accompanying notes to consolidated financial statements

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E*TRADE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 ORGANIZATION, BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization E*TRADE Financial Corporation (together with its subsidiaries, E*TRADE or the Company) is a global company offering a wide range of financial services to consumers under the brand E*TRADE Financial. The Company offers trading, investing and banking products and services to its retail and institutional customers.

Basis of Presentation The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. Entities in which the Company holds at least a 20% ownership or in which there are other indicators of significant influence are generally accounted for by the equity method. Entities in which the Company holds less than 20% ownership and does not have the ability to exercise significant influence are generally carried at cost. Intercompany accounts and transactions are eliminated in consolidation. The Company evaluates investments including joint ventures, low income housing tax credit partnerships and other limited partnerships to determine if the Company is required to consolidate the entities under the guidance of Financial Accounting Standards Board (FASB) Interpretation No. 46, *Consolidation of Variable Interest Entities-an interpretation of ARB No. 51* (FIN 46R).

Certain prior period items in these consolidated financial statements have been reclassified to conform to the current period presentation. These consolidated financial statements reflect all adjustments, which are all normal and recurring in nature, necessary to present fairly the financial position, results of operations and cash flows for the periods presented, and should be read in conjunction with the consolidated financial statements of E*TRADE Financial Corporation included in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

The Company reports corporate interest income and expense separately from operating interest income and expense. The Company believes reporting these two items separately provides a clearer picture of the financial performance of the Company s operations than would a presentation that combined these two items. Operating interest income and expense is generated from the operations of the Company and is a broad indicator of the Company s success in its banking and balance sheet management business. Corporate debt, which is the primary source of the corporate interest expense has been issued primarily in connection with the Citadel Investment and acquisitions, such as Harris*direct* and BrownCo.

Similarly, the Company reports gain on sales of investments, net separately from gain (loss) on loans and securities, net. The Company believes reporting these two items separately provides a clearer picture of the financial performance of its operations than would a presentation that combined these two items. Gain (loss) on loans and securities, net are the result of activities in the Company s operations, namely its balance sheet management businesses, including impairment on our available-for-sale mortgage-backed and investment securities portfolio. Gain on sales of investments, net relates to historical equity investments of the Company at the corporate level and are not related to the ongoing business of the Company s operating subsidiaries.

Use of Estimates The consolidated financial statements were prepared in accordance with GAAP, which require management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes for the periods presented. Actual results could differ from management s estimates. Material estimates in which management believes near-term changes could reasonably occur include allowance for loan losses and uncollectible margin receivables; classification and valuation of certain investments; valuation of certain debt instruments; valuation and accounting for financial derivatives; estimates of effective tax rates; deferred taxes and valuation allowances; valuation of goodwill and other intangibles; and valuation and expensing of share-based payments.

Financial Statement Descriptions and Related Accounting Policies

Margin Receivables At March 31, 2008, the fair value of securities that the Company received as collateral in connection with margin receivables and stock borrowing activities, where the Company is permitted to sell or re-pledge the securities, was approximately $8.8 billion. Of this amount, $2.2 billion had been pledged or sold at March 31, 2008 in connection with securities loans, bank borrowings and deposits with clearing organizations.

Loans Receivable, Net Loans receivable, net consists of real estate and consumer loans that management has the intent and ability to hold for the foreseeable future or until maturity. These loans are carried at amortized cost adjusted for charge-offs, net, allowance for loan losses, deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred and the net fee or cost is recognized in interest income using the interest method over the contractual life of the loans. Premiums and discounts on purchased loans are amortized or accreted into income using the interest method over the remaining period to contractual maturity and adjusted for actual prepayments. The Company classifies loans as nonperforming when full and timely collection of interest or principal becomes uncertain or when they are 90 days past due. Interest previously accrued, but not collected, is reversed against current income when a loan is placed on nonaccrual status and is considered nonperforming. Accretion of deferred fees is discontinued for nonperforming loans. Payments received on nonperforming loans are recognized as interest income when the loan is considered collectible and applied to principal when it is doubtful that full payment will be collected. One- to four-family and home equity loans are charged off to the extent that the carrying value of the loan exceeds the estimated value of the underlying collateral when the loan has been delinquent for 180 days, regardless of whether or not the property is in foreclosure. Credit cards are charged-off when the loan has been delinquent for 180 days. Consumer loans are charged-off when the loan has been delinquent for 120 days.

Fair Value Effective January 1, 2008, the Company adopted SFAS No. 157, which defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Company determines the fair values of its financial instruments and for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis in accordance with SFAS No. 157. The Company will not adopt this statement until January 1, 2009 for nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis. Examples of nonfinancial assets and nonfinancial liabilities for which the Company has not applied the provisions of SFAS No. 157 include reporting units, nonfinancial assets and nonfinancial liabilities and indefinite-lived intangible assets measured at fair value in impairment tests under SFAS No. 142, nonfinancial long-lived assets measured at fair value for an impairment assessment under SFAS No. 144 as well as nonfinancial liabilities for exit or disposal activities initially measured at fair value under SFAS No. 146.

In determining fair value, the Company uses various valuation approaches, including market, income and/or cost approaches. The fair value hierarchy established in SFAS No. 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is a market-based measure considered from the perspective of a market participant. As such, even when market assumptions are not readily available, the Company s own assumptions reflect those that market participants would use in pricing the asset or liability at the measurement date. The standard describes three levels of inputs that may be used to measure fair value and are as follows:

Level 1 Quoted prices in active markets for identical assets or liabilities. Examples of assets and liabilities utilizing Level 1 inputs include actively traded equity securities.

Level 2 Quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly. Examples of assets and liabilities utilizing Level 2 inputs include mortgage- backed securities backed by U.S. Government sponsored and Federal agencies, certain CMOs, most investment securities and most OTC derivatives.

Level 3 Unobservable inputs that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. Examples of assets and liabilities utilizing significant Level 3 inputs or those that require significant management judgment include most CMOs, servicing rights, retained interest in securitizations, certain other mortgage-backed securities and certain OTC derivatives. In certain securities, including a portion of the CMO portfolio, where there has been limited activity or less transparency around inputs to the valuation, securities are classified as Level 3 even though the Company believes that Level 2 inputs could likely be obtainable in a more active market.

The availability of observable inputs can vary from instrument to instrument and in certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an instrument s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company s assessment of the significance of a particular input to the fair value measurement of an instrument requires judgment and consideration of factors specific to the instrument.

Fair Value Option Effective January 1, 2008, the Company elected to carry investments in FNMA and FHLMC preferred stock at fair value through earnings under SFAS No. 159. The Company elected to carry the investment in preferred stock at fair value through earnings to allow the Company to economically hedge the portfolio without the burden of complying with SFAS No. 133, as amended. The impact of this adoption was an after-tax decrease to opening retained earnings as of January 1, 2008 of approximately $86.9 million. As of December 31, 2007, the Company s investment in preferred stock was reported in the balance sheet line item available-for-sale mortgage-backed and investment securities. In accordance with SFAS No. 159, as a result of the fair value election the investment in preferred stock is reported in the balance sheet line item trading securities as of March 31, 2008. Realized and unrealized gains and losses on securities classified as trading are included in the gain (loss) on loans and securities, net line item.

For additional information regarding the adoption of SFAS No. 157 and SFAS No. 159, see Note 15 Fair Value Disclosures.

New Accounting Standards Below are the new accounting pronouncements that relate to activities in which the Company is engaged.

SFAS No. 156 Accounting for Servicing Financial Assets, an Amendment of SFAS No. 140

In March 2006, the FASB issued SFAS No. 156. This statement establishes, among other things, the accounting for all separately recognized servicing assets and liabilities. The Company adopted this statement on January 1, 2007. As of January 1, 2008, the Company elected to account for servicing rights under the fair value measurement method. The transition adjustment to opening retained earnings as of January 1, 2008 related to the fair value measurement election was $0.3 million.

SFAS No. 157 Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, which establishes, among other things, a framework for measuring fair value and expands disclosure requirements as they relate to fair value measurements. The Company adopted this statement on January 1, 2008 for financial assets and financial liabilities and for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis, the effects of which were not material to the financial condition, results of operations or cash flows. The Company will not adopt this statement until January 1, 2009 for nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the consolidated financial statements on a recurring basis, for which the Company does not expect the adoption of this statement to have a material impact on the Company s financial condition, results of operations or cash flows in future periods. For additional information regarding the adoption of SFAS No. 157 and SFAS No. 159, see Note 15 Fair Value Disclosures.

SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued SFAS No. 159 which provides an option under which a company may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities. This fair value option will be available on a contract-by-contract basis with changes in fair value recognized in earnings as those changes occur. The Company adopted this statement on January 1, 2008 and elected the fair value option for FNMA and FHLMC preferred stock. The impact of this adoption was an after-tax decrease to opening retained earnings as of January 1, 2008 of approximately $86.9 million. For additional information regarding the adoption of SFAS No. 157 and SFAS No. 159, see Note 15 Fair Value Disclosures.

SFAS No. 161 Disclosures About Derivative Instruments and Hedging Activities

In March 2008, the FASB issued SFAS No. 161, *Disclosures About Derivative Instruments and Hedging Activities*. This statement establishes, among other things, the disclosure requirements for derivative instruments and for hedging activities. This statement is effective at the beginning of an entities first interim period beginning after November 15, 2008 or January 1, 2009 for the Company. The Company is currently evaluating the impact this guidance will have on its financial condition, results of operations or cash flows.

Staff Accounting Bulletin (SAB) No. 109 Written Loan Commitments Recorded at Fair Value Through Earnings

In November 2007, the SEC issued Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value Through Earnings* (SAB No. 109), which becomes effective for the Company January 1, 2008. SAB No. 109 supersedes SAB No. 105, *Application of Accounting Principles to Loan Commitments* (SAB No. 105), and states, consistent with the guidance in SFAS No. 156 and SFAS No. 159, that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SAB No. 109 retains the view expressed in SAB No. 105 that internally developed intangible assets (such as customer relationship intangible assets) should not be recorded as part of the fair value of a derivative loan commitment and broadens its application to all written loan commitments that are accounted for at fair value through earnings. The Company adopted this statement on January 1, 2008 and the impact of adoption was not material to the Company s financial condition, results of operations or cash flows.

NOTE 2 FACILITY RESTRUCTURING AND OTHER EXIT ACTIVITIES

Restructuring liabilities are included in accounts payable, accrued and other liabilities in the consolidated balance sheet. The following table summarizes the expense recognized by the Company as facility restructuring and other exit activities for the periods presented (dollars in thousands):

	Three Months Ended March 31, 2008	2007
Restructuring of institutional brokerage operations	$ 9,991	$
Other exit activities	501	733
Total facility restructuring and other exit activities	$ 10,492	$ 733

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Exit of Non-Core Operations

Institutional Brokerage Operations

Toward the end of the third quarter in 2007, the Company announced a plan to simplify and streamline the business by exiting and/or restructuring certain non-core operations. The Company has taken steps to restructure the institutional equity business to focus on areas that complement order flow generated by retail customers. In the first quarter of 2008, the Company announced the decision to exit the institutional trading operations that do not align with the core retail business. As a result of these exits, the Company incurred costs of $5.8 million for facilities consolidation and asset write-off costs, $2.9 million in severance costs and $1.3 million of other costs related to these exits for the three months ended March 31, 2008. The total charge for both of these exit activities is expected to be between $25.0 million and $30.0 million, all of which will be recorded to the institutional segment.

Other Exit Activities

In the first quarter of 2008, the Company has continued the consolidation and relocation of certain facilities. The Company incurred $0.5 million related to facilities consolidation and relocation primarily related to the exit of certain operating leases. In the first quarter of 2007, the Company incurred cost of $1.2 million to exit certain facilities in California and recognized $(0.5) million of adjustments to restructuring activities from prior periods.

NOTE 3 OPERATING INTEREST INCOME AND OPERATING INTEREST EXPENSE

The following table shows the components of operating interest income and operating interest expense (dollars in thousands):

	Three Months Ended March 31,	
	2008	2007
Operating interest income:		
Loans, net	$ 451,574	$ 451,399
Mortgage-backed and investment securities	109,276	210,507
Margin receivables	94,913	123,986
Other	54,974	43,903
Total operating interest income	710,737	829,795
Operating interest expense:		
Deposits	(186,704)	(182,988)
Repurchase agreements and other borrowings	(94,934)	(159,031)
FHLB advances	(70,802)	(62,852)
Other	(25,526)	(34,338)
Total operating interest expense	(377,966)	(439,209)
Net operating interest income	$ 332,771	$ 390,586

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NOTE 4 AVAILABLE-FOR-SALE MORTGAGE-BACKED AND INVESTMENT SECURITIES

The amortized cost basis and estimated fair values of available-for-sale mortgage-backed and investment securities are shown in the following tables (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Values
March 31, 2008:				
Mortgage-backed securities:				
Backed by U.S. Government sponsored and Federal agencies	$ 7,526,011	$ 12,797	$ (224,491)	$ 7,314,317
CMOs and other	1,108,723	143	(138,206)	970,660
Total mortgage-backed securities	8,634,734	12,940	(362,697)	8,284,977
Investment securities:				
Debt securities:				
Municipal bonds	105,866		(10,170)	95,696
Corporate bonds	25,548		(6,908)	18,640
Total debt securities	131,414		(17,078)	114,336
Publicly traded equity securities:				
Corporate investments	1,256		(242)	1,014
Retained interests from securitizations	964	786		1,750
Total investment securities	133,634	786	(17,320)	117,100
Total available-for-sale securities	$ 8,768,368	$ 13,726	$ (380,017)	$ 8,402,077
December 31, 2007:				
Mortgage-backed securities:				
Backed by U.S. Government sponsored and Federal agencies	$ 9,638,676	$ 86	$ (308,633)	$ 9,330,129
CMOs and other	1,170,360	2	(47,107)	1,123,255
Total mortgage-backed securities	10,809,036	88	(355,740)	10,453,384
Investment securities:				
Debt securities:				
Municipal bonds	320,521	58	(6,231)	314,348
Corporate bonds	36,557	2,134	(3,412)	35,279
Other debt securities	78,836	1	(1,546)	77,291
Total debt securities	435,914	2,193	(11,189)	426,918
Publicly traded equity securities:				
Preferred stock	505,498		(134,094)	371,404
Corporate investments	1,460		(189)	1,271
Retained interests from securitizations	980	1,091		2,071
Total investment securities	943,852	3,284	(145,472)	801,664
Total available-for-sale securities	$ 11,752,888	$ 3,372	$ (501,212)	$ 11,255,048

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Other-Than-Temporary Impairment of Investments

The following tables show the fair values and unrealized losses on investments, aggregated by investment category, and the length of time that individual securities have been in a continuous unrealized loss position (dollars in thousands):

	Less than 12 Months		12 Months or More		Total	
	Fair Values	Unrealized Losses	Fair Values	Unrealized Losses	Fair Values	Unrealized Losses
March 31, 2008:						
Mortgage-backed securities:						
Backed by U.S. Government sponsored and Federal agencies	$ 329,538	$ (4,147)	$ 5,803,092	$ (220,344)	$ 6,132,630	$ (224,491)
CMOs and other	317,808	(59,847)	578,593	(78,359)	896,401	(138,206)
Debt securities:						
Municipal bonds	71,824	(6,991)	23,872	(3,179)	95,696	(10,170)
Corporate bonds			18,439	(6,908)	18,439	(6,908)
Publicly traded equity securities:						
Corporate investments			120	(242)	120	(242)
Total temporarily impaired securities	$ 719,170	$ (70,985)	$ 6,424,116	$ (309,032)	$ 7,143,286	$ (380,017)
December 31, 2007:						
Mortgage-backed securities:						
Backed by U.S. Government sponsored and Federal agencies	$ 1,394,002	$ (6,802)	$ 7,849,331	$ (301,831)	$ 9,243,333	$ (308,633)
CMOs and other	537,522	(25,415)	585,629	(21,692)	1,123,151	(47,107)
Debt securities:						
Municipal bonds	272,698	(4,898)	29,052	(1,333)	301,750	(6,231)
Corporate bonds			21,935	(3,412)	21,935	(3,412)
Other debt securities			76,433	(1,546)	76,433	(1,546)
Publicly traded equity securities:						
Preferred stock	355,942	(134,094)			355,942	(134,094)
Corporate investments			173	(189)	173	(189)
Total temporarily impaired securities	$ 2,560,164	$ (171,209)	$ 8,562,553	$ (330,003)	$ 11,122,717	$ (501,212)

The Company does not believe that any individual unrealized loss as of March 31, 2008 represents an other-than-temporary impairment. The majority of the unrealized losses on mortgage-backed securities are attributable to changes in interest rates and a re-pricing of risk in the market. Substantially all mortgage-backed securities backed by U.S. Government sponsored and Federal agencies are AAA-rated. The Company has the intent and ability to hold the securities in an unrealized loss position at March 31, 2008 until the market value recovers or the securities mature. Municipal bonds and corporate bonds are evaluated by reviewing the credit-worthiness of the issuer and general market conditions.

Within the securities portfolio, the asset-backed securities portfolio, which was sold in the fourth quarter of 2007, represented the highest concentration of credit risk. Subsequent to the sale of that portfolio, the highest concentration of remaining credit risk, while dramatically lower than the credit risk inherent in asset-backed securities, is the CMO portfolio. While the vast majority of this portfolio is AAA-rated, the Company identified approximately $183 million of CMO securities with a possibility of future loss. As a result, $95 million of these securities were written down to their estimated fair market value by recording a $26.6 million impairment during the first quarter of 2008. The Company recorded other-than-temporary impairment charges of $0.2 million for asset-backed securities in the first quarter of 2007.

The Company elected the fair value option for its preferred stock under SFAS No. 159 as of January 1, 2008. Subsequent to the adoption, preferred stock was classified as trading securities.

The detailed components of the gain (loss) on loans and securities, net and gain on sales of investments, net line items on the consolidated statement of income (loss) are shown below.

Gain (Loss) on Loans and Securities, Net

Gain (loss) on loans and securities, net are as follows (dollars in thousands):

	Three Months Ended March 31,	
	2008	**2007**
Gain on sales of originated loans	$ 730	$ 1,915
Loss on sales of loans held-for-sale, net	(157)	(1,662)
Gain (loss) on securities, net		
Gain on securities and other investments	13,263	8,517
Loss on impairment	(26,602)	(249)
Gain on trading securities	3,621	8,854
Gain (loss) on securities, net	(9,718)	17,122
Gain (loss) on loans and securities, net	$ (9,145)	$ 17,375

Gain on Sales of Investments, Net

Gain on sales of investments, net are as follows (dollars in thousands):

	Three Months Ended March 31,	
	2008	**2007**
Realized gains on sales of publicly traded equity securities	$ 254	$ 19,717
Other	248	39
Gain on sales of investments, net	$ 502	$ 19,756

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NOTE 5 LOANS, NET

Loans, net are summarized as follows (dollars in thousands):

	March 31, 2008	December 31, 2007
Loans held-for-sale	$ 19,327	$ 100,539
Loans receivable, net:		
One- to four-family	14,639,145	15,506,529
Home equity	11,385,998	11,901,324
Consumer and other loans:		
Recreational vehicle	1,811,794	1,910,454
Marine	497,693	526,580
Commercial	264,909	272,156
Credit card	85,547	90,764
Other	15,925	23,334
Total consumer and other loans	2,675,868	2,823,288
Total loans receivable	28,701,011	30,231,141
Unamortized premiums, net	289,735	315,866
Allowance for loan losses	(565,908)	(508,164)
Total loans receivable, net	28,424,838	30,038,843
Total loans, net	$ 28,444,165	$ 30,139,382

The following table provides an analysis of the allowance for loan losses for the three months ended March 31, 2008 and 2007 (dollars in thousands):

	Three Months Ended March 31, 2008	2007
Allowance for loan losses, beginning of period	$ 508,164	$ 67,628
Provision for loan losses	233,871	21,186
Charge-offs	(182,412)	(26,444)
Recoveries	6,285	5,619
Net charge-offs	(176,127)	(20,825)
Allowance for loan losses, end of period	$ 565,908	$ 67,989

The Company has a CDS on $4.0 billion of its first-lien residential real estate loan portfolio through a synthetic securitization structure. A CDS provides, for a fee, an assumption by a third party of a portion of the credit risk related to the underlying loans. The CDS the Company entered into provides protection for losses in excess of 10 basis points, but not to exceed approximately 75 basis points. In addition, the Company s regulatory risk-weighted assets were reduced as a result of this transaction because it transferred a portion of the Company s credit risk to an unaffiliated third party.

NOTE 6 ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

The Company enters into derivative transactions to protect against the risk of market price or interest rate movements on the value of certain assets, liabilities and future cash flows. The Company is also required to recognize certain contracts and commitments as derivatives when the characteristics of those contracts and commitments meet the definition of a derivative as promulgated by SFAS No. 133, as amended.

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Fair Value Hedges

Overview of Fair Value Hedges

The Company uses a combination of interest rate swaps, forward-starting swaps and purchased options on swaps to offset its exposure to changes in value of certain fixed-rate assets and liabilities. Changes in the fair value of the derivatives are recognized currently in earnings. To the extent that the hedge is ineffective, the changes in the fair values will not offset and the difference, or hedge ineffectiveness, is reflected in other expense excluding interest in the consolidated statement of income (loss).

The following table summarizes information related to financial derivatives in fair value hedge relationships (dollars in thousands):

	Notional Amount of Derivatives	Fair Value of Derivatives			Weighted-Average			
		Asset	Liability	Net	Pay Rate	Receive Rate	Strike Rate	Remaining Life (Years)
March 31, 2008:								
Receive-fixed interest rate swaps:								
Corporate debt	$ 1,139,000	$ 56,269	$	$ 56,269	4.02%	7.73%	N/A	5.05
Brokered certificates of deposit	72,961	260	(166)	94	3.32%	5.47%	N/A	12.65
Total fair value hedges	$ 1,211,961	$ 56,529	$ (166)	$ 56,363	3.98%	7.60%	N/A	5.50
December 31, 2007:								
Pay-fixed interest rate swaps:								
Mortgage-backed securities	$ 527,000	$	$ (21,318)	$ (21,318)	5.11%	5.16%	N/A	7.00
Receive-fixed interest rate swaps:								
Corporate debt	1,214,000	57,760		57,760	7.04%	7.71%	N/A	5.32
Brokered certificates of deposit	110,948		(1,343)	(1,343)	4.97%	5.33%	N/A	11.46
FHLB advances	100,000		(194)	(194)	5.03%	3.64%	N/A	1.79
Purchased interest rate options[(1)]:								
Swaptions[(2)]	905,000	17,881		17,881	N/A	N/A	5.40%	10.20
Total fair value hedges	$ 2,856,948	$ 75,641	$ (22,855)	$ 52,786	6.30%	6.68%	5.40%	7.29

(1) Purchased interest rate options were used to hedge mortgage loans and mortgage-backed securities.
(2) Swaptions are options to enter swaps starting on a given day.

De-designated Fair Value Hedges

During the three months ended March 31, 2008 and 2007, certain fair value hedges were de-designated; therefore, hedge accounting was discontinued during those periods. The net gain or loss on the underlying transactions being hedged is amortized to operating interest expense or operating interest income over the original forecasted period at the time of de-designation. Changes in the fair value of these derivative instruments after de-designation of fair value hedge accounting were recorded in the gain (loss) on loans and securities, net line item in the consolidated statement of income (loss).

Cash Flow Hedges

Overview of Cash Flow Hedges

The Company uses a combination of interest rate swaps, forward-starting swaps and purchased options on caps and floors to hedge the variability of future cash flows associated with existing variable-rate liabilities and

assets and forecasted issuances of liabilities. These cash flow hedge relationships are treated as effective hedges as long as the future issuances of liabilities remain probable and the hedges continue to meet the requirements of SFAS No. 133, as amended. The Company also enters into interest rate swaps to hedge changes in the future variability of cash flows of certain investment securities resulting from changes in a benchmark interest rate. Additionally, the Company enters into forward purchase and sale agreements, which are considered cash flow hedges, when the terms of the commitments exactly match the terms of the securities purchased or sold.

Changes in the fair value of derivatives that hedge cash flows associated with repurchase agreements, FHLB advances and home equity lines of credit are reported in accumulated other comprehensive loss as unrealized gains or losses, for both active and terminated hedges. If the derivatives are determined to be effective hedges, the amounts in accumulated other comprehensive loss are included in operating interest expense or operating interest income as a yield adjustment during the same periods in which the related interest on the funding affects earnings. If the derivatives are determined not to be effective hedges, the amount recorded in other comprehensive income would be reclassified into earnings. During the upcoming twelve months, the Company expects to include a pre-tax amount of approximately $21.4 million of net unrealized gains that are currently reflected in accumulated other comprehensive loss in operating interest expense as a yield adjustment in the same periods in which the related items affect earnings.

The following table summarizes information related to the Company s financial derivatives in cash flow hedge relationships, hedging variable-rate assets and liabilities and the forecasted issuances of liabilities (dollars in thousands):

	Notional Amount of Derivatives	Fair Value of Derivatives			Weighted-Average			
		Asset	Liability	Net	Pay Rate	Receive Rate	Strike Rate	Remaining Life (Years)
March 31, 2008:								
Pay-fixed interest rate swaps:								
Repurchase agreements	$ 1,840,000	$	$ (180,201)	$ (180,201)	5.26%	3.06%	N/A	10.96
FHLB advances	650,000		(63,413)	(63,413)	5.27%	3.64%	N/A	9.50
Purchased interest rate options[1]:								
Caps	4,410,000	16,374		16,374	N/A	N/A	5.06%	2.37
Floors	1,400,000	59,938		59,938	N/A	N/A	6.86%	2.36
Total cash flow hedges	$ 8,300,000	$ 76,312	$ (243,614)	$ (167,302)	5.26%	3.21%	5.50%	4.83
December 31, 2007:								
Pay-fixed interest rate swaps:								
Repurchase agreements	$ 2,105,000	$	$ (136,867)	$ (136,867)	5.47%	5.13%	N/A	11.38
FHLB advances	800,000		(37,748)	(37,748)	5.25%	5.15%	N/A	9.65
Purchased interest rate options[1]:								
Caps	4,410,000	26,260		26,260	N/A	N/A	5.06%	2.62
Floors	1,400,000	31,205		31,205	N/A	N/A	6.86%	2.61
Total cash flow hedges	$ 8,715,000	$ 57,465	$ (174,615)	$ (117,150)	5.41%	5.14%	5.50%	5.38

(1) Caps are used to hedge repurchase agreements and FHLB advances. Floors are used to hedge home equity lines of credit.

Under SFAS No. 133, as amended, the Company is required to record the fair value of gains and losses on derivatives designated as cash flow hedges in accumulated other comprehensive loss in the consolidated balance sheet. In addition, during the normal course of business, the Company terminates certain interest rate swaps and options.

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The following tables show: 1) amounts recorded in accumulated other comprehensive loss related to derivative instruments accounted for as cash flow hedges; 2) the notional amounts and fair values of derivatives terminated for the periods presented; and 3) the amortization of terminated interest rate swaps included in operating interest expense and operating interest income (dollars in thousands):

	Three Months Ended March 31, 2008	2007
Impact on accumulated other comprehensive loss (net of taxes):		
Beginning balance	$ (132,223)	$ (27,844)
Unrealized losses, net	(78,157)	(1,124)
Reclassifications into earnings, net	2,393	188
Ending balance	$ (207,987)	$ (28,780)
Derivatives terminated during the period:		
Notional	$ 1,590,000	$ 690,000
Fair value of net losses recognized in accumulated other comprehensive loss	$ (76,034)	$ (2,377)
Amortization of terminated interest rate swaps and options included in operating interest expense and operating interest income	$ (688)	$ 308

The gains (losses) accumulated in other comprehensive loss on the derivative instruments terminated shown in the preceding table will be included in operating interest expense and operating interest income over the periods the variable rate liabilities and hedged forecasted issuance of liabilities will affect earnings, ranging from 25 days to more than 14 years.

The following table shows the balance in accumulated other comprehensive loss attributable to open cash flow hedges and discontinued cash flow hedges (dollars in thousands):

	Three Months Ended March 31, 2008	2007
Accumulated other comprehensive loss balance (net of taxes) related to:		
Open cash flow hedges	$ (171,979)	$ (49,820)
Discontinued cash flow hedges	(36,008)	21,040
Total cash flow hedges	$ (207,987)	$ (28,780)

Hedge Ineffectiveness

In accordance with SFAS No. 133, as amended, the Company recognizes hedge ineffectiveness on both fair value and cash flow hedge relationships. The amount of ineffectiveness recorded in earnings for cash flow hedges is equal to the excess of the cumulative change in the fair value of the actual derivative over the cumulative change in the fair value of a hypothetical derivative which is created to match the exact terms of the underlying instruments being hedged. These amounts are reflected in the other expense excluding interest line item in the consolidated statement of income (loss). Cash flow and fair value ineffectiveness is re-measured on a quarterly basis. The following table summarizes income (expense) recognized by the Company as fair value and cash flow hedge ineffectiveness (dollars in thousands):

	Three Months Ended March 31, 2008	2007
Fair value hedges	$ 1,733	$ (1,082)
Cash flow hedges	(84)	40

Total hedge ineffectiveness	$ 1,649	$ (1,042)

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Economic Hedges

During the first quarter of 2008, the Company used equity put options and credit default swaps as economic hedges against potential changes in the value of the preferred stock. Derivatives used as economic hedges but not designated in a hedging relationship for accounting purposes are included in derivative assets or derivative liabilities. The mark on the net hedged position is recognized in gain (loss) on loans and securities, net.

NOTE 7 DEPOSITS

Deposits are summarized as follows (dollars in thousands):

	Weighted-Average Rate		Amount		Percentage to Total	
	March 31, 2008	December 31, 2007	March 31, 2008	December 31, 2007	March 31, 2008	December 31, 2007
Money market and savings accounts	3.27%	4.55%	$ 11,978,286	$ 10,028,115	43.6%	38.7%
Sweep deposit accounts[1]	0.51%	0.87%	10,001,293	10,112,123	36.5	39.1
Certificates of deposit[2]	4.55%	4.93%	3,719,406	4,156,674	13.5	16.1
Brokered certificates of deposit[3]	4.51%	4.51%	1,219,370	1,092,225	4.4	4.2
Checking accounts	1.73%	1.79%	548,872	495,618	2.0	1.9
Total deposits	2.47%	3.12%	$ 27,467,227	$ 25,884,755	100.0%	100.0%

(1) A sweep product that transfers brokerage customer balances to the Bank, who holds these funds as customer deposits in FDIC-insured demand deposits and money market deposit accounts.
(2) Includes retail brokered certificates of deposit.
(3) Includes institutional brokered certificates of deposit.

NOTE 8 SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND OTHER BORROWINGS

The maturities of borrowings at March 31, 2008 and total borrowings at December 31, 2007 are shown below (dollars in thousands):

		Other Borrowings			
	Repurchase Agreements	FHLB Advances	Other	Total	Weighted Average Interest Rate
Years Ending December 31,					
2008	$ 5,183,803	$ 1,550,000	$ 9,042	$ 6,742,845	3.11%
2009	620,499	1,200,000	1,662	1,822,161	3.73%
2010		150,000	1,197	151,197	4.56%
2011					
2012	100,367	350,000		450,367	4.78%
Thereafter	1,205,047	1,553,600	427,420	3,186,067	4.53%
Total borrowings at March 31, 2008	$ 7,109,716	$ 4,803,600	$ 439,321	$ 12,352,637	3.65%
Total borrowings at December 31, 2007	$ 8,932,693	$ 6,967,406	$ 479,098	$ 16,379,197	4.98%

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NOTE 9 CORPORATE DEBT

The Company s corporate debt by type is shown below (dollars in thousands):

March 31, 2008	Face Value	Premium / (Discount)	Fair Value Adjustment(1)	Net
Senior notes:				
8% Notes, due 2011	$ 453,815	$ (2,354)	$ 20,145	$ 471,606
7 3/8% Notes, due 2013	487,160	(5,871)	32,130	513,419
7 7/8% Notes, due 2015	248,177	(2,342)	20,954	266,789
Total senior notes	1,189,152	(10,567)	73,229	1,251,814
Springing lien notes 12 1/2%, due 2017	1,936,000	(474,906)		1,461,094
Mandatory convertible notes 6 1/8%, due 2018	450,000	(6,209)		443,791
Total corporate debt	$ 3,575,152	$ (491,682)	$ 73,229	$ 3,156,699

December 31, 2007	Face Value	Premium / (Discount)	Fair Value Adjustment(1)	Net
Senior notes:				
8% Notes, due 2011	$ 453,815	$ 1,884	$ 15,422	$ 471,121
7 3/8% Notes, due 2013	512,160	(1,555)	31,001	541,606
7 7/8% Notes, due 2015	248,177		11,838	260,015
Total senior notes	1,214,152	329	58,261	1,272,742
Springing lien notes 12 1/2%, due 2017	1,786,000	(481,609)		1,304,391
Mandatory convertible notes 6 1/8%, due 2018	450,000	(4,435)		445,565
Total corporate debt	$ 3,450,152	$ (485,715)	$ 58,261	$ 3,022,698

(1) The fair value adjustment is related to changes in fair value of the debt while in a fair value hedge relationship in accordance with SFAS No. 133, as amended.

Senior Notes

7 3/8% Senior Notes due September 2013

In March 2008, the Company began exchanging debt into common stock to extinguish a portion of its outstanding senior notes. The Company exchanged $25.0 million of its 7 3/8% Senior Notes for 4.5 million shares of common stock. This exchange resulted in the Company recording an $8.5 million pre-tax gain on extinguishment.

Springing Lien Notes

12 1/2 % Springing Lien Notes Due November 2017

In January 2008, the Company issued an additional $150.0 million of springing lien notes due November 2017 (12 1/2% Notes), in accordance with the terms of the agreement with Citadel. Interest is payable semi-annually and the notes are non-callable for five years and may then be called by the Company at a premium, which declines over time. This is the final issuance under this agreement and brings the total springing lien notes to $1.9 billion. In connection with this issuance, the Company received $150.0 million in cash.

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NOTE 10 SHAREHOLDERS EQUITY

Issuance of Common Stock

In the first quarter of 2008, the Company exchanged $25.0 million of outstanding senior notes for 4.5 million shares of common stock.

Additionally the Company received all necessary regulatory approvals for the remaining 46.7 million shares of common stock to be issued in conjunction with the Citadel Investment; however, as of March 31, 2008, the shares had not yet been issued.

NOTE 11 EARNINGS (LOSS) PER SHARE

The following table is a reconciliation of basic and diluted earnings (loss) per share (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2008	**2007**
Basic:		
Numerator:		
Net income (loss)	$ (91,193)	$ 169,410
Denominator:		
Basic weighted-average shares outstanding	460,857	423,786
Diluted:		
Numerator:		
Net income (loss)	$ (91,193)	$ 169,410
Denominator:		
Basic weighted-average shares outstanding	460,857	423,786
Effect of dilutive securities:		
Weighted-average options and restricted stock issued to employees		12,121
Weighted-average warrants and contingent shares outstanding		248
Weighted-average mandatory convertible notes		1,380
Diluted weighted-average shares outstanding	460,857	437,535
Per share:		
Basic earnings (loss) per share	$ (0.20)	$ 0.40
Diluted earnings (loss) per share	$ (0.20)	$ 0.39

For the three months ended March 31, 2008, the Company excluded from the calculations of diluted earnings per share 85.0 million shares of stock options, restricted stock awards and units, and contingent shares that would have been anti-dilutive. Of the excluded shares, 48.1 million shares were anti-dilutive because of the Company s net loss for the period, including 46.7 million shares that had not been issued in connection with the Citadel Investment. The Company excluded from the calculations of diluted earnings per share 8.1 million shares of stock options that would have been anti-dilutive for the three months ended March 31, 2007.

NOTE 12 EMPLOYEE SHARE-BASED PAYMENTS

Employee Stock Option Plans

The Company recognized $8.2 million and $8.3 million in compensation expense for stock options for the three months ended March 31, 2008 and 2007, respectively. The Company recognized a tax benefit of $2.2 million and $3.0 million related to the stock options for the three months ended March 31, 2008 and 2007, respectively.

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The fair value of each option award is estimated on the date of grant using a Black-Scholes-Merton option pricing model based on the assumptions noted in the table below. Expected volatility is based on a combination of historical volatility of the Company s stock and implied volatility of publicly traded options on the Company s stock. The expected term represents the period of time that options granted are expected to be outstanding. The expected term is estimated using employees actual historical behavior and projected future behavior based on expected exercise patterns. The risk-free interest rate is based on the U.S. Treasury zero-coupon bond where the remaining term equals the expected term. Dividend yield is zero as the Company has not, nor does it currently plan to, issue dividends to its shareholders.

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Expected volatility	47%	32%
Expected term (years)	4.6	4.5
Risk-free interest rate	3%	5%
Dividend yield		

The weighted-average fair values of options granted were $2.04 and $8.07 for the three months ended March 31, 2008 and 2007, respectively. Intrinsic value of options exercised were $0.03 million and $18.8 million for the three months ended March 31, 2008 and 2007, respectively.

A summary of options activity is presented below:

	Shares (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2007	32,756	$ 14.02	4.43	$ 18
Granted	8,861	$ 4.75		
Exercised	(23)	$ 3.43		
Canceled	(5,176)	$ 10.45		
Outstanding at March 31, 2008	36,418	$ 12.09	5.22	$ 28
Vested and expected to vest at March 31, 2008	33,889	$ 12.05	5.13	$ 26
Exercisable at March 31, 2008	20,423	$ 12.26	4.26	$ 21

As of March 31, 2008, there was $50.1 million of total unrecognized compensation cost related to non-vested stock options. This cost is expected to be recognized over a weighted-average period of 2.0 years.

Restricted Stock Awards and Restricted Stock Units

The Company issues restricted stock awards and restricted stock units to its employees. Each restricted stock unit can be converted into one share of the Company s common stock upon vesting. These awards are issued at the fair market value on the date of grant and generally vest ratably over the period, generally two to four years. The fair value is calculated as the market price upon issuance.

In connection with the Company s contract to hire the Chief Executive Officer (CEO) (attached as Exhibit 10.1), the Company s Board of Directors (the Board) made grants of restricted stock and stock options, as disclosed on Form 4 filed on March 4, 2008. The grants vest through October 2009, 62.5% of which time vests through January 1, 2009 and the balance of which time-vest through October 2009. In making these awards, the Board exercised its discretion to amend the 2005 Equity Incentive Plan and issue grants in excess of the stated maximum to any individual in any single year but did not increase the aggregate number of shares that may be issued under the 2005 Equity Incentive Plan; however, as previously disclosed, the Board will not issue any further equity, cash bonus or non-equity incentive plan payments to the CEO through at least the end of 2009. None of the restricted stock awards and no more than 37.5% of the stock option awards are expected to be deductible for federal income tax purposes.

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The Company recorded $5.8 million and $3.3 million for the three months ended March 31, 2008 and 2007, respectively, in compensation expense related to restricted stock awards and restricted stock units. The Company recognized a tax benefit of $1.4 million and $1.2 million related to restricted stock awards and restricted stock units for the three months ended March 31, 2008 and 2007, respectively.

A summary of non-vested restricted stock award activity is presented below:

	Shares (in thousands)	Weighted-Average Grant Date Fair Value	
Non-vested at December 31, 2007:	1,884	$	15.54
Issued		$	
Released (vested)	(187)	$	21.54
Canceled	(20)	$	24.40
Non-vested at March 31, 2008:	1,677	$	13.50

A summary of non-vested restricted stock unit activity is presented below:

	Units (in thousands)	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)	
Outstanding at December 31, 2007	113	1.56	$	390
Issued	3,945			
Released (vested)	(6)			
Canceled	(71)			
Outstanding at March 31, 2008	3,981	1.32	$	15,129
Vested and expected to vest at March 31, 2008	3,593	1.13	$	13,655
Exercisable at March 31, 2008			$	

As of March 31, 2008, there was $29.5 million of total unrecognized compensation cost related to non-vested awards and units. This cost is expected to be recognized over a weighted-average period of 1.6 years. The total fair value of restricted shares and restricted stock units vested was $1.0 million and $4.3 million for the three months ended March 31, 2008 and 2007, respectively.

NOTE 13 REGULATORY REQUIREMENTS

Registered Broker-Dealers

The Company s U.S. broker-dealer subsidiaries are subject to the Uniform Net Capital Rule (the Rule) under the Securities Exchange Act of 1934 administered by the SEC and FINRA, which requires the maintenance of minimum net capital. The minimum net capital requirements can be met under either the Aggregate Indebtedness method or the Alternative method. Under the Aggregate Indebtedness method, a broker-dealer is required to maintain minimum net capital of the greater of 6 $^{2}/_{3}$% of its aggregate indebtedness, as defined, or a minimum dollar amount. Under the Alternative method, a broker-dealer is required to maintain net capital equal to the greater of $250,000 or 2% of aggregate debit balances arising from customer transactions. The method used depends on the individual U.S. broker-dealer subsidiary. The Company s international broker-dealer subsidiaries, located in Canada, Europe and Asia, are subject to capital requirements determined by their respective regulators.

As of March 31, 2008, all of the Company s significant broker-dealer subsidiaries met minimum regulatory capital requirements. Total required net capital was $0.2 billion at March 31, 2008. In addition, the Company s broker-dealer subsidiaries had excess net capital of $0.8 billion at March 31, 2008.

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Banking

E*TRADE Bank is subject to various regulatory capital requirements administered by Federal banking agencies. Failure to meet minimum capital requirements can trigger certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on E*TRADE Bank s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, E*TRADE Bank must meet specific capital guidelines that involve quantitative measures of E*TRADE Bank s assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. E*TRADE Bank s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require E*TRADE Bank to maintain minimum amounts and ratios of Total and Tier I Capital to risk-weighted assets and Tier I Capital to adjusted total assets. As shown in the table below, at March 31, 2008, the OTS categorized E*TRADE Bank as well capitalized under the regulatory framework for prompt corrective action. E*TRADE Bank is also required by OTS regulations to maintain tangible capital of at least 1.50% of tangible assets. E*TRADE Bank satisfied this requirement at March 31, 2008 and December 31, 2007. However, events beyond management s control, such as a continued deterioration in residential real estate and credit markets, could adversely affect future earnings and E*TRADE Bank s ability to meet its future capital requirements.

E*TRADE Bank s required actual capital amounts and ratios are presented in the table below (dollars in thousands):

	Actual		Minimum Required to Qualify as Adequately Capitalized		Minimum Required to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
March 31, 2008:						
Total Capital to risk-weighted assets	$ 3,647,275	12.36%	>$ 2,361,577	>8.0%	>$ 2,951,972	>10.0%
Tier I Capital to risk-weighted assets	$ 3,275,848	11.10%	>$ 1,180,789	>4.0%	>$ 1,771,183	> 6.0%
Tier I Capital to adjusted total assets	$ 3,275,848	6.78%	>$ 1,932,751	>4.0%	>$ 2,415,938	> 5.0%
December 31, 2007:						
Total Capital to risk-weighted assets	$ 3,618,454	11.37%	>$ 2,546,669	>8.0%	>$ 3,183,336	>10.0%
Tier I Capital to risk-weighted assets	$ 3,219,176	10.11%	>$ 1,273,335	>4.0%	>$ 1,910,002	> 6.0%
Tier I Capital to adjusted total assets	$ 3,219,176	6.22%	>$ 2,070,287	>4.0%	>$ 2,587,858	> 5.0%

NOTE 14 COMMITMENTS, CONTINGENCIES AND OTHER REGULATORY MATTERS

Legal Matters

Litigation Matters

On October 27, 2000, a complaint was filed in the Superior Court for the State of California, County of Santa Clara, entitled, Ajaxo, Inc., a Delaware corporation, Plaintiff, versus E*TRADE GROUP, INC., a Delaware corporation; and Everypath, Inc., a California corporation; and Does 1 through 50, inclusively, Defendants. Through this complaint, Ajaxo sought damages and certain non-monetary relief for the Company s alleged breach of a non-disclosure agreement with Ajaxo pertaining to certain wireless technology offered to the Company by Ajaxo as well as damages and other relief against both the Company and defendant Everypath, Inc., for their alleged misappropriation of Ajaxo s trade secrets. Following a jury trial, a judgment was entered in 2003 in favor of Ajaxo against the Company for $1.3 million dollars for breach of the Ajaxo non-disclosure agreement. Although the jury also found in favor of Ajaxo on its misappropriation of trade secrets claim against the Company and defendant Everypath, the trial court subsequently denied Ajaxo s requests for additional damages and relief on these claims. Thereafter, all parties appealed, and on December 21, 2005, the California Court of Appeal affirmed the above-described award against the Company for breach of the nondisclosure agreement but remanded the case to the trial court for the limited purpose of determining what, if any, additional damages Ajaxo may be entitled to as a result of the jury s previous finding in favor of Ajaxo on its misappropriation of trade secrets claim against the Company and defendant Everypath. Following the foregoing ruling by the Court of Appeal, defendant Everypath ceased operations and made an assignment for the benefit of its creditors in January, 2006. As a result, defendant Everypath is no longer defending the case. Although the Company paid Ajaxo the full amount due on the judgment against it above, the case, consistent with the rulings issued by the Court of Appeal, has now been remanded back to the trial court solely on the issue of what, if any, additional damages Ajaxo may be entitled to receive on its misappropriation of trade secrets claim. The re-trial of this case commenced on April 28, 2008 and the Company estimates that it will conclude on or about May 16, 2008. At trial, Ajaxo will now seek alleged damages of $65,000,000 to $365,000,000 plus unspecified punitive damages. The Company denies that Ajaxo is entitled to any further damages or relief of any kind and will vigorously defend itself against Ajaxo s renewed damage claims.

On October 2, 2007, a class action complaint alleging violations of the federal securities laws was filed in the United States District Court for the Southern District of New York against the Company and its Chief Executive Officer and Chief Financial Officer entitled, Larry Freudenberg, Individually and on Behalf of All Others Similarly Situated, Plaintiff, versus E*TRADE Financial Corporation, Mitchell H. Caplan and Robert J. Simmons, Defendants. Plaintiff contends, among other things, that between December 14, 2006, and September 25, 2007 (the class period) defendants issued materially false and misleading statements and failed to disclose that the Company was experiencing a rise in delinquency rates in its mortgage and home equity portfolios; failed to timely record an impairment on its mortgage and home equity portfolios; materially overvalued its securities portfolio, which includes assets backed by mortgages; and based on the foregoing, lacked a reasonable basis for the positive statements it made about the Company s earnings and prospects. Plaintiff seeks to recover damages in an amount to be proven at trial, including interest and attorneys fees and costs. Four additional class action complaints alleging similar violations of the federal securities laws and alleging either the same or somewhat longer class periods were filed in the same court between October 12, 2007 and November 21, 2007 by named plaintiffs William Boston, Robert D. Thulman, Wendy M. Davidson, and Joshua Ferenc who subsequently dismissed his complaint on May 2, 2008. On January 23, 2008, the trial court heard motions from various plaintiffs seeking to be appointed lead plaintiff in these actions but has yet to issue its decision. Once the court rules on the lead plaintiff motions, the cases are to be consolidated. A consolidated amended complaint is expected to be filed within 60 days of the court s ruling. The Company intends to vigorously defend itself against these claims.

Based upon the same facts and circumstances alleged in the Freudenberg class action complaint above, a verified shareholder derivative complaint was filed in United States District Court for the Southern District of New York on October 4, 2007, against the Company s Chief Executive Officer, President/Chief Operating Officer, Chief Financial Officer and individual members of its board of directors entitled, Catherine Rubery, Derivatively on behalf of E*TRADE Financial Corporation, Plaintiff, versus Mitchell H. Caplan, R. Jarrett Lilien, Robert J. Simmons, George A. Hayter, Daryl Brewster, Ronald D. Fisher, Michael K. Parks, C. Catherine Raffaeli, Lewis E. Randall, Donna L. Weaver, and Stephen H. Willard, Defendants, -and- E*TRADE Financial Corporation, a Delaware corporation, Nominal Defendant. Plaintiff alleges, among other things, causes of action for breach of fiduciary duty, waste of corporate assets, unjust enrichment, and violation of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The above shareholder derivative complaint has been consolidated with another shareholder derivative complaint brought in the same court and against the same named defendants entitled, Marilyn Clark, Derivatively On Behalf of E*TRADE Financial Corporation, Plaintiff, versus Mitchell H. Caplan, et al., Defendants (collectively, with the Rubery case, the federal derivative actions). Three similar derivative actions, based on the same facts and circumstances as the federal derivative actions but alleging exclusively state causes of action, have been filed in the Supreme Court of the State of New York, New York County. These three cases have been ordered consolidated in that court under the caption In re: E*Trade Financial Corporation Derivative Litigation, Lead Index No. 07-603736 (the state derivative actions). The Company intends to vigorously defend itself against the claims raised in the federal derivative actions and state derivative actions.

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In addition to the matters described above, the Company is subject to various legal proceedings and claims that arise in the normal course of business which could have a material adverse effect on its financial position, results of operations or cash flows. In each pending matter, the Company contests liability or the amount of claimed damages. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages, or where investigation or discovery have yet to be completed, the Company cannot predict with certainty the loss or range of loss related to such matters, how such matters will be resolved, when they will ultimately be resolved, or what any eventual settlement, fine, penalty or other relief might be. Subject to the foregoing, the Company believes that the outcome of any such pending matter will not have a material adverse effect on the consolidated financial condition of the Company, although the outcome could be material to the Company s or a business segment s operating results in the future, depending, among other things, upon the Company s or business segment s income for such period.

An unfavorable outcome in any matter that is not covered by insurance could have a material adverse effect on the Company s business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in the Company s favor, the defense of such litigation could entail considerable cost or the diversion of the efforts of management, either of which could have a material adverse effect on the Company s results of operation.

Regulatory Matters

The securities and banking industries are subject to extensive regulation under Federal, state and applicable international laws. From time to time, the Company has been threatened with or named as a defendant in, lawsuits, arbitrations and administrative claims involving securities, banking and other matters. The Company is also subject to periodic regulatory audits and inspections. Compliance and trading problems that are reported to regulators, such as the SEC, FINRA, OTS or FDIC by dissatisfied customers or others are investigated by such regulators, and may, if pursued, result in formal claims being filed against the Company by customers or disciplinary action being taken against the Company or its employees by regulators. Any such claims or disciplinary actions that are decided against the Company could have a material impact on the financial results of the Company or any of its subsidiaries.

The SEC, in conjunction with various regional securities exchanges, is conducting an inquiry into the trading activities of certain specialist firms, including the Company s subsidiary E*TRADE Capital Markets, LLC (ETCM), on various regional exchanges in order to determine whether such firms executed proprietary orders in a given security prior to a customer order in the same security (a practice commonly known as trading ahead) during the period 1999 - 2005. ETCM was a specialist on the Chicago Stock Exchange during the period under review. The SEC has indicated that it will seek disgorgement, prejudgment interest, and penalties from any firm found to have engaged in trading ahead activity to the detriment of its customers during that time period. It is possible that such sanctions, if imposed against ETCM, could have a material impact on the financial results of the Company during the period in which such sanctions are imposed. The Company and ETCM are cooperating with the investigation.

On October 17, 2007, the SEC initiated an informal inquiry into matters related to the Company s loan and securities portfolios. That inquiry is continuing. The Company is cooperating fully with the SEC in this matter.

Insurance

The Company maintains insurance coverage that management believes is reasonable and prudent. The principal insurance coverage it maintains covers commercial general liability; property damage; hardware/software damage; cyber liability; directors and officers; employment practices liability; certain criminal acts against the Company; and errors and omissions. The Company believes that such insurance coverage is adequate for the purpose of its business. The Company s ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the marketplace.

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Reserves

For all legal matters, reserves are established in accordance with SFAS No. 5. Once established, reserves are adjusted based on available information when an event occurs requiring an adjustment.

Commitments

In the normal course of business, the Company makes various commitments to extend credit and incur contingent liabilities that are not reflected in the consolidated balance sheet. Significant changes in the economy or interest rates influence the impact that these commitments and contingencies have on the Company in the future.

Loans

The Company had the following mortgage loan commitments (dollars in thousands):

	March 31, 2008[1]		
	Fixed Rate	Variable Rate	Total
Originate loans	$ 205,860	$ 73,163	$ 279,023
Sell loans	$ 6,276	$ 3,918	$ 10,194

(1) The Company had no commitments to purchase loans at March 31, 2008.

Securities, Unused Lines of Credit and Certificates of Deposit

At March 31, 2008, the Company had commitments to purchase $0.04 billion and sell $0.6 billion in securities. In addition, the Company had approximately $4.2 billion of certificates of deposit scheduled to mature in less than one year and $6.1 billion of unfunded commitments to extend credit.

Guarantees

The Company provides guarantees to investors purchasing mortgage loans, which are considered standard representations and warranties within the mortgage industry. The primary guarantees are as follows:

The mortgage and the mortgage note have been duly executed and each is the legal, valid and binding obligation of the Company, enforceable in accordance with its terms. The mortgage has been duly acknowledged and recorded and is valid. The mortgage and the mortgage note are not subject to any right of rescission, set-off, counterclaim or defense, including, without limitation, the defense of usury, and no such right of rescission, set-off, counterclaim or defense has been asserted with respect thereto. If these claims prove to be untrue, the investor can require the Company to repurchase the loan and return all loan purchase and servicing release premiums.

Should any eligible mortgage loan delivered pay off prior to the receipt of the first payment, the loan purchase and servicing release premiums shall be fully refunded.

Should any eligible mortgage loan delivered to an investor pay off between the receipt of the first payment and a contractually designated period of time (typically 60-120 days from the date of purchase), the servicing release premiums shall be fully refunded.

Management has determined that quantifying the potential liability exposure is not meaningful due to the nature of the standard representations and warranties, which rarely result in loan repurchases. The current carrying amount of the liability recorded at March 31, 2008 is $0.2 million, which we consider adequate based upon analysis of historical trends and current economic conditions for these guarantees.

ETBH raises capital through the formation of trusts, which sell trust preferred stock in the capital markets. The capital securities are mandatorily redeemable in whole at the due date, which is generally 30 years after issuance. Each trust issues Floating Rate Cumulative Preferred Securities at par, with a liquidation amount of $1,000 per capital security. The proceeds from the sale of issuances are invested in ETBH s Floating Rate Junior Subordinated Debentures.

During the 30-year period prior to the redemption of the Floating Rate Cumulative Preferred Securities, ETBH guarantees the accrued and unpaid distributions on these securities, as well as the redemption price of the securities and certain costs that may be incurred in liquidating, terminating or dissolving the trusts (all of which would otherwise be payable by the trusts). At March 31, 2008, management estimated that the maximum potential liability under this arrangement is equal to approximately $439.2 million or the total face value of these securities plus dividends, which may be unpaid at the termination of the trust arrangement.

NOTE 15 FAIR VALUE DISCLOSURES

Effective January 1, 2008, the Company adopted SFAS No. 157, which defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Company determines the fair values of its financial instruments and for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis in accordance with SFAS No. 157. The Company will not adopt this statement until January 1, 2009 for nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis. Examples of nonfinancial assets and nonfinancial liabilities for which the Company has not applied the provisions of SFAS No. 157 include reporting units, nonfinancial assets and nonfinancial liabilities and indefinite-lived intangible assets measured at fair value in impairment tests under SFAS No. 142, nonfinancial long-lived assets measured at fair value for an impairment assessment under SFAS No. 144 as well as nonfinancial liabilities for exit or disposal activities initially measured at fair value under SFAS No. 146.

In determining fair value, the Company uses various valuation approaches, including market, income and/or cost approaches. The fair value hierarchy established in SFAS No. 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is a market-based measure considered from the perspective of a market participant. As such, even when market assumptions are not readily available, the Company s own assumptions reflect those that market participants would use in pricing the asset or liability at the measurement date. The standard describes three levels of inputs that may be used to measure fair value and are as follows:

Level 1 Quoted prices in active markets for identical assets or liabilities. Examples of assets and liabilities utilizing Level 1 inputs include actively traded equity securities.

Level 2 Quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly. Examples of assets and liabilities utilizing Level 2 inputs include mortgage-backed securities backed by U.S. Government sponsored and Federal agencies, certain CMOs, most investment securities and most OTC derivatives.

Level 3 Unobservable inputs that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. Examples of assets and liabilities utilizing Level 3 inputs or those that require significant management judgment include most CMOs, servicing rights, retained interest in securitizations, certain other mortgage-backed securities and certain OTC derivatives. In certain securities, including a portion of the CMO portfolio, where there has been limited activity or less transparency around inputs to the valuation, securities are classified as Level 3 even though the Company believes that Level 2 inputs could likely be obtainable in a more active market.

The availability of observable inputs can vary from instrument to instrument and in certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an instrument s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company s assessment of the significance of a particular input to the fair value measurement of an instrument requires judgment and consideration of factors specific to the instrument.

Fair Value Option

Effective January 1, 2008, the Company elected to carry investments in FNMA and FHLMC preferred stock at fair value through earnings under SFAS No. 159. The Company elected to carry the investment in preferred stock at fair value through earnings to allow the Company to economically hedge the portfolio without the burden of complying with SFAS No. 133, as amended. The impact of this adoption was an after-tax decrease to opening retained earnings as of January 1, 2008 of approximately $86.9 million. As of December 31, 2007, the Company s investment in preferred stock was reported in the balance sheet line item available-for-sale mortgage-backed and investment securities. In accordance with SFAS No. 159, as a result of the fair value election the investment in preferred stock is reported in the balance sheet line item trading securities as of March 31, 2008. Realized and unrealized gains and losses on securities classified as trading are included in the gain (loss) on loans and securities, net line item.

Valuation Techniques

The fair value for certain financial instruments is derived using pricing models and other valuation techniques that involve significant management judgment. The price transparency of financial instruments is a key determinant of the degree of judgment involved in determining the fair value of the Company s financial instruments. Financial instruments for which actively quoted prices or pricing parameters are available will generally have a higher degree of price transparency than financial instruments that are thinly traded or not quoted.

SFAS No. 157 states that the fair value measurement of a liability must reflect the nonperformance risk of the entity. The Company manages credit risk by following an established credit approval process, which includes monitoring credit limits based on counterparty credit rating, as well as by enforcing collateral requirements through credit support agreements which reduce risk by permitting the netting of transactions with the same counterparty upon occurrence of certain events. During the three months ended March 31, 2008, the consideration of credit risk did not result in a material adjustment to the valuation of OTC derivative contracts.

Mortgage-backed Securities Backed by U.S. Government Sponsored and Federal Agencies

Mortgage-backed securities backed by U.S. government sponsored and federal agencies include TBA securities and mortgage pass-through certificates. The fair value of TBA securities is determined using quoted market prices. The fair value of mortgage pass-through certificates is determined using quoted market prices, price activity and spread data for similar instruments. Mortgage-backed securities backed by U.S. government sponsored and federal agencies are generally categorized in Level 2 of the fair value hierarchy.

Collateralized Mortgage Obligations

CMOs, generally non-agency mortgage-backed securities, are typically valued using external price activity and spread data for similar instruments. The valuations of CMOs reflect the Company s best estimate of what market participants would consider in pricing the financial instruments. The Company considers the price transparency for these financial instruments to be a key determinant of the degree of judgment involved in determining the fair value. Due to the limited activity and low level of transparency around inputs to the valuation, a portion of these securities are classified as Level 3 even though the Company believes that Level 2 inputs could likely be obtainable in a more active market.

Investment Securities

Investment securities includes preferred stock, municipal bonds and corporate bonds. The fair value of preferred stock is typically estimated using market price quotations and the investment is generally categorized in Level 2 of the fair value hierarchy. The fair value of municipal bonds is estimated using pricing information based on bond characteristics, such as credit quality, maturity, coupon as well as where bonds with similar characteristics have traded. Municipal bonds are generally categorized in Level 2 of the fair value hierarchy. The fair value of corporate bonds is estimated using market price quotes corroborated by recently executed transactions observable in the market. Corporate bonds are generally categorized in Level 2 of the fair value hierarchy.

Derivative Financial Instruments

Derivative financial instruments include OTC swaps and option contracts related to interest rates, credit standing of reference entities or equity prices. The majority of the Company s derivative financial instruments, interest rate swap and option contracts, are valued with pricing models commonly used by the financial services industry using market observable pricing inputs. The Company does not consider these models to involve significant judgment on the part of management. The majority of the Company s derivative financial instruments are categorized in Level 2 of the fair value hierarchy.

Securities Owned and Securities Sold, Not Yet Purchased

Proprietary securities transactions entered into by broker-dealer subsidiaries for trading or investment purposes are included in Securities owned and Securities sold, not yet purchased in the Company s SFAS No. 157 disclosures. The fair value of securities owned and securities sold, not yet purchased is determined using observable market price quotes from recently executed transactions and are generally categorized in Level 1 or Level 2 of the fair value hierarchy.

Servicing Rights

On January 1, 2008, the Company elected to account for servicing rights under the fair value measurement method in accordance with SFAS No. 156. The fair value of the servicing rights is determined using models that include observable inputs, if available. To the extent observable inputs are not available, the Company estimates fair value based on the present value of expected future cash flows using its best estimate of the key assumptions, including anticipated loan prepayments and discount rates. Servicing rights are categorized as Level 3 in the fair value hierarchy when unobservable inputs are significant to the fair value measurements.

Retained Interests in Securitization

The fair value of the retained interests in securitizations is determined using models that include observable inputs, if available. To the extent observable inputs are not available, the Company estimates fair value based on the present value of expected future cash flows using its best estimate of the key assumptions, including forecasted credit losses, prepayments rates and discount rates. Retained interests in securitizations are categorized as Level 3 in the fair value hierarchy when unobservable inputs are significant to the fair value measurements.

Assets and liabilities measured at fair value on a recurring basis are summarized below (dollars in thousands):

	March 31, 2008			
	Level 1	Level 2	Level 3	Fair Value
Assets				
Trading securities	$ 3,578	$ 390,649	$ 28,714	$ 422,941
Available-for-sale securities:				
Mortgage-backed securities		7,647,115	637,862	8,284,977
Investment securities		115,164	1,936	117,100
Total available-for-sale securities		7,762,279	639,798	8,402,077
Other assets:				
Derivative assets		162,648	35	162,683
Servicing rights			8,576	8,576
Total other assets measured at fair value on a recurring basis		162,648	8,611	171,259
Total assets measured at fair value on a recurring basis	$ 3,578	$ 8,315,576	$ 677,123	$ 8,996,277
Liabilities				
Derivative liabilities	$	$ 263,566	$ 166	$ 263,732
Securities sold, not yet purchased	3,096	7,241		10,337
Total liabilities measured at fair value on a recurring basis	$ 3,096	$ 270,807	$ 166	$ 274,069

Both observable and unobservable inputs may be used to determine the fair value of positions that the Company has classified within the Level 3 category. As a result, the realized and unrealized gains and losses for assets and liabilities within the Level 3 category presented in the tables below may include changes in fair value that were attributable to both observable and unobservable inputs. The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis (dollars in thousands):

		Realized and Unrealized Gains (Losses)				
	January 1, 2008	Included in Earnings[1]	Included in Other Comprehensive Loss	Total [2]	Purchases, Sales, Other Settlements and Issuances Net	March 31, 2008
Trading securities	$ 37,795	$ (1,134)	$	$ (1,134)	$ (7,947)	$ 28,714
Available-for-sale securities:						
Mortgage-backed securities	$ 768,815	$ (26,602)	$ (81,068)	$ (107,670)	$ (23,283)	$ 637,862
Investment securities	$ 2,117	$	$ 796	$ 796	$ (977)	$ 1,936
Servicing rights	$ 8,282	$ (36)	$	$ (36)	$ 330	$ 8,576
Derivative instruments, net[3]	$ (3,644)	$ 3,513	$	$ 3,513	$	$ (131)

(1) The majority of realized and unrealized gains (losses) included in earnings are reported in the gain (loss) on loans and securities, net line item.
(2) The majority of total realized and unrealized gains (losses) were related to assets and liabilities held at March 31, 2008.
(3) Represents Derivative assets net of Derivative liabilities.

Level 3 Valuation Techniques

Assets and liabilities are considered level 3 instruments when their value is determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 instruments also include those for which the determination of fair value requires significant management judgment or estimation.

Trading securities and available-for-sale securities The fair value of trading securities and available-for-sale securities include observable inputs, if available. The valuation of Level 3 trading securities and available-for-sale securities required significant management judgment or estimation. CMOs, generally non-agency mortgage-backed securities, are typically valued using external price activity and spread data for similar instruments. The Company considers the price transparency for these financial instruments to be a key determinant of the degree of judgment involved in determining the fair value; however, the valuations of CMOs reflect the Company s best estimate of what market participants would consider in pricing the financial instruments. The fair value of the retained interests in securitizations is determined using models that include observable inputs, if available. To the extent observable inputs are not available, the Company estimates fair value based on the present value of expected future cash flows using its best estimate of the key assumptions, including forecasted credit losses, prepayments rates and discount rates.

Derivative instruments, net The fair value of derivative instruments is determined using models that include observable and unobservable inputs. Level 3 derivatives have characteristics that relate to unobservable pricing parameters.

Servicing rights The fair value of servicing rights is determined using models that include observable inputs, if available. To the extent observable inputs are not available, the Company estimates fair value based on the present value of expected future cash flows using its best estimate of the key assumptions, including anticipated loan prepayments and discount rates.

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NOTE 16 SEGMENT INFORMATION

The segments presented below reflect the manner in which the Company s chief operating decision maker assesses the Company s performance. The Company has two segments: retail and institutional.

Retail includes:

- trading, investing and banking products and services to individuals; and
- stock plan administration products and services.

Institutional includes:

- balance sheet management activities including generation of institutional net interest spread, gain on loans and securities, net and management income; and
- market-making.

The retail segment originates loans through lending activities[1]. Retail segment loan originations that are not sold directly to outside parties are sold at arm s length prices to the institutional segment which manages the Company s balance sheet. The Company evaluates the performance of its segments based on segment contribution (net revenue less expense excluding operating interest). All corporate overhead, administrative and technology charges are allocated to segments either in proportion to their respective direct costs or based upon specific operating criteria.

[1] In April 2008 the Company announced that it will exit its retail mortgage origination business, which represents the last remaining loan origination channel. After the exit of this business is completed, the Company expects to partner with a third party company to provide access to real estate loans for its customers.

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Financial information for the Company s reportable segments is presented in the following tables (dollars in thousands):

	Three Months Ended March 31, 2008			
	Retail	Institutional	Eliminations[1]	Total
Revenue:				
Operating interest income	$ 427,323	$ 590,856	$ (307,442)	$ 710,737
Operating interest expense	(214,336)	(471,072)	307,442	(377,966)
Net operating interest income	212,987	119,784		332,771
Provision for loan losses		(233,871)		(233,871)
Net operating interest income (expense) after provision for loan losses	212,987	(114,087)		98,900
Commission	128,388	1,376		129,764
Fees and service charges	59,213	5,324	(1,925)	62,612
Principal transactions		20,495		20,495
Gain (loss) on loans and securities, net	1,069	(10,214)		(9,145)
Other revenue	9,683	3,943	(16)	13,610
Total non-interest income	198,353	20,924	(1,941)	217,336
Total net revenue	411,340	(93,163)	(1,941)	316,236
Expense excluding interest:				
Compensation and benefits	88,865	39,912		128,777
Clearing and servicing	20,149	30,371	(1,941)	48,579
Advertising and market development	60,445	27		60,472
Communications	25,201	2,238		27,439
Professional services	15,398	8,949		24,347
Depreciation and amortization	17,222	4,849		22,071
Occupancy and equipment	20,713	1,290		22,003
Amortization of other intangibles	8,777	2,133		10,910
Facility restructuring and other exit activities	108	10,384		10,492
Other	28,968	(11,445)		17,523
Total expense excluding interest	285,846	88,708	(1,941)	372,613
Segment income (loss)	$ 125,494	$ (181,871)	$	$ (56,377)

(1) Reflects elimination of transactions between retail and institutional segments, which includes deposit and customer payable transfer pricing and order flow rebates.

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	Three Months Ended March 31, 2007			
	Retail	Institutional	Eliminations[1]	Total
Revenue:				
Operating interest income	$ 457,764	$ 671,243	$ (299,212)	$ 829,795
Operating interest expense	(230,283)	(508,138)	299,212	(439,209)
Net operating interest income	227,481	163,105		390,586
Provision for loan losses		(21,186)		(21,186)
Net operating interest income after provision for loan losses	227,481	141,919		369,400
Commission	123,305	35,688		158,993
Fees and service charges	54,203	7,475	(2,180)	59,498
Principal transactions		30,082		30,082
Gain on loans and securities, net	4,911	12,464		17,375
Other revenue	9,751	41	(142)	9,650
Total non-interest income	192,170	85,750	(2,322)	275,598
Total net revenue	419,651	227,669	(2,322)	644,998
Expense excluding interest:				
Compensation and benefits	80,296	43,486		123,782
Clearing and servicing	20,761	48,813	(2,322)	67,252
Advertising and market development	43,924	1,668		45,592
Communications	22,795	3,361		26,156
Professional services	15,099	9,886		24,985
Depreciation and amortization	14,809	4,574		19,383
Occupancy and equipment	20,572	3,007		23,579
Amortization of other intangibles	9,619	649		10,268
Facility restructuring and other exit activities	1,017	(284)		733
Other	19,301	13,374		32,675
Total expense excluding interest	248,193	128,534	(2,322)	374,405
Segment income	$ 171,458	$ 99,135	$	$ 270,593

(1) Reflects elimination of transactions between retail and institutional segments, which includes deposit and customer payable transfer pricing and order flow rebates.

Segment Assets

	Retail	Institutional	Eliminations	Total
As of March 31, 2008	$ 11,267,590	$ 41,929,360	$	$ 53,196,950
As of December 31, 2007	$ 13,446,832	$ 43,399,105	$	$ 56,845,937

No single customer accounted for more than 10% of total net revenue for the three months ended March 31, 2008 and 2007.

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NOTE 17 SUBSEQUENT EVENTS

In April 2008, the Company announced that it will exit its retail mortgage origination business, which represents the last remaining loan origination channel. After the exit of this business is completed, the Company expects to partner with a third party company to provide access to real estate loans for its customers.

The Company closed on the sale of Retirement Advisors of America (RAA) to PHH Investments, Ltd on April 11, 2008. The proceeds from the sale were approximately $25 million.

ITEM 4. CONTROLS AND PROCEDURES

(a) Our Chief Executive Officer and our Acting Chief Financial Officer, after evaluating the effectiveness of the Company s disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 (Exchange Act) Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report, have concluded that our disclosure controls and procedures are effective based on their evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.

(b) Our Chief Executive Officer and our Acting Chief Financial Officer have evaluated the changes to the Company s internal control over financial reporting that occurred during our last fiscal quarter ended March 31, 2008, as required by paragraph (d) of Exchange Act Rules 13a-15 and 15d-15, and have concluded that there were no such changes that materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On October 27, 2000, a complaint was filed in the Superior Court for the State of California, County of Santa Clara, entitled, Ajaxo, Inc., a Delaware corporation, Plaintiff, versus E*TRADE GROUP, INC., a Delaware corporation; and Everypath, Inc., a California corporation; and Does 1 through 50, inclusively, Defendants. Through this complaint, Ajaxo sought damages and certain non-monetary relief for the Company s alleged breach of a non-disclosure agreement with Ajaxo pertaining to certain wireless technology offered to the Company by Ajaxo as well as damages and other relief against both the Company and defendant Everypath, Inc., for their alleged misappropriation of Ajaxo s trade secrets. Following a jury trial, a judgment was entered in 2003 in favor of Ajaxo against the Company for $1.3 million dollars for breach of the Ajaxo non-disclosure agreement. Although the jury also found in favor of Ajaxo on its misappropriation of trade secrets claim against the Company and defendant Everypath, the trial court subsequently denied Ajaxo s requests for additional damages and relief on these claims. Thereafter, all parties appealed, and on December 21, 2005, the California Court of Appeal affirmed the above-described award against the Company for breach of the nondisclosure agreement but remanded the case to the trial court for the limited purpose of determining what, if any, additional damages Ajaxo may be entitled to as a result of the jury s previous finding in favor of Ajaxo on its misappropriation of trade secrets claim against the Company and defendant Everypath. Following the foregoing ruling by the Court of Appeal, defendant Everypath ceased operations and made an assignment for the benefit of its creditors in January, 2006. As a result, defendant Everypath is no longer defending the case. Although the Company paid Ajaxo the full amount due on the judgment against it above, the case, consistent with the rulings issued by the Court of Appeal, has now been remanded back to the trial court solely on the issue of what, if any, additional damages Ajaxo may be entitled to receive on its misappropriation of trade secrets claim. The re-trial of this case commenced on April 28, 2008 and the Company estimates that it will conclude on or about May 16, 2008. At trial, Ajaxo will now seek alleged damages of $65,000,000 to $365,000,000 plus unspecified punitive damages. The Company denies that Ajaxo is entitled to any further damages or relief of any kind and will vigorously defend itself against Ajaxo s renewed damage claims.

On October 2, 2007, a class action complaint alleging violations of the federal securities laws was filed in the United States District Court for the Southern District of New York against the Company and its Chief Executive Officer and Chief Financial Officer entitled, Larry Freudenberg, Individually and on Behalf of All Others Similarly Situated, Plaintiff, versus E*TRADE Financial Corporation, Mitchell H. Caplan and Robert J. Simmons, Defendants. Plaintiff contends, among other things, that between December 14, 2006, and September 25, 2007 (the class period) defendants issued materially false and misleading statements and failed to disclose that the Company was experiencing a rise in delinquency rates in its mortgage and home equity portfolios; failed to timely record an impairment on its mortgage and home equity portfolios; materially overvalued its securities portfolio, which includes assets backed by mortgages; and based on the foregoing, lacked a reasonable basis for the positive statements it made about the Company s earnings and prospects. Plaintiff seeks to recover damages in an amount to be proven at trial, including interest and attorneys fees and costs. Four additional class action complaints alleging similar violations of the federal securities laws and alleging either the same or somewhat longer class periods were filed in the same court between October 12, 2007 and November 21, 2007 by named plaintiffs William Boston, Robert D. Thulman, Wendy M. Davidson, and Joshua Ferenc who subsequently dismissed his complaint on May 2, 2008. On January 23, 2008, the trial court heard motions from various plaintiffs seeking to be appointed lead plaintiff in these actions but has yet to issue its decision. Once the court rules on the lead plaintiff motions, the cases are to be consolidated. A consolidated amended complaint is expected to be filed within 60 days of the court s ruling. The Company intends to vigorously defend itself against these claims.

Based upon the same facts and circumstances alleged in the Freudenberg class action complaint above, a verified shareholder derivative complaint was filed in United States District Court for the Southern District of New York on October 4, 2007, against the Company s Chief Executive Officer, President/Chief Operating Officer, Chief Financial Officer and individual members of its board of directors entitled, Catherine Rubery,

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Derivatively on behalf of E*TRADE Financial Corporation, Plaintiff, versus Mitchell H. Caplan, R. Jarrett Lilien, Robert J. Simmons, George A. Hayter, Daryl Brewster, Ronald D. Fisher, Michael K. Parks, C. Catherine Raffaeli, Lewis E. Randall, Donna L. Weaver, and Stephen H. Willard, Defendants, -and- E*TRADE Financial Corporation, a Delaware corporation, Nominal Defendant. Plaintiff alleges, among other things, causes of action for breach of fiduciary duty, waste of corporate assets, unjust enrichment, and violation of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The above shareholder derivative complaint has been consolidated with another shareholder derivative complaint brought in the same court and against the same named defendants entitled, Marilyn Clark, Derivatively On Behalf of E*TRADE Financial Corporation, Plaintiff, versus Mitchell H. Caplan, et al., Defendants (collectively, with the Rubery case, the federal derivative actions). Three similar derivative actions, based on the same facts and circumstances as the federal derivative actions but alleging exclusively state causes of action, have been filed in the Supreme Court of the State of New York, New York County. These three cases have been ordered consolidated in that court under the caption In re: E*Trade Financial Corporation Derivative Litigation, Lead Index No. 07-603736 (the state derivative actions). The Company intends to vigorously defend itself against the claims raised in the federal derivative actions and state derivative actions.

The SEC, in conjunction with various regional securities exchanges, is conducting an inquiry into the trading activities of certain specialist firms, including the Company s subsidiary E*TRADE Capital Markets, LLC (ETCM), on various regional exchanges in order to determine whether such firms executed proprietary orders in a given security prior to a customer order in the same security (a practice commonly known as trading ahead) during the period 1999-2005. ETCM was a specialist on the Chicago Stock Exchange during the period under review. The SEC has indicated that it will seek disgorgement, prejudgment interest, and penalties from any firm found to have engaged in trading ahead activity to the detriment of its customers during that time period. It is possible that such sanctions, if imposed against ETCM, could have a material impact on the financial results of the Company during the period in which such sanctions are imposed. The Company and ETCM are cooperating with the investigation.

On October 17, 2007, the SEC initiated an informal inquiry into matters related to the Company s loan and securities portfolios. That inquiry is continuing. The Company is cooperating fully with the SEC in this matter.

An unfavorable outcome in any matter that is not covered by insurance could have a material adverse effect on our business, financial condition, results of operations or cash flows. In addition, even if the ultimate outcomes are resolved in our favor, the defense of such litigation could entail considerable cost or the diversion of the efforts of management, either of which could have a material adverse effect on our results of operations. In addition to the matters described above, the Company is subject to various legal proceedings and claims that arise in the normal course of business which could have a material adverse effect on our financial position, results of operations or cash flows.

We maintain insurance coverage that we believe is reasonable and prudent. The principal insurance coverage we maintain covers commercial general liability; property damage; hardware/software damage; cyber liability; directors and officers; employment practices liability; certain criminal acts against the Company; and errors and omissions. We believe that such insurance coverage is adequate for the purpose of our business. Our ability to maintain this level of insurance coverage in the future, however, is subject to the availability of affordable insurance in the marketplace.

ITEM 1A. RISK FACTORS

There have been no material changes in our risk factors from those disclosed in our 2007 Annual Report on Form 10-K.

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

In March 2008, the Company issued 4,500,000 shares of common stock to retire $25.0 million of the Company s 37/8% senior notes. The issuances were exempt from registration pursuant to Section 3(a)(9) of the Securities Act of 1933. The Company did not engage in a general solicitation or advertising with regard to the issuances of common stock and has not offered securities to the public in connection with the issuances.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

*10.1	Employment Agreement dated March 2, 2008 by and between the Company and Donald H. Layton.
*10.2	Separation Agreement dated April 22, 2008 by and between the Company and Arlen W. Gelbard.
*10.3	Separation Agreement dated April 22, 2008 by and between the Company and R. Jarrett Lilien.
*10.4	Separation Agreement dated April 25, 2008 by and between the Company and Robert J. Simmons.
*31.1	Certification Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herein.

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SIGNATURES

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

Dated: May 9, 2008

E*TRADE Financial Corporation

(Registrant)

By /s/ DONALD H. LAYTON
Donald H. Layton

Chief Executive Officer

By /s/ MATTHEW J. AUDETTE

Matthew J. Audette

Acting Chief Financial Officer

(Principal Financial and Accounting Officer)