

OSI SYSTEMS INC  
Form 10-Q  
January 27, 2015  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended December 31, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-23125

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## OSI SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**33-0238801**  
(I.R.S. Employer  
Identification No.)

**12525 Chadron Avenue**

**Hawthorne, California 90250**

(Address of principal executive offices) (Zip Code)

**(310) 978-0516**

(Registrant's telephone number, including area code)

**N/A**

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

As of January 26, 2015, there were 19,804,943 shares of the registrant's common stock outstanding.

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OSI SYSTEMS, INC.

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(amounts in thousands, except share amounts)

	June 30, 2014	(Unaudited) December 31, 2014
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 38,831	\$ 44,780
Accounts receivable, net	185,773	184,228
Inventories	234,138	263,901
Deferred taxes	73,510	73,293
Prepaid expenses and other current assets	46,978	53,131
Total current assets	579,230	619,333
Property and equipment, net	260,479	240,369
Goodwill	92,607	98,410
Intangible assets, net	43,615	48,865
Other assets	48,255	49,681
Total assets	\$ 1,024,186	\$ 1,056,658
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Bank lines of credit	\$ 24,000	\$ 23,000
Current portion of long-term debt	2,819	2,816
Accounts payable	74,460	96,513
Accrued payroll and related expenses	32,997	29,681
Advances from customers	38,493	42,486
Deferred revenue	60,677	51,742
Income taxes payable	20,556	30,872
Other accrued expenses and current liabilities	55,977	61,473
Total current liabilities	309,979	338,583
Long-term debt	10,436	9,399
Advances from customers	50,000	37,500
Deferred income taxes	73,161	73,933
Other long-term liabilities	48,397	55,920
Total liabilities	491,973	515,335
Commitments and contingencies (Note 7)		
Stockholders Equity:		
Preferred stock, \$0.001 par value, 10,000,000 shares authorized; no shares issued or outstanding		
Common stock, \$0.001 par value authorized, 100,000,000 shares; issued and outstanding, 19,942,923 shares at June 30, 2014 and 19,788,531 shares at December 31, 2014	287,434	271,988

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Retained earnings	247,680	277,170
Accumulated other comprehensive loss	(2,901)	(7,835)
Total stockholders' equity	532,213	541,323
Total liabilities and stockholders' equity	\$ 1,024,186	\$ 1,056,658

See accompanying notes to condensed consolidated financial statements.

Table of Contents**OSI SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(amounts in thousands, except per share data)

(Unaudited)

	For the Three Months Ended		For the Six Months Ended	
	December 31,		December 31,	
	2013	2014	2013	2014
Net revenues:				
Products	\$ 173,974	\$ 190,821	\$ 317,450	\$ 347,309
Services	62,434	67,008	125,232	128,917
Total net revenues	236,408	257,829	442,682	476,226
Cost of goods sold:				
Products	118,781	126,366	222,374	233,790
Services	36,688	42,189	71,423	78,920
Total cost of goods sold	155,469	168,555	293,797	312,710
Gross profit	80,939	89,274	148,885	163,516
Operating expenses:				
Selling, general and administrative	45,556	47,894	87,770	92,076
Research and development	11,175	13,240	22,195	25,910
Restructuring and other charges	2,179	2,079	6,418	2,805
Total operating expenses	58,910	63,213	116,383	120,791
Income from operations	22,029	26,061	32,502	42,725
Interest and other expense, net	(1,503)	(832)	(2,973)	(1,696)
Income before income taxes	20,526	25,229	29,529	41,029
Provision for income taxes	5,953	6,988	8,562	11,539
Net income	\$ 14,573	\$ 18,241	\$ 20,967	\$ 29,490
Net income per share:				
Basic	\$ 0.73	\$ 0.92	\$ 1.05	\$ 1.49
Diluted	\$ 0.71	\$ 0.89	\$ 1.02	\$ 1.44
Shares used in per share calculation:				
Basic	19,961	19,811	19,966	19,815
Diluted	20,589	20,487	20,604	20,506

See accompanying notes to condensed consolidated financial statements.

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**OSI SYSTEMS, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(amounts in thousands)

(Unaudited)

	For the Three Months Ended December 31,		For the Six Months Ended December 31,	
	2013	2014	2013	2014
Net income	\$ 14,573	\$ 18,241	\$ 20,967	\$ 29,490
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustment	471	(2,433)	1,779	(5,133)
Other	30	71	122	199
Other comprehensive income (loss)	501	(2,362)	1,901	(4,934)
Comprehensive income	\$ 15,074	\$ 15,879	\$ 22,868	\$ 24,556

See accompanying notes to condensed consolidated financial statements.



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(amounts in thousands)

(Unaudited)

	For the Six Months Ended December 31,	
	2013	2014
Cash flows from operating activities:		
Net income	\$ 20,967	\$ 29,490
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	26,417	32,082
Stock based compensation expense	10,721	12,078
Provision for losses on accounts receivable	977	647
Other	39	215
Changes in operating assets and liabilities net of business acquisitions:		
Accounts receivable	46,781	456
Inventories	(8,768)	(29,164)
Prepaid expenses and other assets	(5,649)	4,186
Accounts payable	(32,798)	19,201
Advances from customers	(10,648)	(8,465)
Deferred revenue	27,542	(7,557)
Other	(608)	7,781
Net cash provided by operating activities	74,973	60,950
Cash flows from investing activities:		
Acquisition of property and equipment	(41,702)	(6,447)
Acquisition of businesses, net of cash acquired	(10,087)	(14,687)
Acquisition of intangible and other assets	(2,467)	(3,376)
Net cash used in investing activities	(54,256)	(24,510)
Cash flows from financing activities:		
Net borrowings (repayments) on bank lines of credit	1,000	(1,000)
Proceeds from long-term debt	2,841	653
Payments on long-term debt	(1,562)	(1,470)
Proceeds from exercise of stock options and employee stock purchase plan	1,501	1,941
Repurchase of common shares	(12,056)	(22,617)
Taxes paid related to net share settlements of equity awards	(8,230)	(6,847)
Net cash used in financing activities	(16,506)	(29,340)
Effect of exchange rate changes on cash	991	(1,151)
Net increase in cash and cash equivalents	5,202	5,949
Cash and cash equivalents-beginning of period	34,697	38,831
Cash and cash equivalents-end of period	\$ 39,899	\$ 44,780
Supplemental disclosure of cash flow information:		
Cash paid, net during the period for:		
Interest	\$ 2,878	\$ 1,347
Income taxes	\$ 8,716	\$ 6,559

See accompanying notes to condensed consolidated financial statements.



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**OSI SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation**

*Description of Business*

OSI Systems, Inc., together with its subsidiaries (the Company), is a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. The Company sells its products and provides related services in diversified markets, including homeland security, healthcare, defense and aerospace.

The Company has three reporting segments: (i) Security, providing security inspection systems, turnkey security screening solutions and related services; (ii) Healthcare, providing patient monitoring, cardiology and anesthesia systems, and related services and (iii) Optoelectronics and Manufacturing, providing specialized electronic components and electronic manufacturing services for the Security and Healthcare divisions as well as to external original equipment manufacturing clients for applications in the defense, aerospace, medical and industrial markets, among others.

Through its Security division, the Company provides security screening, threat detection and non-intrusive inspection products and related services globally. These products fall into the following categories: baggage and parcel inspection systems; cargo and vehicle inspection systems; hold (checked) baggage screening systems; people screening; radiation detection; and trace detection. In addition to these products, the Company provides site design, installation, training and technical support services to its customers. The Company also provides turnkey security screening solutions, which can include the construction, staffing and long-term operation of security screening checkpoints for its customers.

Through its Healthcare division, the Company designs, manufactures, markets and services patient monitoring, cardiology and anesthesia delivery and ventilation systems, and related supplies and accessories worldwide. These products are used by care providers in critical care, emergency and perioperative areas within hospitals as well as physicians' offices, medical clinics and ambulatory surgery centers amongst others.

Through its Optoelectronics and Manufacturing division, the Company designs, manufactures and markets optoelectronic devices and provides electronics manufacturing services worldwide for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostic products, telecommunications, computer peripherals, industrial automation systems, automotive diagnostic systems, gaming systems and consumer products. This division provides products and services to original equipment manufacturers and end users as well as to the Company's own Security and Healthcare divisions.

***Basis of Presentation***

The condensed consolidated financial statements include the accounts of OSI Systems, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to interim financial reporting guidelines. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of the Company's management, the condensed consolidated financial statements include all adjustments, consisting of only normal and recurring adjustments, necessary for a fair presentation of the financial position and the results of operations for the periods presented. These condensed consolidated financial statements and the accompanying notes should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2014. The results of operations for the three and six months ended December 31, 2014 are not necessarily indicative of the operating results to be expected for the full 2015 fiscal year or any future periods.

***Use of Estimates***

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and costs of sales during the reporting period. The most significant of these estimates and assumptions for the Company relate to contract revenue, profit and loss recognition, fair values of assets acquired and liabilities assumed in business combinations, market values for inventories reported at lower of cost or market, stock-based employee compensation expense, income taxes, accrued product warranty costs, and the recoverability, useful lives and valuation of recorded amounts of long-lived assets, identifiable intangible assets and goodwill. Changes in estimates are reflected in the periods during which they become known. Actual amounts will differ from these estimates and could differ materially.

***Per Share Computations***

The Company computes basic earnings per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. The Company computes diluted earnings per share by dividing net income available to common stockholders by the sum of the weighted average number of common and dilutive potential common shares outstanding. Potential common shares consist of the shares issuable upon the exercise of stock options and restricted stock or unit awards under the treasury stock method. During the three and six months ended December 31, 2013 and 2014, the number of stock options and stock awards or units excluded from the calculations because they were antidilutive was de minimis.

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The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2014	2013	2014
Net income for diluted earnings per share calculation	\$ 14,573	\$ 18,241	\$ 20,967	\$ 29,490
Weighted average shares outstanding for basic earnings per share calculation	19,961	19,811	19,966	19,815
Dilutive effect of stock awards	628	676	638	691
Weighted average shares outstanding for diluted earnings per share calculation	20,589	20,487	20,604	20,506
Basic net income per share	\$ 0.73	\$ 0.92	\$ 1.05	\$ 1.49
Diluted net income per share	\$ 0.71	\$ 0.89	\$ 1.02	\$ 1.44

**Reclassifications**

Certain reclassifications have been made to prior year amounts within the condensed consolidated balance sheet and condensed consolidated statement of cash flows to conform to the current year's presentation.

**Cash Equivalents**

The Company considers all highly liquid investments purchased with maturities of approximately three months or less as of the acquisition date to be cash equivalents.

**Fair Value of Financial Instruments**

The Company's financial instruments consist primarily of cash, marketable securities, derivative instruments, accounts receivable, accounts payable and debt instruments. The carrying values of financial instruments, other than long-term debt instruments, are representative of their fair values due to their short-term maturities. The carrying values of the Company's long-term debt instruments are considered to approximate their fair values because the interest rates of these instruments are variable or comparable to current rates offered to the Company.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Level 1 category includes assets and liabilities at the quoted prices in active markets for identical assets and liabilities.

Level 2 category includes assets and liabilities from observable inputs other than quoted market prices. Level 3 category includes assets and liabilities whose valuation techniques are unobservable and significant to the fair value measurement. There were no assets or liabilities where

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Level 3 valuation techniques were used, and there were no assets and liabilities measured at fair value on a non-recurring basis.

The following is a summary of the inputs used in valuing investments carried at fair value (in thousands):

	Level 1		Level 2		June 30, 2014		Level 1		Level 2		December 31, 2014	
Equity securities	414		500		914		326		1,600		1,926	
Insurance company contracts			17,383		17,383				18,176		18,176	
Interest rate contract			28		28				36		36	
Total	\$	414	\$	17,911	\$	18,325	\$	326	\$	19,812	\$	20,138

### *Derivative Instruments and Hedging Activity*

The Company's use of derivatives consists of an interest rate swap agreement. The interest rate swap agreement was entered into to improve the predictability of cash flows from interest payments related to variable, LIBOR-based debt for the duration of the term loan. The interest rate swap matures in October 2019. The interest rate swap is considered an effective cash flow hedge, and, as a result, the net gains or losses on such instrument were reported as a component of Other comprehensive income in the condensed consolidated financial statements and are reclassified as net income when the hedge transaction settles.

### *Revenue Recognition*

The Company recognizes revenue from sales of products upon shipment when title and risk of loss passes, and when terms are fixed and collection is probable. Revenue from services includes after-market services, installation and implementation of products, and turnkey security screening services. The portion of revenue for the sale attributable to installation is deferred and recognized when the installation service is provided. In an instance where terms of sale include subjective customer acceptance criteria, revenue is deferred until the Company has achieved the acceptance criteria. Concurrent with the shipment of the product, the Company accrues estimated product return reserves and warranty expenses. Critical judgments made by management related to revenue recognition include the determination of whether or not customer acceptance criteria are perfunctory or inconsequential. The determination of whether or not customer acceptance terms are perfunctory or inconsequential impacts the amount and timing of revenue recognized. Critical judgments also include estimates of warranty reserves, which are established based on historical experience and knowledge of the product under warranty.

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Revenue from turnkey services agreements is included in revenue from services. In certain agreements, revenue is recognized based upon proportional performance, measured by the actual number of hours incurred divided by the total estimated number of hours for the project. The impact of changes in the estimated hours to service the agreement is reflected in the period during which the change becomes known. Deferred revenue for such agreements arises when payments from customers are received in advance of revenue recognition.

Revenues from out of warranty service maintenance contracts are recognized ratably over the term of such contract. For services not derived from specific maintenance contracts, revenues are recognized as the services are performed. Deferred revenue for such services arises from payments received from customers for services not yet performed. On occasion, the Company receives advances from customers that are amortized against future customer payments pursuant to the underlying agreements. Such advances are classified in the condensed consolidated balance sheets as either a current or long term liability dependent upon when the Company estimates the corresponding amortization to occur.

***Business Combinations***

During the normal course of business the Company makes acquisitions. In the event that an individual acquisition (or an aggregate of acquisitions) is material, appropriate disclosure of such acquisition activity is provided. During the six months ended December 31, 2014, the Company completed acquisitions that were not material both individually and in aggregate.

***Recent Accounting Updates Not Yet Adopted***

In May 2014, the Financial Accounting Standards Board issued an accounting standards update amending revenue recognition requirements for multiple deliverable revenue arrangements. This update provides guidance on how revenue is recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the goods or services. This determination is made in five steps: (i) identify the contract with the customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The update is effective for annual reporting periods after December 15, 2016 and for interim reporting periods within that reporting period. Early adoption is not permitted. The Company has not yet adopted this update and is currently evaluating the impact it may have on its financial condition and results of operations.

**2. Balance Sheet Details**

The following tables provide details of selected balance sheet accounts (in thousands):

	June 30, 2014	December 31, 2014
<b>Accounts receivable</b>		
Billed receivables	\$ 189,489	\$ 188,351
Unbilled receivables	1,975	2,727

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Less allowance for doubtful accounts		(5,691)		(6,850)
<b>Total</b>	<b>\$</b>	<b>185,773</b>	<b>\$</b>	<b>184,228</b>

		<b>June 30, 2014</b>		<b>December 31, 2014</b>
<b>Inventories</b>				
Raw materials	\$	117,945	\$	154,948
Work-in-process		33,394		52,909
Finished goods		82,799		56,044
<b>Total</b>	<b>\$</b>	<b>234,138</b>	<b>\$</b>	<b>263,901</b>

		<b>June 30, 2014</b>		<b>December 31, 2014</b>
<b>Property and equipment</b>				
Buildings and improvements	\$	163,952	\$	166,453
Leasehold improvements		9,744		10,318
Equipment and tooling		154,367		155,642
Furniture and fixtures		4,017		4,093
Computer equipment		17,466		18,276
Computer software		15,670		16,185
		365,216		370,967
Less: accumulated depreciation and amortization		(131,038)		(155,344)
		234,178		215,623
Land		13,651		13,651
Construction in process		12,650		11,095
<b>Property and equipment, net</b>	<b>\$</b>	<b>260,479</b>	<b>\$</b>	<b>240,369</b>

Depreciation expense was approximately \$12.3 million and \$13.3 million for the three months ended December 31, 2013 and 2014, respectively, and approximately \$23.8 million and \$30.2 million for the six months ended December 31, 2013 and 2014, respectively.



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The changes in the carrying value of goodwill for the six month period ended December 31, 2014 are as follows (in thousands):

	<b>Optoelectronics and</b>			
	<b>Security</b>	<b>Healthcare</b>	<b>Manufacturing</b>	<b>Consolidated</b>
Balance as of June 30, 2014	\$ 29,507	\$ 37,237	\$ 25,863	\$ 92,607
Goodwill acquired or adjusted during the period	957	6,522	37	7,516
Foreign currency translation adjustment	(430)	(656)	(627)	(1,713)
Balance as of December 31, 2014	\$ 30,034	\$ 43,103	\$ 25,273	\$ 98,410

Intangible assets consisted of the following (in thousands):

		<b>June 30, 2014</b>			<b>December 31, 2014</b>		
	<b>Weighted Average Lives</b>	<b>Gross Carrying Value</b>	<b>Accumulated Amortization</b>	<b>Intangibles Net</b>	<b>Gross Carrying Value</b>	<b>Accumulated Amortization</b>	<b>Intangibles Net</b>
<b>Amortizable assets:</b>							
Software development costs	9 years	\$ 21,165	\$ 6,716	\$ 14,449	\$ 23,024	\$ 7,105	\$ 15,919
Patents	17 years	6,566	765	5,801	6,938	873	6,065
Core technology	10 years	2,289	2,150	139	2,094	2,072	22
Developed technology	10 years	18,308	11,559	6,749	20,650	12,187	8,463
Customer relationships/ backlog	7 years	11,419	7,011	4,408	10,226	4,380	5,846
<b>Total amortizable assets</b>		<b>59,747</b>	<b>28,201</b>	<b>31,546</b>	<b>62,932</b>	<b>26,617</b>	<b>36,315</b>
<b>Non-amortizable assets -</b>							
Trademarks		12,069		12,069	12,550		12,550
<b>Total intangible assets</b>		<b>\$ 71,816</b>	<b>\$ 28,201</b>	<b>\$ 43,615</b>	<b>\$ 75,482</b>	<b>\$ 26,617</b>	<b>\$ 48,865</b>

Amortization expense related to intangibles assets was \$1.2 million and \$1.1 million for the three months ended December 31, 2013 and 2014, respectively. For the six months ended December 31, 2013 and 2014, amortization expense was \$2.6 million and \$1.9 million, respectively. At December 31, 2014, the estimated future amortization expense was as follows (in thousands):

**Fiscal Years**

2015 (remaining 6 months)	\$ 1,970
2016	3,975
2017	4,327
2018	4,363
2019	3,790
2020	3,350
2021 and thereafter, including assets that have not yet begun to be amortized	14,540
<b>Total</b>	<b>\$ 36,315</b>

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Software development costs for software products incurred before establishing technological feasibility are charged to operations. Software development costs incurred after establishing technological feasibility are capitalized on a product by product basis until the product is available for general release to customers at which time amortization begins. Annual amortization, charged to cost of goods sold, is the amount computed using the ratio that current revenues for a product bear to the total current and anticipated future revenues for that product. In the event that future revenues are not estimable, such costs are amortized on a straight line basis over the remaining estimated economic life of the product. Amortizable assets that have not yet begun to be amortized are included in thereafter in the table above. For the three months ended December 31, 2013 and 2014, \$0.5 million and \$0.8 million were capitalized, respectively. During the six months ended December 31, 2013 and 2014, the Company capitalized software development costs in the amount of \$1.8 million and \$1.4 million, respectively.

Table of Contents**4. Borrowings**

The Company has a \$450 million credit agreement maturing in May 2019. The credit agreement consists of a \$450 million revolving credit facility, including a \$375 million sub-limit for letters of credit. The Company has the ability to increase the facility by \$200 million under certain circumstances. Borrowings under this facility bear interest at the London Interbank Offered Rate ( LIBOR ) plus a margin of 1.25% as of December 31, 2014. This margin is determined by the Company's consolidated leverage ratio and may range from 1.25% to 2.0%. Letters of credit reduce the amount available to borrow by their face value. As of December 31, 2014, the unused portion of the facility bears a commitment fee of 0.20%, but can range from 0.20% to 0.35% based on the Company's consolidated leverage ratio. The Company's borrowings under the credit agreement are guaranteed by the Company's U.S.-based subsidiaries and are secured by substantially all of the Company's and certain subsidiaries' assets. The agreement contains various representations, warranties, affirmative, negative and financial covenants, and conditions of default customary for financing agreements of this type. As of December 31, 2014, there was \$23.0 million outstanding under the revolving credit facility and \$90.7 million outstanding under the letters-of-credit sub-facility.

Several of the Company's foreign subsidiaries maintain bank lines-of- credit, denominated in local currencies and US dollars, to meet short-term working capital requirements and for the issuance of letters-of-credit. As of December 31, 2014, \$8.0 million was outstanding under these letter-of-credit facilities, while no debt was outstanding. As of December 31 2014, the total amount available under these credit facilities was \$27.3 million, with a total cash borrowing sub-limit of \$1.6 million.

In September 2012, the Company entered into a term loan agreement for \$11.1 million to fund the acquisition of land and a building in the state of Washington. The loan, which bears interest at LIBOR plus 1.25%, is payable on a monthly basis over seven years. Concurrent with entering into the floating rate loan, the Company entered into an interest rate swap agreement that effectively locks the interest rate of the loan to 2.2% per annum for the term of the loan.

Long-term debt consisted of the following (in thousands):

	June 30, 2014	December 31, 2014
Term loans	\$ 10,921	\$ 9,810
Other long-term debt	2,334	2,405
	13,255	12,215
Less current portion of long-term debt	2,819	2,816
Long-term portion of debt	\$ 10,436	\$ 9,399

**5. Stock-based Compensation**

As of December 31, 2014, the Company maintained two share-based employee compensation plans (the OSI Plans ): the 2012 Incentive Award Plan ( 2012 Plan ) and the Amended and Restated 2006 Equity Participation Plan ( 2006 Plan ). Upon stockholder approval of the 2012 Plan, the Company ceased to make grants under the 2006 Plan.

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The Company recorded stock-based compensation expense in the condensed consolidated statements of operations as follows (in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2014	2013	2014
Cost of goods sold	\$ 255	\$ 290	\$ 525	\$ 495
Selling, general and administrative	4,770	5,724	10,072	11,488
Research and development	58	68	124	95
Stock-based compensation expense before taxes	\$ 5,083	\$ 6,082	10,721	\$ 12,078
Less: related income tax benefit	(1,963)	(2,354)	(4,138)	(4,761)
Stock-based compensation expense, net of estimated taxes	\$ 3,120	\$ 3,728	\$ 6,583	\$ 7,317

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As of December 31, 2014, total unrecognized compensation cost related to share-based compensation grants were estimated at \$1.2 million for stock options and \$24.4 million for restricted stock and restricted stock units ( RSUs ) under the OSI Plans. The Company expects to recognize these costs over a weighted-average period of 1.9 years with respect to the options and 1.8 years for grants of restricted stock and RSUs.

The following summarizes stock option activity during the six months ended December 31, 2014:

	Number of Options	Weighted- Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
Outstanding at June 30, 2014	1,022,991	\$ 26.60		
Granted	42,476	\$ 68.03		
Exercised	(19,803)	\$ 41.00		
Expired or forfeited	(2,899)	\$ 58.42		
Outstanding at December 31, 2014	1,042,765	\$ 27.92	5.3 years	\$ 44,681
Exercisable at December 31, 2014	949,969	\$ 24.19	4.9 years	\$ 43,608

The following summarizes restricted stock and RSU award activity during the six months ended December 31, 2014:

	Shares	Weighted- Average Fair Value
Nonvested at June 30, 2014	661,400	\$ 54.78
Granted	279,121	64.65
Vested	(248,502)	42.25
Forfeited	(7,075)	38.33
Nonvested at December 31, 2014	684,944	\$ 63.52

As of December 31, 2014, there were 2,979,007 shares available for grant under the 2012 Plan. Under the terms of that plan, restricted stock and RSUs granted from the pool of shares available for grant on or after December 12, 2012 reduce the pool by 1.87 shares for each share granted. Restricted stock and RSUs forfeited and returned to the pool of shares available for grant increase the pool by 1.87 shares for each share forfeited.

The Company granted 160,922 and 151,469 performance-based RSUs during the six months ended December 31, 2013 and 2014, respectively. These performance-based restricted stock awards are contingent on the achievement of certain financial performance metrics. The payout can range from zero to 250% of the original number of shares or units awarded, which are converted into shares of the Company's common stock.

### **6. Retirement Benefit Plans**

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The Company sponsors various retirement benefit plans including qualified and nonqualified defined benefit pension plans for its employees. The components of net periodic pension expense are as follows (in thousands):

	Three Months Ended December 31,				Six Months Ended December 31,			
	2013		2014		2013		2014	
Service cost	\$	309	\$	266	\$	602	\$	530
Amortization of prior service cost		202		202		404		404
Net periodic pension expense	\$	511	\$	468	\$	1,006	\$	934

For the three months ended December 31, 2013, the Company made contributions of \$0.8 million to these defined benefit plans; while no contributions were made during the three months ended December 31, 2014. For the six months ended December 31, 2013 and 2014, the Company made contributions of \$0.9 million and \$1.0 million, respectively, to these defined benefit plans.

In addition, the Company maintains various defined contribution plans. For the three months ended December 31, 2013 and 2014, the Company made contributions of \$1.0 and \$1.1 million, respectively, to these defined contribution plans. For the six months ended December 31, 2013 and 2014, the Company made contributions of \$2.0 million and \$2.2 million, respectively, to these defined contribution plans.

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**7. Commitments and Contingencies**

*Contingent Acquisition Obligations*

Under the terms and conditions of the purchase agreements associated with certain acquisitions, the Company may be obligated to make additional payments based on the achievement by the acquired operations of certain sales or profitability milestones. The maximum amount of such future payments under arrangements with contingent consideration caps is \$57 million as of December 31, 2014. In addition, one of the purchase agreements the Company entered into requires royalty payments through 2022 based on the license of, or sales of products containing the technology of CXR Limited, a company acquired in 2004. For acquisitions that occurred prior to fiscal year 2010, the Company accounts for such contingent payments as an addition to the purchase price of the acquired business. Otherwise, the estimated fair value of these obligations is recorded as a liability at the time of the acquisition in the condensed consolidated balance sheets with subsequent revisions reflected in the condensed consolidated statements of operations. As of June 30, 2014 and December 31, 2014, \$23.2 million and \$23.7 million of contingent payment obligations, respectively, are included in Other long-term liabilities in the accompanying condensed consolidated balance sheets.

*Advances from Customers*

The Company receives advances from customers associated with certain projects. In fiscal 2012, the Company entered into an agreement with the Mexican government to provide a turnkey security screening solution along the country's borders, and in its ports and airports. Associated with the agreement, the Company was provided an advance totaling \$100 million that is scheduled to become fully amortized in fiscal 2017. As of December 31, 2014, \$62.5 million of this advance remains outstanding.

*Environmental Contingencies*

The Company is subject to various environmental laws. The Company's practice is to conduct appropriate environmental investigations at its manufacturing facilities in North America, Asia Pacific, and Europe, and, to the extent practicable, on all new properties in order to identify, as of the date of such report, potential areas of environmental concern related to past and present activities or from nearby operations. In certain cases, the Company has conducted further environmental assessments consisting of soil and groundwater testing and other investigations deemed appropriate by independent environmental consultants.

During one investigation at the Company's Hawthorne, California facility, the Company discovered soil and groundwater contamination that it believes was the result of unspecified on- and off-site releases occurring prior to the Company's occupancy. Historical usage of this site includes semiconductor and electronics manufacturing, dating back to the mid-1960s, as well as possible aircraft and related manufacturing dating to the early 1940s. Similar operations, including chemical manufacturing and storage, were conducted at neighboring sites throughout that period and into the 1990s. It is not presently known when the releases occurred or by whom they were caused, though Company records, in conjunction with data obtained from soil and groundwater surveys, support the Company's assertion that these releases are historical in nature. Further, the groundwater contamination is a known regional issue, not limited to the Company's premises or its immediate surroundings. The Company has filed all requisite reports with the appropriate environmental authorities and continues to cooperate with the local governing agency to develop a complete and accurate characterization of this site. Recent actions during fiscal years 2014 and 2015 include the installation of groundwater monitoring wells and the implementation of a groundwater monitoring program, focused soils investigations, and indoor vapor intrusion surveys,

per regulatory requirements. Results from these studies are being evaluated to determine the extent of the on-site releases and whether any soils remediation will be required. Periodic groundwater monitoring is expected to continue until such time as the governing authority requests further action.

The Company has not accrued for loss contingencies relating to the Hawthorne facility or any other environmental matters because it believes that, although unfavorable outcomes may be possible, they are not considered by the Company's management to be probable and reasonably estimable. If one or more of environmental matters are resolved in a manner adverse to the Company, the impact on the Company's business, financial condition, results of operations, financial position and/or liquidity could be material.

*Indemnifications*

In the normal course of business, the Company has agreed to indemnify certain parties with respect to certain matters. The Company has agreed to hold certain parties harmless against losses arising from a breach of representations, warranties or covenants, or out of intellectual property infringement or other claims made by third parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. In addition, the Company has entered into indemnification agreements with its directors and certain of its officers. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. The Company has not recorded any liability for costs related to indemnification as of December 31, 2014.



Table of Contents**Product Warranties**

The Company offers its customers warranties on many of the products that it sells. These warranties typically provide for repairs and maintenance of the products if problems arise during a specified time period after original shipment. Concurrent with the sale of products, the Company records a provision for estimated warranty expenses with a corresponding increase in cost of goods sold. The Company periodically adjusts this provision based on historical experience and anticipated expenses. The Company charges actual expenses of repairs under warranty, including parts and labor, to this provision when incurred.

The following table presents changes in warranty provisions (in thousands):

	Six Months Ended			
	December 31,		December 31,	
	2013		2014	
Balance at beginning of period	\$	12,890	\$	11,923
Additions and adjustments		2,536		2,452
Reductions for warranty repair costs		(2,157)		(1,704)
Balance at end of period		13,269	\$	12,671

**Legal Proceedings**

On December 12, 2013, a putative class action complaint was filed against the Company and certain of its officers in the United States District Court for the Central District of California ( Court ) captioned *Roberti v. OSI Systems, Inc., et al.*, Case No. 2:13-cv-09174-MWF-VBK (the Securities Class Action ). The Amended Complaint, filed on May 20, 2014, alleges that the Company and the individual defendants violated the Securities Exchange Act of 1934 by misrepresenting or failing to disclose facts concerning the status of Rapiscan's efforts to develop Automated Threat Recognition software and the alleged use of unapproved parts in its baggage scanning systems in violation of its contract with the U.S. Transportation Security Administration (TSA). The Amended Complaint also asserts that the individual defendants allegedly sold stock based on material non-public information. Plaintiff demands a jury trial and seeks class certification, unspecified damages, an award of pre-judgment and post-judgment interest, attorneys' and experts' fees, costs, and other unspecified relief.

On April 15, 2014, a shareholder derivative complaint was filed in the Court purportedly on behalf of the Company against the members of the Company's Board of Directors (as individual defendants), captioned *Hagan v. Chopra, et al.*, Case No. 2:14-cv-02910-ODW-PJW (the Hagan Derivative Action ). The complaint generally asserts the same factual allegations as those at issue in the related Securities Class Action and purports to allege claims for breach of fiduciary duties and unjust enrichment against the individual defendants on behalf of the Company. The complaint seeks unspecified damages, restitution, injunctive relief, attorneys' and experts' fees, costs, expenses, and other unspecified relief.

On December 29, 2014, a second shareholder derivative complaint was filed in the Court against the members of the Company's Board of Directors, captioned *City of Irving Benefit Plan, Derivatively on Behalf of OSI Systems, Inc. v. Deepak Chopra, et al.*, Case No. 2:14-cv-09869 (the Irving Derivative Action ) and, together with the Hagan Derivative Action, the Derivative Actions ), which generally makes the same factual allegations as those contained in the Securities Class Action and Hagan Derivative Action.

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While the Company believes that the Securities Class Action and the Derivative Actions are without merit and intends to defend the litigation vigorously, it expects to incur costs associated with defending the Securities Class Action and the Derivative Actions. At this early stage of litigation, the ultimate outcomes of the Securities Class Action and the Derivative Actions are uncertain and the Company cannot reasonably predict the timing or outcomes, or estimate the amount of loss, if any, or their effect, if any, on its financial statements.

The Company is involved in various other claims and legal proceedings arising in the ordinary course of business. In the Company's opinion after consultation with legal counsel, the ultimate disposition of such proceedings is not likely to have a material adverse effect on its business, financial condition, results of operations or cash flows. The Company has not accrued for loss contingencies relating to such matters because the Company believes that, although unfavorable outcomes in the proceedings may be possible, they are not considered by management to be probable or reasonably estimable. If one or more of these matters are resolved in a manner adverse to the Company, the impact on the Company's business, financial condition, results of operations and/or liquidity could be material.

### *Other Matters*

On December 5, 2013, the Company's Security division was notified by the TSA that a delivery order that it had received on September 26, 2013, for baggage and handling inspection systems was being terminated for default. The termination resulted from the use of an upgraded X-ray generator component. While the component had been vetted by the Security division's internal quality assurance, the Security division had not met the contractual requirement of obtaining the TSA's approval in advance. The upgraded X-ray generator component has since been approved for use by the TSA. The termination has resulted in a claim by the Government for compensation. The Company is in communication with the TSA regarding such matters. Also, as a result of this termination for default, the Security division was referred to the U.S. Department of Homeland Security (DHS) for further review. As a result of this review, in October 2014 the Security division entered into an Addendum to its Administrative Agreement dated June 21, 2013 with DHS. Pursuant to the terms of the Addendum, the Security division has agreed, among other things, to extend the term of the Administrative Agreement by 24 months.

Table of Contents**8. Income Taxes**

The provision for income taxes is determined using an effective tax rate that is subject to fluctuations during the year as new information is obtained. The assumptions used to estimate the annual effective tax rate include factors such as the mix of pre-tax earnings in the various tax jurisdictions in which the Company operates, valuation allowances against deferred tax assets, increases or decreases in uncertain tax positions, utilization of research and development tax credits, changes in or the interpretation of tax laws in jurisdictions where the Company conducts business and certain tax elections. The Company recognizes deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of its assets and liabilities along with net operating loss and tax credit carryovers. The Company records a valuation allowance against its deferred tax assets to reduce the net carrying value to an amount that it believes is more likely than not to be realized. When the Company establishes or reduces the valuation allowance against its deferred tax assets, the provision for income taxes will increase or decrease, respectively, in the period such determination is made.

**9. Segment Information**

The Company has determined that it operates in three identifiable industry segments: (a) security and inspection systems (Security division), (b) medical monitoring and anesthesia systems (Healthcare division) and (c) optoelectronic devices and manufacturing (Optoelectronics and Manufacturing division). The Company also has a corporate segment (Corporate) that includes executive compensation and certain other general and administrative expenses, expenses related to stock issuances and legal and audit and other professional service fees not allocated to product segments. Both the Security and Healthcare divisions comprise primarily end-user businesses, while the Optoelectronics and Manufacturing division primarily supplies components and subsystems to original equipment manufacturers, including to the Security and Healthcare divisions. Sales between divisions are at transfer prices that approximate market values. All other accounting policies of the segments are the same as described in Note 1, Summary of Significant Accounting Policies of the Form 10-K for the fiscal year ended June 30, 2014.

The following tables present the operations and identifiable assets by industry segment (in thousands):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2014	2013	2014
<b>Revenues (2) by Segment:</b>				
Security division	\$ 106,588	\$ 137,005	\$ 203,741	\$ 250,444
Healthcare division	63,106	69,493	108,893	117,327
Optoelectronics and Manufacturing division, including intersegment revenues	76,358	65,535	147,669	134,621
Intersegment revenues elimination	(9,644)	(14,204)	(17,621)	(26,166)
<b>Total</b>	<b>\$ 236,408</b>	<b>\$ 257,829</b>	<b>\$ 442,682</b>	<b>\$ 476,226</b>

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2014	2013	2014
<b>Operating income (loss) by Segment:</b>				
Security division	\$ 15,149	\$ 20,401	26,771	\$ 37,660
Healthcare division	9,226	7,489	7,228	7,551
Optoelectronics and Manufacturing division	2,121	4,366	6,886	8,693

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Corporate	(4,355)	(5,733)	(8,400)	(10,250)
Eliminations (1)	(112)	(462)	17	(929)
<b>Total</b>	<b>\$ 22,029</b>	<b>\$ 26,061</b>	<b>\$ 32,502</b>	<b>\$ 42,725</b>

	<b>June 30, 2014</b>	<b>December 31, 2014</b>
<b>Assets by Segment:</b>		
Security division	\$ 535,306	\$ 539,775
Healthcare division	190,612	214,392
Optoelectronics and Manufacturing division	169,084	167,528
Corporate	133,836	140,294
Eliminations (1)	(4,652)	(5,331)
<b>Total</b>	<b>\$ 1,024,186</b>	<b>1,056,658</b>

(1) Eliminations within operating income primarily reflect the change in the elimination of intercompany profit in inventory not-yet-realized. Eliminations in assets reflect the amount of intercompany profits in inventory as of the balance sheet date. Such intercompany profit will be realized when inventory is shipped to the external customers of the Security and Healthcare divisions.

(2) The Company had certain customers whose revenue individually represented 10% or more of the Company's total revenue, or whose accounts receivable balances individually represented 10% or more of the Company's total accounts receivable, as follows:

a) For the three months ended December 31, 2013 and 2014, one customer accounted for 13% and 11% of total net revenues, respectively; and a different customer accounted for 15% of net revenues for the three months ended December 31, 2014. For the six months ended December 31, 2013 and 2014, one customer accounted for 14% and 13% of total net revenues, respectively; and a different customer accounted for 11% of net revenues for the six months ended December 31, 2014.

b) At December 31, 2014, one customer accounted for 14% of the accounts receivable. At June 30, 2014, one customer accounted for 13% of accounts receivable.

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

In this report, OSI, the Company, we, us, our and similar terms refer to OSI Systems, Inc. together with its wholly-owned subsidiaries.

This management's discussion and analysis of financial condition as of December 31, 2014 and results of operations for the six-months ended December 31, 2013 and 2014 should be read in conjunction with management's discussion and analysis of financial condition and results of operations included in our Annual Report on Form 10-K for the year ended June 30, 2014.

**Forward-Looking Statements**

*Certain statements contained in this Quarterly Report on Form 10-Q that are not related to historical results, including, without limitation, statements regarding our business strategy, objectives and future financial position, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and involve risks and uncertainties. These forward-looking statements may be identified by the use of forward-looking terms such as anticipate, believe, expect, may, could, likely to, should, or will, or by discussions of strategy that involve predictions which are based upon a number of future conditions that ultimately may prove to be inaccurate. Statements in this Quarterly Report on Form 10-Q that are forward-looking are based on current expectations and actual results may differ materially. These forward-looking statements should be considered in light of numerous risks and uncertainties described in this Quarterly Report on Form 10-Q, our Annual Report on Form 10-K and other documents previously filed or hereafter filed by us from time to time with the Securities and Exchange Commission. Such factors, of course, do not include all factors that might affect our business and financial condition. Although we believe that the assumptions upon which our forward-looking statements are based are reasonable, such assumptions could prove to be inaccurate and actual results could differ materially from those expressed in or implied by the forward-looking statements. For example, the Company could be exposed to a variety of negative consequences as a result of delays related to the award of domestic and international contracts; delays in customer programs; unanticipated impacts of sequestration and other provisions of the Budget Control Act of 2011 as modified by the Bipartisan Budget Act of 2013; changes in domestic and foreign government spending, budgetary, procurement and trade policies adverse to our businesses; market acceptance of our new and existing technologies, products and services; our ability to win new business and convert any orders received to sales within the fiscal year in accordance with our annual operating plan; enforcement actions in respect of any noncompliance with laws and regulations including export control and environmental regulations and the matters that are the subject of some or all of the Company's ongoing investigations and compliance reviews, contract and regulatory compliance matters, and actions, if brought, resulting in judgments, settlements, fines, injunctions, debarment and/or penalties as well as other risks and uncertainties, including but not limited to those detailed herein and from time to time in our Securities and Exchange Commission filings, which could have a material and adverse impact on the Company's business, financial condition and results of operation. All forward-looking statements contained in this Quarterly Report on Form 10-Q are qualified in their entirety by this statement. We undertake no obligation other than as may be required under securities laws to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.*

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**Executive Summary**

We are a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. We sell our products and provide related services in diversified markets, including homeland security, healthcare, defense and aerospace. We have three operating divisions: (a) Security, providing security and inspection systems, turnkey security screening solutions and related services; (b) Healthcare, providing patient monitoring, cardiology and anesthesia systems; and (c) Optoelectronics and Manufacturing, providing specialized electronic components for our Security and Healthcare divisions, as well as to external original equipment manufacturer clients for applications in the defense, aerospace, medical and industrial markets, among others.

*Security Division.* Through our Security division, we provide security screening, threat detection and non-intrusive inspection products and services worldwide, and provide turnkey security screening solutions. These products and services are used to inspect baggage, cargo, vehicles and other objects for weapons, explosives, drugs, radioactive material and other contraband as well as to screen people. Revenues from our Security division accounted for 46% and 52% of our total consolidated revenues for the six months ended December 31, 2013 and 2014, respectively.

As a result of the terrorist attacks of September 11, 2001, and subsequent attacks in other locations worldwide, security and inspection products have increasingly been used at a wide range of facilities other than airports, such as border crossings, railway stations, seaports, cruise line terminals, freight forwarding operations, sporting venues, government and military installations and nuclear facilities. We believe that our wide-ranging product portfolio together with our ability to provide turnkey screening solutions position us to competitively pursue security and inspection opportunities as they arise throughout the world.

Currently, the U.S. federal government is discussing various options to address sequestration and the U.S. federal government's overall fiscal challenges and we cannot predict the outcome of these efforts. We believe that the diversified product portfolio and international customer mix of our Security division position us well to withstand the impact of these uncertainties and even benefit from specific initiatives within the U.S. federal government and other foreign governments. However, depending on how future sequestration cuts are implemented and how the U.S. federal government manages its fiscal challenges, we believe that these federal actions could have a material, adverse effect on our business, financial condition and results of operations.

*Healthcare Division.* Through our Healthcare division, we design, manufacture, market and service patient monitoring, cardiology and anesthesia delivery and ventilation systems and related supplies and accessories worldwide for sale primarily to hospitals and medical centers. Our products monitor patients in critical, emergency and perioperative care areas of the hospital and provide such information, through wired and wireless networks, to physicians and nurses who may be at the patient's bedside, in another area of the hospital or even outside the hospital. Revenues from our Healthcare division accounted for 25% of our total consolidated revenues for each of the six months ended December 31, 2013 and 2014.

The healthcare markets in which we operate are highly competitive. We believe that our customers choose among competing products on the basis of product performance, functionality, value and service. In addition, there is continued uncertainty regarding the ongoing debates related to the U.S. budget and debt ceiling and the Patient Protection and Affordable Care Act, amended by the Health Care and Education and Reconciliation Act of 2010 (the Affordable Care Act), in the U.S., any of which may impact hospital spending, reimbursement and fees which will be levied on certain medical device revenues and adversely affect our business and results of operations. In addition, hospital capital spending appears to have been impacted by strategic uncertainties surrounding the Affordable Care Act and economic pressures. We also

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believe that the worldwide economic slowdown has caused some hospitals and healthcare providers to delay purchases of our products and services. During this period of uncertainty, sales of our healthcare products may be negatively impacted. Although there are indications that a general economic recovery is underway, we cannot predict when the markets will fully recover or when the uncertainties related to the U.S. federal government will be resolved and, therefore, when this period of delayed and diminished purchasing will end. A prolonged delay could have a material adverse effect on our business, financial condition and results of operations.

During the six months ended December 31, 2014, our Healthcare division completed a small acquisition that expands our customer base and geographic footprint, while leveraging our existing infrastructure.

*Optoelectronics and Manufacturing Division.* Through our Optoelectronics and Manufacturing division, we design, manufacture and market optoelectronic devices and provide electronics manufacturing services globally for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostics, telecommunications, office automation, computer peripherals, industrial automation systems, automotive diagnostic systems, gaming systems and consumer products. We also provide our optoelectronic devices and electronics manufacturing services to original equipment manufacturers, as well as our own Security and Healthcare divisions. Revenues from external customers in our Optoelectronics and Manufacturing division accounted for approximately 29% and 23% of our total consolidated revenues for the six months ended December 31, 2013 and 2014, respectively.

Table of Contents**Results of Operations for the Three Months Ended December 31, 2013 (Q2 2014) Compared to Three Months Ended December 31, 2014 (Q2 2015) (amounts in millions)****Net Revenues**

The table below and the discussion that follows are based upon the way in which we analyze our business. See Note 9 to the condensed consolidated financial statements for additional information about our business segments.

	Q2 2014	% of Net Sales	Q2 2015	% of Net Sales	\$ Change	% Change
Security division	\$ 106.6	45%	\$ 137.0	53%	\$ 30.4	29%
Healthcare division	63.1	27%	69.5	27%	6.4	10%
Optoelectronics and Manufacturing division	76.4	32%	65.5	25%	(10.9)	(14)%
Less: inter-division sales	(9.7)	(4)%	(14.2)	(5)%	(4.5)	46%
Total revenues	\$ 236.4	100%	\$ 257.8	100%	\$ 21.4	9%

Revenues for the Security division for the three months ended December 31, 2014 increased primarily as a result of partial fulfillment of a large Foreign Military Sale contract to the U.S. Department of Defense to supply multiple units of cargo and vehicle inspection systems and related training, spare parts, service and logistics support for Iraq.

Revenues for the Healthcare division for the three months ended December 31, 2014 increased primarily due to the acquisition of a European cardiology equipment business during the first quarter of the current fiscal year and increased sales in our Latin American and Asian markets. These increases were partially offset by a decrease in organic sales in our North American and Europe, Middle East and African regions.

Revenues for the Optoelectronics and Manufacturing division for the three months ended December 31, 2014 decreased as a result of lower contract manufacturing sales in the current fiscal year. This decrease was primarily attributable to significant sales to two customers during the second quarter of the prior fiscal year to whom we continue to sell but at a lower level.

**Gross Profit**

	Q2 2014	% of Net Sales	Q2 2015	% of Net Sales
Gross profit	\$ 80.9	34.2%	\$ 89.3	34.6%

Gross profit during the three months ended December 31, 2014 increased as a result of increased sales and an improvement in gross margin. The gross margin increase was a result of the impact of operational improvements in our Optoelectronics and Manufacturing division combined



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with the decrease in revenue in this division, which has historically generated the lowest gross margins across the three divisions, partially offset by a decrease in gross margin in our Healthcare division as a result of product and geographic mix.

### Operating Expenses

	Q2 2014	% of Net Sales	Q2 2015	% of Net Sales	\$ Change	% Change
Selling, general and administrative	\$ 45.6	19.3%	\$ 47.9	18.6%	\$ 2.3	5%
Research and development	11.1	4.7%	13.2	5.1%	2.1	19%
Restructuring and other charges	2.2	0.9%	2.1	0.8%	(0.1)	(5)%
Total operating expenses	\$ 58.9	24.9%	\$ 63.2	24.5%	\$ 4.3	7%

**Selling, general and administrative.** Selling, general and administrative (SG&A) expenses consist primarily of compensation paid to sales, marketing and administrative personnel, professional service fees and marketing expenses. SG&A for the three months ended December 31, 2014 increased 5% primarily to support our 9% revenue growth.

**Research and development.** Research and development (R&D) expenses include research related to new product development and product enhancement expenditures. R&D for the three months ended December 31, 2014 increased significantly as we invested in the next generation of products within our Security division, while R&D spending in our Healthcare and Optoelectronics and Manufacturing divisions was in line with the prior year.

**Restructuring and other charges.** Restructuring and other charges generally consist of non-recurring charges related to facility consolidation, reducing excess workforce and other opportunities to improve operational efficiency. In addition, during the quarter we incurred costs related to contract issues with the TSA and professional fees associated with defending against class action and derivative lawsuits filed against the Company.

Table of Contents**Other Income and Expenses**

**Interest and other expense, net.** For the three months ended December 31, 2014, interest and other expense, net amounted to \$0.8 million as compared to \$1.5 million in the comparable prior-year period. This decrease was due to decreased interest expense related to lower average outstanding borrowings under our revolving credit facility as we have generated significant levels of free cash flow over the past several quarters, and the reduction in the cost of borrowing in connection with the amended credit facility completed in May 2014.

**Income taxes.** For the three months ended December 31, 2014, our income tax provision was \$7.0 million, compared to \$6.0 million for the comparable prior-year period. Our effective tax rate for the three months ended December 31, 2014 was 27.7%, compared to 29.0% in the comparable prior-year period. The effective tax rate for a particular period varies depending on a number of factors including (i) the mix of income earned in various tax jurisdictions, each of which applies a unique range of income tax rates and income tax credits, (ii) changes in previously established valuation allowances for deferred tax assets (changes are based upon our current analysis of the likelihood that these deferred tax assets will be realized), (iii) the level of non-deductible expenses, (iv) certain tax elections and (v) tax holidays granted to certain of our international subsidiaries.

**Results of Operations for the Six Months Ended December 31, 2013 (YTD Q2 2014) Compared to Six Months Ended December 31, 2014 (YTD Q2 2015) (amounts in millions)**

**Net Revenues**

The table below and the discussion that follows are based upon the way in which we analyze our business. See Note 9 to the condensed consolidated financial statements for additional information about our business segments.

	YTD Q2 2014	% of Net Sales	YTD Q2 2015	% of Net Sales	\$ Change	% Change
Security division	\$ 203.8	46%	\$ 250.5	52%	\$ 46.7	23%
Healthcare division	108.9	25%	117.3	25%	8.4	8%
Optoelectronics and Manufacturing division	147.6	33%	134.6	28%	(13.0)	(9)%
Less: inter-division sales	(17.6)	(4)%	(26.2)	(5)%	(8.6)	(49)%
Total revenues	\$ 442.7	100%	\$ 476.2	100%	\$ 33.5	8%

Revenues for the Security division for the six months ended December 31, 2014 increased primarily as a result of increased baggage and parcel inspection sales, new product launches and partial fulfillment of a large million Foreign Military Sale contract awarded in June 2014.

Revenues for the Healthcare division for the six months ended December 31, 2014 increased primarily due to the acquisition of a European cardiology equipment business during the first quarter of the current fiscal year and increased sales in our Latin American and Asian markets. These increases were partially offset by a decrease in organic sales in our North American and Europe, Middle East and African regions.

Revenues for the Optoelectronics and Manufacturing division for the six months ended December 31, 2014 decreased as a result of lower contract manufacturing sales in the current fiscal year. This decrease was primarily attributable to significant sales to two customers during the first half of the prior fiscal year to whom we continue to sell but at a lower level.

**Gross Profit**

	YTD Q2 2014	% of Net Sales	YTD Q2 2015	% of Net Sales
Gross profit	\$ 148.9	33.6%	\$ 163.5	34.3%

Gross profit during the six months ended December 31, 2014 increased as a result of increased sales and an improvement in gross margin. The gross margin increase was a result of the impact of operational improvements our Optoelectronics and Manufacturing division combined with the decrease in revenue in this division, which has historically generated the lowest gross margins across the three divisions, partially offset by a decrease in gross margin in our Healthcare division as a result of product and channel mix.

Table of Contents**Operating Expenses**

	YTD Q2 2014	% of Net Sales	YTD Q2 2015	% of Net Sales	\$ Change	% Change
Selling, general and administrative	\$ 87.8	19.8%	\$ 92.1	19.3%	\$ 4.3	5%
Research and development	22.2	5.0%	25.9	5.5%	3.7	17%
Restructuring and other charges	6.4	1.5%	2.8	0.6%	(3.6)	(56)%
Total operating expenses	\$ 116.4	26.3%	\$ 120.8	25.4%	\$ 4.4	4%

**Selling, general and administrative.** Selling, general and administrative (SG&A) expenses consist primarily of compensation paid to sales, marketing and administrative personnel, professional service fees and marketing expenses. SG&A for the six months ended December 31, 2014 increased 5% primarily to support our 8% revenue growth.

**Research and development.** Research and development (R&D) expenses include research related to new product development and product enhancement expenditures. R&D for the six months ended December 31, 2014 increased significantly as we invested in the next generation of products within our Security division, while R&D spending in our Healthcare and Optoelectronics and Manufacturing divisions was in line with the prior year.

**Restructuring and other charges.** Restructuring and other charges generally consist of non-recurring charges related to facility consolidation, reducing excess workforce and other opportunities to improve operational efficiency. In addition, we incurred costs related to contracts with the TSA and professional fees associated with defending against class action and derivative lawsuits filed against the Company. Restructuring and other charges for the six months ended December 31, 2014 decreased significantly as we incurred significant charges in the prior year including: (i) \$1.9 million in our Security and our Optoelectronics and Manufacturing divisions for employee termination costs and costs related to facility consolidations; (ii) \$2.0 million in our Healthcare division related to our move into a new building to serve as the division's headquarters and primary manufacturing facility; and (iii) \$2.5 million of costs incurred within our Security division related to contract issues with the TSA. During the current year we incurred charges including: (i) \$1.8 million of costs incurred within our Security division related to contract issues with the TSA; (ii) \$0.4 million in our Healthcare and Optoelectronics and Manufacturing divisions related to facility consolidations; and (iii) \$0.6 million in our Corporate segment related to the class action and derivative lawsuits.

**Other Income and Expenses**

**Interest and other expense, net.** For the six months ended December 31, 2014, interest and other expense, net, was \$1.7 million as compared to \$3.0 million for the same prior-year period. This decrease was due to decreased interest expense related to lower average outstanding borrowings under our revolving credit facility as we have generated significant levels of free cash flow over the past several quarters, and the reduction in the cost of borrowing in connection with the amended credit facility completed in May 2014.

**Income taxes.** For the six months ended December 31, 2014, our income tax provision was \$11.5 million, compared to \$8.6 million for the comparable prior-year period. Our effective tax rate for the six months ended December 31, 2014, was 28.1% compared to 29.0% in the comparable prior-year period. The effective tax rate for a particular period varies depending on a number of factors including (i) the mix of income earned in various tax jurisdictions, each of which applies a unique range of income tax rates and income tax credits, (ii) changes in

previously established valuation allowances for deferred tax assets (changes are based upon our current analysis of the likelihood that these deferred tax assets will be realized), (iii) the level of non-deductible expenses, (iv) certain tax elections and (v) tax holidays granted to certain of our international subsidiaries.

### **Liquidity and Capital Resources**

Our principal sources of liquidity are our cash and cash equivalents, cash generated from operations and our credit facility. Cash and cash equivalents totaled \$44.8 million at December 31, 2014, an increase of \$6.0 million from \$38.8 million at June 30, 2014. During the six months ended December 31, 2014, we generated \$61.0 million of cash flow from operations. These proceeds were used for the following: (i) \$6.4 million invested in capital expenditures, (ii) \$18.1 million for the acquisition of businesses and other assets and (iii) \$29.5 million for the repurchase of our common stock, including net share settlement of equity awards. If we continue to net settle equity awards, we will use additional cash to pay our tax withholding obligations in connection with such settlements. We currently anticipate that our available funds, credit facilities and cash flow from operations will be sufficient to meet our operational cash needs for at least the next 12 months. In addition, without repatriating earnings from non-U.S. subsidiaries, we anticipate that cash generated from operations will be able to satisfy our obligations in the U.S., including our outstanding lines of credit as accounting earnings in the U.S. are not necessarily indicative of cash flows since earnings are generally reduced by non-cash expenses including depreciation, amortization, and stock-based compensation.

We have a five-year revolving credit facility that allows us to borrow up to \$450 million at London Interbank Offered Rate (LIBOR) plus 1.25% depending upon our leverage ratio. As of December 31, 2014, there was \$23.0 million outstanding under the revolving credit facility and \$90.7 million outstanding under the letters-of-credit sub-facility.

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**Cash Provided by Operating Activities.** Cash flows from operating activities can fluctuate significantly from period to period, as net income, adjusted for non-cash items, and working capital fluctuations impact cash flows. During the six months ended December 31, 2014, we generated cash from operations of \$61.0 million compared to \$75.0 million in the prior year period. Cash flow from operating activities during the first six months of fiscal 2015 primarily consisted of net income of \$29.5 million, adjusted for certain non-cash items, including total depreciation and amortization of \$32.1 million, stock-based compensation expense of \$12.1 million, and the net negative impact of changes in operating assets and liabilities on cash of \$13.6 million. The year-over-year decrease in cash from operations resulted from the impact of changes in working capital as the prior year changes in working capital provided \$15.9 million of cash as compared to the current year, when we used \$13.6 million of cash. This deficit was partially offset by improved profitability in the current year.

**Cash Used in Investing Activities.** Net cash used in investing activities was \$24.5 million for the six months ended December 31, 2014 as compared to \$54.3 million used for the six months ended December 31, 2013. During the six months ended December 31, 2014, we made \$6.4 million in capital expenditures compared to \$41.7 million during the comparable prior-year period. This decrease is primarily a result of the timing of capital expenditures in support of our turnkey screening program in Mexico. In the six months ended December 31, 2014, we also used cash of \$14.7 million for acquisitions of businesses as compared to \$10.1 million in the comparable prior-year period.

**Cash Used in Financing Activities.** Net cash used in financing activities was \$29.3 million for the six months ended December 31, 2014, compared to \$16.5 million used in financing activities for the six months ended December 31, 2013. During the six months ended December 31, 2014, we repurchased \$29.5 million of our common stock including net share settlement of equity awards compared to \$20.3 million for the same period in the prior year. In addition, during the current year we repaid \$1.0 million from our credit facility as compared to an increase in the revolver of \$1.0 million in the prior year.

**Borrowings**

Outstanding lines of credit and current and long-term debt totaled \$35.2 million at December 31, 2014, a decrease of \$2.1 million from \$37.3 million at June 30, 2014. See Note 4 to the condensed consolidated financial statements for further discussion.

**Cash Held by Foreign Subsidiaries**

Our cash, cash equivalents, and investments totaled \$44.8 million at December 31, 2014. Of this amount, approximately 73% was held by our foreign subsidiaries and subject to repatriation tax considerations. These foreign funds were located primarily in the United Kingdom, Malaysia and Mexico, and to a lesser extent in India, Singapore, China, Germany and Canada amongst others. We intend to permanently reinvest a significant portion of our earnings from foreign operations, and we currently do not anticipate that we will need this cash in foreign countries to fund our U.S. operations. In the event that funds from foreign operations are needed to fund operations in the United States and if U.S. taxes have not been previously provided on the related earnings, we would provide for and pay additional U.S. taxes at the time we change our intention with regard to the reinvestment of those earnings.

**Issuer Purchases of Equity Securities**

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The following table contains information about the shares acquired during the quarter ended December 31, 2014:

	Total number of shares (or units) purchased(1)(2)	Average price paid per share (or unit)	Total number of shares (or units) purchased as part of publicly announced plans or programs	Maximum number (or appropriate dollar value) of shares (or units) that may yet be purchased under the plans or programs (3)
October 1, 2014 to October 31, 2014	562(1)(2)	\$ 69.79		942,195
November 1, 2014 to November 30, 2014	40,295(1)(2)	\$ 68.81	40,000	902,195
December 1, 2014 to December 31, 2014	24,489(1)(2)	\$ 70.53	21,200	880,995
	65,346	\$ 69.46	61,200	

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(1) A total of 562 shares, 295 shares and 3,289 shares of common stock were tendered to satisfy minimum statutory tax withholding obligations related to the vesting of restricted shares for the months October, November and December 2014, respectively.

(2) For the three months ended December 31, 2014, a total of 61,200 shares of common stock were purchased under the stock repurchase program at an average price of \$69.34 per share.

(3) In March 1999, our Board of Directors authorized a stock repurchase program of up to 2,000,000 shares. In September 2004, our Board of Directors authorized an additional 1,000,000 shares for repurchase pursuant to this program. In April 2013, our Board of Directors authorized an additional 1,000,000 shares for repurchase pursuant to this program. This program does not have an expiration date. Upon repurchase, the shares are restored to the status of authorized but unissued and we record them as a reduction in the number of shares of common stock issued and outstanding in our consolidated financial statements.

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**Dividend Policy**

We have not paid cash dividends on our common stock in the past and have no plans to do so in the foreseeable future. Certain of our current bank credit facilities restrict the payment of cash dividends and future borrowings may contain similar restrictions.

**Contractual Obligations**

We presented our contractual obligations in our Annual Report on Form 10-K for the fiscal year ended June 30, 2014. See Note 7 to the condensed consolidated financial statements for further discussion regarding significant changes in those obligations during the first six months of fiscal 2015.

**Off Balance Sheet Arrangements**

As of December 31, 2014, we did not have any significant off balance sheet arrangements as defined in Item 303(a)(4) of Regulation S-K.

**Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions and select accounting policies that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Our critical accounting policies are detailed in our Annual Report on Form 10-K for the year ended June 30, 2014.

Please refer Note 1 to our condensed consolidated financial statements for discussion concerning recent accounting updates not yet adopted.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

For the six months ended December 31, 2014, no material changes occurred with respect to market risk as disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2014.



## Market Risk

We are exposed to certain market risks, which are inherent in our financial instruments and arise from transactions entered into in the normal course of business. We may enter into derivative financial instrument transactions in order to manage or reduce market risk in connection with specific foreign-currency-denominated transactions. We do not enter into derivative financial instrument transactions for speculative purposes.

We are subject to interest rate risk on our short-term borrowings under our bank lines of credit. Borrowings under these lines of credit do not give rise to significant interest rate risk because these borrowings have short maturities and are borrowed at variable interest rates. Historically, we have not experienced material gains or losses due to interest rate changes.

## Foreign Currency

Our international operations are subject to certain opportunities and risks, including foreign currency fluctuations and governmental actions. We closely monitor our operations in each country and seek to adopt appropriate strategies that are responsive to changing economic and political environments, and to fluctuations in foreign currencies. We conduct business in more than 20 countries. Due to our global operations, weaknesses in the currencies of some of these countries are often offset by strengths in others. Foreign currency financial statements are translated into U.S. dollars at period-end rates, with the exception of revenues, costs and expenses, which are translated at average rates during the reporting period. We include gains and losses resulting from foreign currency transactions in income, while we exclude those resulting from translation of financial statements from income and include them as a component of accumulated other comprehensive income. Transaction gains and losses, which were included in our condensed consolidated statements of operations, amounted to loss of \$0.2 million and gain of \$0.6 million during the three months ended December 31, 2013 and December 31, 2014, respectively. We incurred a loss of \$0.9 million and a gain of \$1.1 million during the six months ended December 31, 2013 and 2014, respectively. Furthermore, a 10% appreciation of the U.S. dollar relative to each of the local currencies would have resulted in a net increase in our operating income of approximately \$3.0 million in the second quarter of fiscal 2015. Conversely, a 10% depreciation of the U.S. dollar relative to each of the local currencies would have resulted in a net decrease in our operating income of approximately \$3.0 million in the second quarter of fiscal 2015.

## Use of Derivatives

On occasion we enter into derivative contracts to hedge the impact of fluctuations in foreign currencies and the volatility of variable interest rate borrowing. Our current use of derivatives consists of an interest swap agreement. As discussed in Note 1 to the condensed consolidated financial statements, we had an interest rate swap of \$7.6 million outstanding as of December 31, 2014.

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**Importance of International Markets**

International markets provide us with significant growth opportunities. However, as a result of our worldwide business operations, we are subject to various risks, including: international regulatory requirements and policy changes; difficulties in accounts receivable collection and the management of distributors; geopolitical and economic instability; currency exchange rate fluctuations; and tariff regulations. In response to these risks and others, we continue to perform ongoing credit evaluations of our customers' financial condition and, if deemed necessary, we require advance payments for sales. Also, we monitor geopolitical, economic and currency conditions around the world to evaluate whether there may be any significant effect on our international sales in the future.

**Inflation**

We do not believe that inflation had a material impact on our results of operations during the three and six months ended December 31, 2014.

**Interest Rate Risk**

We classify all highly liquid investments with maturities of three months or less as cash equivalents and record them on our balance sheet at fair value.

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

Based upon an evaluation of the effectiveness of disclosure controls and procedures, our Chief Executive Officer (CEO) and Chief Financial Officer (CFO) have concluded that as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures as defined under Exchange Act Rule 13a-15(e) and 15d-15(e) were effective to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission and is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control over Financial Reporting*

There were no changes in our internal control over financial reporting during the second quarter of fiscal 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

*Limitations on Effectiveness of Controls and Procedures*

In designing and evaluating our disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

Certain of the legal proceedings in which we are involved are discussed in Note 7, Commitments and Contingencies, to our Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q, and are hereby incorporated by reference.

**ITEM 1A. RISK FACTORS**

The discussion of our business and operations in this Quarterly Report on Form 10-Q should be read together with the risk factors contained in our Annual Report on Form 10-K for the fiscal year ended June 30, 2014, filed with the Securities and Exchange Commission on August 27, 2014, which describe various risks and uncertainties to which we are or may become subject. There have been no material changes to the risk factors included in our Annual Report.

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

See Issuer Purchases of Equity Securities discussion under Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations, which is hereby incorporated by reference.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4. MINE SAFETY DISCLOSURES**

None

**ITEM 5. OTHER INFORMATION**

None

**ITEM 6. EXHIBITS**

- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.1 The following financial information from the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2014, as filed with the SEC on January 27, 2015, formatted in XBRL, as follows:
  - (i) the condensed consolidated balance sheets
  - (ii) the condensed consolidated statements of operations
  - (iii) the condensed consolidated statements of comprehensive income
  - (iv) the condensed consolidated statements of cash flows the notes to
  - (v) the condensed consolidated financial statements, tagged in summary and detail

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**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, in the City of Hawthorne, State of California on the 27th day of January 2015.

**OSI SYSTEMS, INC.**

By: /s/ Deepak Chopra  
Deepak Chopra  
President and Chief Executive Officer

By: /s/ Alan Edrick  
Alan Edrick  
Executive Vice President and Chief Financial Officer