SUPERCONDUCTOR TECHNOLOGIES INC
Form 10-Q
August 10, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 1, 2006

o **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 0-21074

SUPERCONDUCTOR TECHNOLOGIES INC.

(Exact name of registrant as specified in its charter)

Delaware	**77-0158076**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

460 Ward Drive,
Santa Barbara, California 93111-2356
(Address of principal executive offices & zip code)
(805) 690-4500
(Registrant s telephone number including area code)

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 o

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

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o

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

The registrant had 12,483,367 shares of the common stock outstanding as of the close of business on July 31, 2006.

SUPERCONDUCTOR TECHNOLOGIES INC.
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Three Months Ended July 1, 2006

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements that involve risks and uncertainties. We have made these statements in reliance on the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Our forward-looking statements relate to future events or our future performance and include, but are not limited to, statements concerning our business strategy, future commercial revenues, market growth, capital requirements, new product introductions, expansion plans and our funding requirements. Other statements contained in our filings that are not historical facts are also forward-looking statements. We have tried, wherever possible, to identify forward-looking statements by terminology such as may, will, could, should, expects, anticipates, intends, believes, seeks, estimates and other comparable terminology.

Forward-looking statements are not guarantees of future performance and are subject to various risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially from those expressed in forward-looking statements. They can be affected by many factors, including, those discussed under the captions *Management s Discussion and Analysis of Financial Condition and Results of Operations* and *Risk Factors* in this Quarterly Report on Form 10-Q and Item 1A *Risk Factors* in our 2005 Annual Report on Form 10-K. Forward-looking statements are based on information presently available to senior management, and we do not assume any duty to update our forward-looking statements.

WHERE YOU CAN FIND MORE INFORMATION

As a public company, we are required to file annually, quarterly and special reports, proxy statements and other information with the SEC. You may read and copy any of our materials on file with the SEC at the SEC s Public Reference Room at 450 Fifth Street, N.W., Judiciary Plaza, Washington, DC 20549, as well as at the SEC s regional office at 5757 Wilshire Boulevard, Suite 500, Los Angeles, California 90036. Our filings are available to the public over the Internet at the SEC s website at http://www.sec.gov. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. We also provide copies of our Forms 8-K, 10-K, 10-Q, Proxy and Annual Report at no charge to investors upon request and make electronic copies of our most recently filed reports available through our website at www.suptech.com as soon as reasonably practicable after filing such material with the SEC.

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PART I
FINANCIAL INFORMATION

Item 1. Financial Statements.

SUPERCONDUCTOR TECHNOLOGIES INC.
CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS
(Unaudited)

	Three Months Ended		Six Months Ended	
	July 2, 2005	**July 1, 2006**	**July 2, 2005**	**July 1, 2006**
Net revenues:				
Net commercial product revenues	$ 7,581,000	$ 3,932,000	$ 11,349,000	$ 8,422,000
Government and other contract revenues	972,000	1,088,000	1,543,000	1,430,000
Sub license royalties		1,000	15,000	9,000
Total net revenues	**8,553,000**	**5,021,000**	**12,907,000**	**9,861,000**
Costs and expenses:				
Cost of commercial product revenues	5,801,000	3,658,000	10,000,000	7,516,000
Contract research and development	1,048,000	703,000	1,731,000	1,007,000
Other research and development	775,000	630,000	1,936,000	1,931,000
Selling, general and administrative	2,850,000	2,678,000	6,632,000	5,395,000
Restructuring expenses and impairment charges	144,000	20,107,000	228,000	20,107,000
Total costs and expenses	**10,618,000**	**27,776,000**	**20,527,000**	**35,956,000**
Loss from operations	**(2,065,000)**	**(22,755,000)**	**(7,620,000)**	**(26,095,000)**
Interest income	53,000	107,000	110,000	234,000
Interest expense	(34,000)	(11,000)	(73,000)	(24,000)
Net loss	**$ (2,046,000)**	**$ (22,659,000)**	**$ (7,583,000)**	**$ (25,885,000)**
Basic and diluted loss per common share	**$ (0.19)**	**$ (1.82)**	**$ (0.70)**	**$ (2.07)**
Weighted average number of common shares outstanding	**10,771,102**	**12,483,367**	**10,771,102**	**12,483,367**

See accompanying notes to the condensed consolidated financial statement

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SUPERCONDUCTOR TECHNOLOGIES INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	December 31, 2005 (See Note)	July 1, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 13,018,000	$ 7,095,000
Accounts receivable, net	2,166,000	1,090,000
Inventory, net	5,364,000	7,529,000
Prepaid expenses and other current assets	723,000	516,000
Total Current Assets	**21,271,000**	**16,230,000**
Property and equipment, net of accumulated depreciation of $17,295,000 and $17,635,000, respectively	7,803,000	6,771,000
Patents, licenses and purchased technology, net of accumulated amortization of $1,065,000 and $1,227,000, respectively	2,514,000	2,445,000
Goodwill	20,107,000	
Other assets	350,000	250,000
Total Assets	**$ 52,045,000**	**$ 25,696,000**
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	2,036,000	1,814,000
Accrued expenses	1,998,000	1,774,000
Current portion of capitalized lease obligations and long term debt	19,000	20,000
Total Current Liabilities	**4,053,000**	**3,608,000**
Capitalized lease obligations and long term-debt	14,000	4,000
Other long term liabilities	721,000	580,000
Total Liabilities	**4,788,000**	**4,192,000**
Commitments and contingencies-Notes 6, 8 and 9		
Stockholders Equity:		
Preferred stock, $.001 par value, 2,000,000 shares authorized, none issued and outstanding		
Common stock, $.001 par value, 250,000,000 shares authorized, 12,483,367 shares issued and outstanding	12,000	12,000
Capital in excess of par value	208,545,000	208,643,000
Notes receivable from stockholder net	(65,000)	(31,000)
Accumulated deficit	(161,235,000)	(187,120,000)

Total Stockholders Equity	**47,257,000**	**21,504,000**
Total Liabilities and Stockholders Equity	**$ 52,045,000**	**$ 25,696,000**

See accompanying notes to the condensed consolidated financial statements
Note-December 31, 2005 balances were derived from audited financial statements

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SUPERCONDUCTOR TECHNOLOGIES INC.
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

	Six Months Ended	
	July 2, 2005	**July 1, 2006**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	**$ (7,583,000)**	**$ (25,885,000)**
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,454,000	1,365,000
Non-cash restructuring and impairment charges	137,000	20,107,000
Warrants-Options	7,000	101,000
Provision for excess and obsolete inventories	180,000	180,000
Forgiveness of note receivable	150,000	
Reserve for impairment of note and interest receivable from Stockholder		34,000
Changes in assets and liabilities:		
Accounts receivable	422,000	1,076,000
Inventory	2,836,000	(2,345,000)
Prepaid expenses and other current assets	36,000	213,000
Patents, licenses and purchased technology	(43,000)	(101,000)
Other assets	(34,000)	100,000
Accounts payable, accrued expenses and other long-term liabilities	(1,792,000)	(589,000)
Net cash used in operating activities	**(4,230,000)**	**(5,744,000)**
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(64,000)	(170,000)
Net cash used in investing activities	**(64,000)**	**(170,000)**
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short-term borrowings	662,000	
Payments on short-term borrowings	(1,600,000)	
Payments on long-term obligations	(32,000)	(9,000)
Payment of common stock issuance costs	(797,000)	
Net cash used in financing activities	**(1,767,000)**	**(9,000)**
Net decrease in cash and cash equivalents	(6,061,000)	(5,923,000)
Cash and cash equivalents at beginning of period	12,802,000	13,018,000
Cash and cash equivalents at end of period	**$ 6,741,000**	**$ 7,095,000**

See accompanying notes to the condensed consolidated financial statements.

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SUPERCONDUCTOR TECHNOLOGIES INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
UNAUDITED

1. General

Superconductor Technologies Inc. (the Company) was incorporated in Delaware on May 11, 1987 and maintains its headquarters in Santa Barbara, California. The Company operates in a single industry segment, the research, development, manufacture and marketing of high-performance infrastructure products for wireless voice and data applications. The Company s commercial products are divided into three product offerings: SuperLink (high-temperature superconducting filters), AmpLink (high performance, ground-mounted amplifiers) and SuperPlex (high performance multiplexers). The Company s research and development contracts are used as a source of funds for its commercial technology development. From 1987 to 1997, the Company was engaged primarily in research and development and generated revenues primarily from government research contracts.

The Company continues to be involved as either contractor or subcontractor on a number of contracts with the United States government. These contracts have been and continue to provide a significant source of revenues for the Company. For the six months ended July 2, 2005 and July 1, 2006, government related contracts account for 12% and 15%, respectively, of the Company s net revenues.

The unaudited consolidated financial information furnished herein has been prepared in accordance with generally accepted accounting principles and reflects all adjustments, consisting only of normal recurring adjustments, which in the opinion of management, are necessary for a fair statement of the results of operations for the periods presented.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates and such differences may be material to the financial statements. This quarterly report on Form 10-Q should be read in conjunction with the Company s Form 10-K for the year ended December 31, 2005. The results of operations for the three and six months ended July 1, 2006 are not necessarily indicative of results for the entire fiscal year ending December 31, 2006.

2. Summary of Significant Accounting Policies

Basis of Presentation

In 2005, the Company incurred a net loss of $14,213,000 and negative cash flows from operations of $9,404,000. In the first half of 2006, the Company incurred a net loss of $25,885,000 and negative cash flows from operations of $5,744,000. Excluding a goodwill impairment charge of $20,107,000 our net loss for the first half of 2006 was $5,778,000.

The principal sources of the Company s liquidity consists of existing cash balances and funds expected to be generated from future operations. The Company believes that its existing cash resources, together with its line of credit, will be sufficient to fund its planned operations for at least the next twelve months. The Company believes the key factor to its liquidity in 2006 will be its ability to successfully execute on its plan to increase sales levels. There is no assurance that the Company will be able to increase sales levels. Its cash requirements will also depend on numerous other variable factors, including the rate of growth of sales, the timing and levels of products purchased, payment terms and credit limits from manufacturers, and the timing and level of accounts receivable collections.

If actual cash flows deviate significantly from forecasted amounts, the Company may require additional financing in the next twelve months. There is no assurance that additional financing (public or private) will be available on acceptable terms or at all. If the Company issues additional equity securities to raise funds, the ownership percentage of its existing stockholders would be reduced. New investors may demand rights, preferences or privileges senior to those of existing holders of common stock. If the Company cannot raise any needed funds, it might be forced to make further substantial reductions in its operating expenses, which could adversely affect its ability to implement its current business plan and ultimately its viability as a company.

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The Company s financial statements have been prepared assuming that it will continue as a going concern. The factors described above raise substantial doubt about its ability to continue as a going concern. These financial statements do not include any adjustments that might result from this uncertainty.

Principles of Consolidation

The interim condensed consolidated financial statements include the accounts of Superconductor Technologies Inc. and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated from the consolidated financial statements.

Cash and Cash Equivalents

Cash and cash equivalents consist of highly liquid investments with original maturities of three months or less. Cash and cash equivalents are maintained with quality financial institutions and from time to time exceed FDIC limits.

Accounts Receivable

The Company sells predominantly to entities in the wireless communications industry and to entities of the United States government. The Company grants uncollateralized credit to its customers. The Company performs ongoing credit evaluations of its customers before granting credit. Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. The Company determines the allowance based on historical write-off experience. Past due balances are reviewed for collectibility. Accounts balances are charged off against the allowance when the Company deems it is probable the receivable will not be recovered. The Company does not have any off balance sheet credit exposure related to its customers.

Revenue Recognition

Commercial revenues are principally derived from the sale of the Company s SuperLink, AmpLink, and SuperPlex products and are recognized once all of the following conditions have been met: a) an authorized purchase order has been received in writing, b) customer s credit worthiness has been established, c) shipment of the product has occurred, d) title has transferred, and e) if stipulated by the contract, customer acceptance has occurred and all significant vendor obligations, if any, have been satisfied.

Contract revenues are principally generated under research and development contracts. Contract revenues are recognized utilizing the percentage-of-completion method measured by the relationship of costs incurred to total estimated contract costs. If the current contract estimate were to indicate a loss, utilizing the funded amount of the contract, a provision would be made for the total anticipated loss. Revenues from research related activities are derived primarily from contracts with agencies of the United States Government. Credit risk related to accounts receivable arising from such contracts is considered minimal. These contracts include cost-plus, fixed price and cost sharing arrangements and are generally short-term in nature.

All payments to the Company for work performed on contracts with agencies of the U.S. Government are subject to adjustment upon audit by the Defense Contract Audit Agency. Contract audits through 2002 are closed. Based on historical experience and review of current projects in process, management believes that the audits will not have a significant effect on the financial position, results of operations or cash flows of the Company.

Warranties

The Company offers warranties generally ranging from one to five years, depending on the product and negotiated terms of purchase agreements with its customers. Such warranties require the Company to repair or replace defective product returned to the Company during such warranty period at no cost to the customer. An estimate by the Company for warranty related costs is recorded by the Company at the time of sale based on its actual historical product return rates and expected repair costs. Such costs have been within management s expectations.

Guarantees

In connection with the sales and manufacturing of its commercial products, the Company indemnifies, without limit or term, its customers and contract manufacturers against all claims, suits, demands, damages, liabilities, expenses, judgments, settlements and penalties arising from actual or alleged infringement or misappropriation of any intellectual property relating to its products or other claims arising from its products. The Company cannot reasonably develop an estimate of the

maximum potential amount of payments that might be made under its guarantees because of the uncertainty as to whether a claim might arise and how much it might total. Historically, the Company has not incurred any expenses related to these guarantees.

Research and Development Costs

Research and development costs are expensed as incurred and include salary, facility, depreciation and material expenses. Research and development costs incurred solely in connection with research and development contracts are charged to contract research and development expense. Other research and development costs are charged to other research and development expense.

Inventories

Inventories are stated at the lower of cost or market, with costs primarily determined using standard costs, which approximate actual costs utilizing the first-in, first-out method. Provision for potentially obsolete or slow moving inventory is made based on management s analysis of inventory levels and sales forecasts. Costs associated with idle capacity are expensed immediately.

Property and Equipment

Property and equipment are recorded at cost. Equipment is depreciated using the straight-line method over their estimated useful lives ranging from three to five years. Leasehold improvements and assets financed under capital leases are amortized over the shorter of their useful lives or the lease term. Furniture and fixtures are depreciated over seven years. Expenditures for additions and major improvements are capitalized. Expenditures for minor tooling, repairs and maintenance and minor improvements are charged to expense as incurred. When property or equipment is retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the accounts. Gains or losses from retirements and disposals are recorded in selling, general and administration expenses.

Patents, Licenses and Purchased Technology

Patents and licenses are recorded at cost and are amortized using the straight-line method over the shorter of their estimated useful lives or approximately seventeen years. Purchased technology acquired through the acquisition of Conductus, Inc. is recorded at its estimated fair value and is amortized using the straight-line method over seven years.

Goodwill

Goodwill represents the excess of purchase price over fair value of net assets acquired in connection with the acquisition of Conductus in December 2002. Conductus was acquired primarily for the synergies the acquisition would bring to our existing business of developing, manufacturing and marketing products for the commercial wireless telecommunications business and for the synergies it would have on the Company s fund raising abilities.

Goodwill is tested for impairment annually in the fourth quarter after the annual planning process, or earlier if events occur which require an impairment analysis be performed. The Company operates in a single business segment as a single reporting unit. The first step of the impairment test, used to identify potential impairment, compares the fair value based on market capitalization of the entire Company with its book value of its net assets, including goodwill. The market capitalization of the Company is based on the closing price of its common stock as traded on NASDAQ multiplied by its outstanding common shares. If the fair value of the Company exceeds the book value of its net assets, goodwill of the Company is not considered impaired. If the book value of the net assets of the Company exceeds its fair value, the second step of the goodwill impairment test shall be performed to measure the amount of impairment loss. The second step of the goodwill impairment test, used to measure the amount of impairment loss, compares the implied fair value of the goodwill with the book value of that goodwill. The implied fair value of goodwill is determined by performing a full evaluation of the fair values of all assets and liabilities of the reporting unit as would be performed in a purchase price allocation under SFAS No. 141, Business Combinations. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess. At December 31, 2005, the fair value of the Company based on its market capitalization totaled $53.7 million, which was in excess of the total book value of the Company. Therefore, the Company s goodwill was not considered impaired.

At July 1, 2006, management concluded that our declining stock price constituted an event under FAS 142 for which goodwill should be tested sooner than our annual test. As of that date the book value of the net assets of the Company exceeded our market capitalization and we began step two of the impairment analysis by determining the fair values of all the tangible and intangible assets of the Company and applying these values to the fair value of the Company. The Company has not completed this exercise, however, the Company determined that an impairment loss is probable and can be reasonably estimated based on the work performed to date including the continued weakness in the Company s stock price. Our analysis, though not yet complete, has led us to reasonably estimate that the fair market value for the Company is less than its net assets excluding goodwill and a full write down of $20.1 million in goodwill has been taken this quarter. Our decision to write-off all the goodwill from the Conductus acquisition is based on preliminary estimates of our net assets and is subject to adjustment after completion of our analysis.

Long-Lived Assets

The realizability of long-lived assets is evaluated periodically as events or circumstances indicate a possible inability to recover the carrying amount. Long-lived assets that will no longer be used in business are written off in the period identified since they will no longer generate any positive cash flows for the Company. Periodically, long lived assets that will continue to be used by the Company need to be evaluated for recoverability. Such evaluation is based on various analyses, including cash flow and profitability projections. The analyses necessarily involve significant management judgment. In the event the projected undiscounted cash flows are less than net book value of the assets, the carrying value of the assets will be written down to their estimated fair value. The Company completed such an analysis as of the fourth quarter of 2005 and determined that no write down was necessary.

Restructuring Expenses

Liability for costs associated with an exit or disposal activity is recognized when the liability is incurred.

Loss Contingencies

In the normal course of business the Company is subject to claims and litigation, including allegations of patent infringement. Liabilities relating to these claims are recorded when it is determined that a loss is probable and the amount of the loss can be reasonably estimated. The costs of defending the Company in such matters are expensed as incurred. Insurance proceeds recoverable are recorded when deemed probable.

Income Taxes

The Company accounts for income taxes under the provisions of Statement of Financial Accounting Standards No. 109 (SFAS 109), Accounting for Income Taxes. SFAS 109 utilizes an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company s financial statements or tax returns. In estimating future tax consequences, SFAS 109 generally considers all expected future events other than enactments of changes in the tax laws or rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

Marketing Costs

All costs related to marketing and advertising the Company s products are expensed as incurred or at the time the advertising takes place. Advertising costs were not material in each of the three and six month periods ended July 2, 2005 and July 1, 2006.

Net Loss Per Share

Basic and diluted net loss per share is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding in each period. Potentially dilutive shares are not included in the calculation of diluted loss per share because their effect is anti-dilutive.

Stock-based Compensation

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(revised 2004), Share-Based Payment (SFAS No. 123(R)). Under this provision, the share-based compensation cost recognized beginning January 1, 2006 includes compensation cost for (i) all share-based payments granted prior to, but not vested as of January 1, 2006, based on the grant date fair value originally estimated in accordance with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS No. 123)and (ii) all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Compensation cost under SFAS No. 123(R) is recognized ratably using the straight-line attribution method over the expected vesting period. Prior periods are not restated under this transition method.

The Company estimates the weighted average fair market value at the date of the grant using the Black-Scholes option-pricing model. The following are the significant weighted average assumptions used in 2005 for the fair value under our stock plans.

	Three months ended July 2, 2005	**Six months ended July 2, 2005**
Risk free interest rate	3.70%	3.70%

Expected volatility	95%	95%
Dividend yield	0%	0%
Forfeiture rate	None	None
Expected life in years	4.0	4.0

In December 2005, in anticipation of the impact of SFAS 123R, the Company s Board of Directors approved the accelerated vesting of all time-vested outstanding out-of-the-money stock options held by current employees or consultants. The primary purpose of the accelerated vesting was to minimize the amount of compensation expense recognized in relation

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to the underwater options in future periods following the adoption by the Company of SFAS 123R. The cost impact of these accelerated options in 2005 was $3.7 million. In addition, because these options have exercise prices in excess of current market values and are not fully achieving their original objectives of incentive compensation and employee retention, the Company believes that the acceleration has had a positive effect on employee morale and retention.

Prior to December 31, 2005, we accounted for share-based compensation plans in accordance with the provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, as permitted by SFAS No. 123. We elected to use the intrinsic value method of accounting for employee and director share-based compensation expense for our noncompensatory employee and director stock option awards and did not recognize compensation expense for the issuance of options with an exercise price equal to or greater than the market price of the underlying common stock at the date of grant. Had we elected to adopt the fair value approach as prescribed by SFAS No. 123, which charges earnings for the estimated fair value of stock options, our pro forma net income and pro forma earnings per share for the second quarter and first half of 2005 would have been as follows:

	Three Months Ended July 2, 2005		Six Months Ended July 2, 2005	
Net loss:				
As reported	$	(2,046,000)	$	(7,583,000)
Stock-based employee compensation included in net loss				
Stock-based compensation expense determined under fair value method		(451,000)		(2,373,000)
Pro forma	$	(2,497,000)	$	(9,956,000)
Basic and Diluted Loss per Share				
As reported	$	(0.19)	$	(0.70)
Stock-based compensation expense determined under fair value method		(0.04)		(0.22)
Pro forma	$	(0.23)	$	(0.92)

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 revenues and expenses during the reporting periods. The significant estimates in the preparation of the financial statements relate to the assessment of the carrying amount of accounts receivable, inventory, intangibles, goodwill, estimated provisions for warranty costs, accruals for restructuring and lease abandonment costs, income taxes and litigation. Actual results could differ from those estimates and such differences may be material to the financial statements.

Fair Value of Financial Instruments

The carrying amount of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value due to the short-term nature of these instruments. The Company estimates that the carrying amount of the debt approximates fair value based on the Company s current incremental borrowing rates for similar types of borrowing arrangements.

Comprehensive Income (Loss)

The Company has no items of other comprehensive income (loss) in any period other than its net loss.

Segment Information

The Company operates in a single business segment, the research, development, manufacture and marketing of high performance products used in cellular base stations to maximize the performance of wireless telecommunications networks by improving the quality of uplink signals from mobile wireless devices. Net commercial product revenues are primarily derived from the sales of the Company s SuperLink, AmpLink and SuperPlex products. We currently sell most of our product directly to wireless network operators in the United States. Net revenues derived principally from government research and development contracts are presented separately on the statement of operations for all periods presented.

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Certain Risks and Uncertainties

The Company has continued to incur operating losses. The Company s long-term prospects and execution of its business plan are dependent upon the continued and increased market acceptance for the product.

The Company currently sells most of its products directly to wireless network operators in the United States and its product sales have historically been concentrated in a small number of customers. In 2005, the Company had three customers that represented 37%, 31% and 15% of total net revenues. At December 31, 2005, these three customers represented 61%, 13%, and 10% of accounts receivable. In the six months ended July 1, 2006, the Company had three customers that represented 30%, 28% and 25% of total net revenues. At July 1, 2006, these three customers represented 22%, 18% and 5% of accounts receivable. The loss of or reduction in sales, or the inability to collect outstanding accounts receivable, from any of these customers could have a material adverse effect on the Company s business, financial condition, results of operations and cash flows.

The Company currently relies on a limited number of suppliers for key components of its products. The loss of any of these suppliers could have a material adverse effect on the Company s business, financial condition, results of operations and cash flows.

In connection with the sales of its commercial products, the Company indemnifies, without limit or term, its customers against all claims, suits, demands, damages, liabilities, expenses, judgments, settlements and penalties arising from actual or alleged infringement or misappropriation of any intellectual property relating to its products or other claims arising from its products. The Company cannot reasonably develop an estimate of the maximum potential amount of payments that might be made under its guarantee because of the uncertainty as to whether a claim might arise and how much it might total.

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation Number 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. The interpretation contains a two step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions are effective for the company beginning in the first quarter of 2007. The company is evaluating the impact this statement will have on its financial statements.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs , an amendment of ARB No. 43, Chapter 4. This statement amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB No. 43, Chapter 4, previously stated that ..under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges... SFAS No. 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal. In addition, this statement requires that allocation of fixed production overheads to the cost of conversion be based on the normal capacity of the production facilities. The provisions of SFAS 151 shall be applied prospectively and are effective for inventory costs incurred during fiscal years beginning after June 15, 2005, with earlier application permitted for inventory costs incurred during fiscal years beginning after the date this Statement was issued. We adopted SFAS No. 151 and it has not had an impact on our financial position and results of operations.

3. Short Term Borrowings

The Company has a line of credit with a bank. The line of credit was renewed June 15, 2006 for a term of one year. The line of credit expires June 15, 2007 and is structured as a sale of accounts receivable. The agreement provides for the sale of up to $5 million of eligible accounts receivable, with advances to the Company totaling 80% of the receivables sold. Advances under the agreement are collateralized by all the Company s assets. Under the terms of the agreement, the Company continues to service the sold receivables and is subject to recourse provisions. Advances bear interest at the prime rate (8.25% at July 1, 2006) plus 2.50% subject to a minimum monthly charge. There was no amount outstanding under this borrowing facility at July 1, 2006.

The agreement contains representations and warranties, affirmative and negative covenants and events of default customary for financings of this type. The failure to comply with these provisions, or the occurrence of any one of the events of default, would prevent any further borrowings and would generally require the repayment of any outstanding borrowings.

Such representations, warranties and events of default include (a) non-payment of debt and interest hereunder, (b) non-compliance with terms of the agreement covenants, (c) insolvency or bankruptcy, (d) material adverse change, (e) merger or consolidation where the Company s shareholders do not hold a majority of the voting rights of the surviving entity, (f) transactions outside the normal course of business, or (g) payment of dividends.

4. Retirement of the Company s Chief Executive Officer

On March 15, 2005, the Company s Chief Executive Officer and President retired. In connection with the retirement, the Company agreed to the continuation of his salary and benefits for one year and to immediately vest and extend all his outstanding stock options and the executive agreed to provide certain consulting services as requested by the Company. Also, in connection with the retirement, a $150,000 loan made to the Company s Chief Executive Officer in 2001, and in accordance with the existing terms of a promissory note which were in effect prior to the adoption of the Sarbanes-Oxley Act of 2002, this loan was forgiven. In connection with the Chief Executive Officer s retirement, the Company recognized expense of $565,000 in the three months ended April 2, 2005, and no additional expense thereafter.

5. Notes Receivable From Stockholder

Mr. Shalvoy, a director and stockholder, owed us a total of $820,244 of principal, plus accrued interest of more than $236,000, under two, full recourse promissory notes as of July 1, 2006. The notes are partially collateralized by 15,176 shares of the Company s common stock with a market value of approximately $31,000 as of July 1, 2006. Mr. Shalvoy notified us in December 2005 of his intention not to repay either of the loans. Notwithstanding its firm belief that the notes are valid and binding debt obligations, the Company concluded that generally accepted accounting principles required the recording of a material, non-cash reserve against these assets in the fourth quarter of 2005 due to the borrower s refusal to pay the notes voluntarily. The reserve of $1.0 million on July 1, 2006 represents the total value of the notes (principal plus accrued interest) less the market value of the collateral. The collateral value of the notes is included in Stockholder s Equity. The Company will reserve any default interest recognized in accordance with the terms of the notes. See Shalvoy Litigation in the Legal Proceedings footnote for a full description of this matter.

6. Stockholders Equity

The Company implemented a one (1) for ten (10) reverse split of its common stock effective as of the open of business on March 13, 2006. In the reverse split, each ten shares of issued and outstanding common stock were converted automatically into one share of common stock. No fractional shares were issued in connection with the reverse stock split, and the Company paid cash in lieu of fractional shares based on a post-split value of $4.00 per share. The number of outstanding shares of common stock was reduced from approximately 124.8 million as of February 28, 2006 to approximately 12.5 million shares immediately after the split. The reverse split also had an automatic proportionate affect on all stock options and warrants outstanding as of March 13, 2006. The Company accounted for the split by transferring approximately $113,000 from common stock par value to capital in excess of par value at December 31, 2005. All share quantities and per share amounts in this report have been adjusted accordingly.

Stock Options

We currently have one active stock option plan, 2003 Equity Incentive Plan. Under the 2003 Equity Incentive Plan, stock awards may consist of stock options, stock appreciation rights, restricted stock awards, performance awards, and performance share awards. Stock awards may be made to directors, key employees, consultants, and non-employee directors of the Company. Stock options granted under these plans must be granted at prices no less than 100% of the market value on the date of grant. Only stock options have been granted under these plans. Generally, stock options become exercisable in installments over a minimum of four years, beginning one year after the date of grant, and expire not more than ten years from the date of grant, with the exception of 10% or greater stockholders which may have options granted at prices no less than the market value on the date of grant, and expire not more than five years from the date of grant. The Company expects to issue new shares to cover stock option exercises and has no plans to repurchase shares. There have been no stock option exercises in 2005 or 2006.

For the Quarter ended July 1, 2006 the weighted average fair value has been estimated at the date of the grant using the Black-Scholes option-pricing model. The following are the significant weighted average assumptions used for estimating the fair value under our stock option plans:

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	Three months ended July 1, 2006	Six months ended July 1, 2006
Per share fair value at grant date	$ 2.66	$ 2.71
Risk free interest rate	4.85%	4.82%
Expected volatility	95%	95%
Dividend yield	0%	0%
Forfeiture rate	10%	10%
Expected life in years	4.0	4.0

The Expected life was based on the contractual term of the options and the expected employee exercise behavior. Typically, options to our employees have a 4 year vesting term and a 10 year contractual term. Options to Board Members have a 2 year vesting term and a 10 year contractual term. Four year vesting term options vest at 25% after one year and ratably, on a monthly basis, thereafter. Two year vesting term options vest at 50% after one year and 50% after two years. The risk-free interest rate is based on the U. S. Treasury zero-coupon issues with a remaining term equal to the expected option life assumed at the grant date. The future volatility is based on our 4 year historical volatility. The Company used an expected dividend yield of 0% because the Company has never paid a dividend and does not anticipate paying dividends. The forfeiture rate is based on historical stock option cancellation rates over the last 4 years.

As a result of adopting SFAS 123R, the impact to the Consolidated Statement of Operations for the three and six months ended July 1, 2006 on net income was a expense of $50,000 and $101,000 and $0.004 and $0.008 on basic and diluted earnings per share. No stock compensation cost was capitalized during the period. The total compensation cost related to non-vested awards not yet recognized is $296,000 and the weighted-average period over which the cost is expected to be recognized is 1.4 years.

The following is a summary of stock option transactions under the Company s stock option plans at July 1, 2006:

	Number of Shares	Price Per Share	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
Balance at December 31, 2005	1,202,376	$ 5.80 - $493.75	$ 40.38	1,162,330	$41.32
Granted	71,300	$2.77 - $ 5.20	$ 3.92		
Exercised					
Canceled	(101,835)	$ 5.90 - $493.75	$40.075		
Balance at July 1, 2006	1,171,841	$ 2.77 - $493.75	$38.277	1,075,678	$41.18

The outstanding options expire by the end of May 2016. The weighted-average contractual term of options outstanding is 7.0 years and the weighted-average contractual term of stock options currently exercisable is slightly less than 7 years. The exercise prices for these options range from $2.77 to $493.75 per share, for an aggregate exercise price of approximately $44.9 million. At July 1, 2006 all outstanding stock options and all exercisable options have exercise prices greater than the current market value and therefore have no intrinsic value.

Warrants

The following is a summary of outstanding warrants at July 1, 2006:

	Common Shares	
	Total and Currently Exercisable	Price per Share

			Expiration Date
Warrants related to issuance of common stock	39,786	55.00	March 10, 2007
	140,658	11.90	December 17, 2007*
	116,279	29.00	June 24, 2008*
	342,466	11.10	August 16, 2010
Warrants related to April 2004 Bridge Loans	69,549	13.30	April 28, 2011* **
	10,000	18.50	April 28, 2011*
Warrants assumed in connection with the Conductus,	109,500	45.83	September 27, 2007
Inc. acquisition	600	312.50	September 1, 2007
Total	828,838		

* The terms of these warrants contain net exercise provisions, wherein instead of a cash exercise holders can elect to receive common stock equal to the difference between the exercise price and the average closing sale price for common shares over 10-30 days immediately preceding the exercise date.

** The terms of these warrants contain anti-dilution adjustment provisions.

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7. Legal Proceedings

Shalvoy Litigation

Mr. Shalvoy, a director and stockholder, owed us a total of $820,244 of principal, plus accrued interest of more than $236,000, under two, full recourse promissory notes as of July 1, 2006. The notes are partially secured by 15,176 shares of the Company s common stock with a market value of approximately $31,000 as of July 1, 2006, with Mr. Shalvoy liable for any deficiency.

The Company acquired the notes in connection with the acquisition of Conductus, Inc. in December 2002. Conductus made these two loans to Mr. Shalvoy, its then President and Chief Executive Officer, prior to the acquisition. Mr. Shalvoy issued the notes to Conductus as payment for the purchase price on the exercise of stock options in December 2000. The first note was due on December 28, 2005 ($460,244 principal amount), and the second note is due on August 21, 2006 ($360,000 principal amount).

Mr. Shalvoy notified the Company in December 2005 of his intention not to repay either of the loans. Mr. Shalvoy alleges, among other things, that the Conductus board committed to forgive the loans should the stock purchase turn out to have negative financial consequences to him. Mr. Shalvoy had not previously disclosed this alleged agreement to the Company, and the Company has not found (and is not aware) of any documentation to support his allegation. The Company does not believe that any agreement to forgive the notes ever existed, and it believes that the notes are valid and binding debt obligations of Mr. Shalvoy. Consequently, the Company filed a lawsuit against Mr. Shalvoy on December 21, 2005 in the California Superior Court (Case No. 1186812) to collect payment in full of all principal and interest due under both notes.

Class Action Lawsuits

The Company and certain of its officers were named as a defendant in several substantially identical class action lawsuits filed in the Unites States District Court for the Central District of California in 2004. In February 2005 the Company settled with the lead plaintiffs appointed by the District Court to handle this matter. Under the terms of the settlement, the Company s insurers paid $4.0 million into a settlement fund, and the Company paid $50,000 of the costs of providing notice of the settlement to settlement class members. The Company recorded a liability in its December 31, 2004 consolidated financials statements for the proposed amount, and therefore recovery from the insurance carrier was probable, a receivable was also recorded for that amount. These amounts were paid into the settlement fund in April 2005.

Litigation expenses on this matter totaled none and a credit of $3,000 for the three and six month periods ended July 1, 2006, respectively, and $21,000 and $237,000 for the three and six month periods ended July 2, 2005, respectively. The Company does not expect any further legal action related to this matter.

8. Earnings Per Share

The computation of per share amounts for the three month periods ended July 2, 2005 and July 1, 2006 is based on the average number of common shares outstanding for the period. Options and warrants to purchase 1,802,089 and 2,000,679 shares of common stock during the three and six month periods ended July 2, 2005 and July 1, 2006, respectively, were not considered in the computation of diluted earnings per share because their inclusion would be anti-dilutive.

9. Commitments and Contingencies

Operating Leases

The Company leases its offices and production facilities under non-cancelable operating leases that expire at various times over the next six years. Generally, these leases contain escalation clauses for increases in annual renewal options and require the

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Company to pay utilities, insurance, taxes and other operating expenses.

Rent expenses totaled $297,000 and $593,000 for the three and six month periods ended July 2, 2005, and $282,000 and $573,000 for the three and six month periods ended July 1, 2006, respectively.

Capital Leases

The Company leases certain property and equipment under a capital lease arrangement that expires in 2007. The lease bears interest at 14.95%.

Patents and Licenses

The Company has entered into various licensing agreements requiring royalty payments ranging from 0.13% to 2.5% of specified product sales. Certain of these agreements contain provisions for the payment of guaranteed or minimum royalty amounts. In the event that the Company fails to pay minimum annual royalties, these licenses may automatically become non-exclusive or be terminated. These royalty obligations terminate in 2009 to 2020. For the three and six months ended July 2, 2005, royalty expense totaled $45,000 and $93,000, respectively. For the three and six months ended July 1, 2006, royalty expense totaled $38,000 and $77,000, respectively. Under the terms of certain royalty agreements, royalty payments made may be subject to audit. There have been no audits to date and the Company does not expect any possible future audit adjustments to be significant.

The minimum lease payments under operating and capital leases and license obligations are as follows:

Year ending December 31,	Licenses	Operating Leases	Capital Leases
Remainder of 2006	$ 150,000	$ 611,000	$ 11,000
2007	150,000	1,257,000	15,000
2008	150,000	1,294,000	
2009	150,000	1,339,000	
2010	150,000	1,386,000	
Thereafter	1,350,000	1,309,000	
Total payments	$ 2,100,000	$ 7,196,000	26,000
Less: amount representing interest			(2,000)
Present value of minimum lease			24,000
Less current portion			(22,000)
Long term portion			$ 4,000

In connection with the acquisition of Conductus, Inc. as of December 31, 2002 operating leases with remaining commitments totaling $2,044,000 and $1,758,000 have been abandoned or are considered unfavorable, respectively. A liability totaling $1,995,000 representing the present value of the minimum lease payments and executory costs was recorded at December 18, 2002 relating to the abandoned leases. A liability totaling $1,140,000 representing the present value of the difference between the fair market rental and lease commitment was recorded at December 31, 2002 relating to unfavorable leases. In 2004, the Company completed closure of its Sunnyvale facility. A liability totaling $279,000 was recorded representing the present value of the remainder of the lease commitment. In connection with the closure of this facility, the remaining unfavorable lease commitment of $558,000 recorded in connection with the acquisition of Conductus, Inc. was transferred to lease abandonment costs. As of July 1, 2006, the remaining minimum lease commitments on these operating leases totaled $8,000 and are included in the above commitment table. These amounts are included in accrued liabilities.

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10. Contractual Guarantees and Indemnities

During its normal course of business, the Company makes certain contractual guarantees and indemnities pursuant to which the Company may be required to make future payments under specific circumstances. The Company has not recorded any liability for these contractual guarantees and indemnities in the accompanying consolidated financial statements.

Warranties

The Company establishes reserves for future product warranty costs that are expected to be incurred pursuant to specific warranty provisions with its customers. The Company s warranty reserves are established at the time of sale and updated throughout the warranty period based upon numerous factors including historical warranty return rates and expenses over various warranty periods.

Intellectual Property Indemnities

The Company indemnifies certain customers and its contract manufacturers against liability arising from third-party claims of intellectual property rights infringement related to the Company s products. These indemnities appear in development and supply agreements with our customers as well as manufacturing service agreements with our contract manufacturers, are not limited in amount or duration and generally survive the expiration of the contract. Given that the amount of any potential liabilities related to such indemnities cannot be determined until an infringement claim has been made, the Company is unable to determine the maximum amount of losses that it could incur related to such indemnifications.

Director and Officer Indemnities and Contractual Guarantees

The Company has entered into indemnification agreements with its directors and executive officers which require the Company to indemnify such individuals to the fullest extent permitted by Delaware law. The Company s indemnification obligations under such agreements are not limited in amount or duration. Certain costs incurred in connection with such indemnifications may be recovered under certain circumstances under various insurance policies. Given that the amount of any potential liabilities related to such indemnities cannot be determined until a lawsuit has been filed against a director or executive officer, the Company is unable to determine the maximum amount of losses that it could incur relating to such indemnifications. Historically, any amounts payable pursuant to such director and officer indemnifications have not had a material negative effect on the Company s business, financial condition or results of operations.

The Company has also entered into severance and change in control agreements with certain of its executives. These agreements provide for the payment of specific compensation benefits to such executives upon the termination of their employment with the Company.

General Contractual Indemnities/Products Liability

In connection with the sales of its commercial products, the Company indemnifies, without limit or term, its customers against all claims, suits, demands, damages, liabilities, expenses, judgments, settlements and penalties arising from actual or alleged infringement or misappropriation of any intellectual property relating to its products or other claims arising from its products. The Company cannot reasonably develop an estimate of the maximum potential amount of payments that might be made under its guarantee because of the uncertainty as to whether a claim might arise and how much it might total.

Short Term Borrowings

Advances under the line of credit with the bank are collateralized by all the Company s assets. Under the terms of the agreement, the Company continues to service the sold receivables and is subject to recourse provisions. Under the terms of the agreement, if the bank determines that there is a material adverse change in the Company s business, they can exercise all their rights and remedies under the agreement. There was no amount outstanding under this facility at July 1, 2006.

Contractual Contingency

The Company has a contract to deliver several custom products to a government contractor. The Company is unable to manufacture the products for technical reasons. The Company has discussed the problem with the contractor and its government customer. They are considering the problem, and further discussions are expected. The Company does not believe that a loss, if

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any, is reasonably estimable at this time and therefore has not recorded any liability relating to this matter. The Company will periodically reassess its potential liability as additional information becomes available. If it later determines that a loss is probable and the amount reasonably estimable, the Company will record a liability for the potential loss. All costs have been expensed and no revenues recognized on this contract.

11. Restructuring Expenses

During the first six months of 2005, the Company implemented a restructuring program and reduced its workforce. This generated restructuring charges totaling $337,000 for the first half of 2005, including $204,000 for the second quarter of 2005. There were no restructuring charges for the three months or six months ended July 1, 2006.

12. Details of Certain Financial Statement Components and Supplemental Disclosures of Cash Flow Information and Non-Cash Activities

Balance Sheet Data:

	December 31, 2005	July 1, 2006
Accounts receivable:		
Accounts receivable-trade	$ 1,930,000	$ 589,000
U.S. government accounts receivable-billed	311,000	576,000
Less: allowance for doubtful accounts	(75,000)	(75,000)
	$ 2,166,000	$ 1,090,000

	December 31, 2005	July 1, 2006
Inventories:		
Raw materials	$ 3,328,000	$ 2,579,000
Work-in-process	2,384,000	1,345,000
Finished goods	2,861,000	5,448,000
Less inventory reserve	(3,209,000)	(1,843,000)
	$ 5,364,000	$ 7,529,000

	December 31, 2005	July 1, 2006
Property and Equipment:		
Equipment	$ 18,000,000	$ 17,223,000
Leasehold improvements	6,647,000	6,732,000
Furniture and fixtures	451,000	451,000
	25,098,000	24,406,000
Less: accumulated depreciation and amortization	(17,295,000)	(17,635,000)
	$ 7,803,000	$ 6,771,000

At December 31, 2005 and July 1, 2006, equipment includes $237,000 of assets financed under capital lease arrangements, net of $210,000 and $218,000 of accumulated amortization, respectively. Depreciation expense amounted to $631,000 and $1,286,000 for the three and six month periods ended July 2, 2005 and $571,000 and

$1,203,000 for the three and six month periods ended July 1, 2006, respectively. Depreciation expense is expected to total $1.1 million for the remainder of 2006, $2.0 million, $1.4 million, $1.0 million and $800,000 in each of the years 2007, 2008, 2009, and 2010, respectively.

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	December 31, 2005	July 1, 2006
Patents and Licenses:		
Patents pending	$ 435,000	$ 528,000
Patents issued	875,000	875,000
Less accumulated amortization	(230,000)	(257,000)
Net patents issued	645,000	618,000
Licenses	563,000	563,000
Less accumulated amortization	(66,000)	(83,000)
Net licenses	497,000	480,000
Purchased technology	1,706,000	1,706,000
Less accumulated amortization	(769,000)	(887,000)
Net purchased technology	937,000	819,000
	$ 2,514,000	$ 2,445,000

Amortization expense related to these items totaled $82,000 and $164,000 for the three and six month periods ended July 2, 2005 and $81,000 and $162,000 for the three and six month periods ended July 1, 2006, respectively. Amortization expenses are expected to total $167,000 for the remainder of 2006, $344,000, $356,000, $347,000, and $118,000 in each of the years 2007, 2008, 2009, and 2010, respectively.

	December 31, 2005	July 1, 2006
Accrued Expenses and Other Long Term Liabilities:		
Salaries Payable	$ 365,000	$ 341,000
Compensated Absences	423,000	464,000
Compensation related	253,000	257,000
Warranty reserve	491,000	389,000
Lease abandonment costs	225,000	8,000
Product line exit costs	402,000	319,000
Severance costs	32,000	
Deferred Rent	378,000	386,000
Other	150,000	190,000
	2,719,000	2,354,000
Less current portion	(1,998,000)	(1,774,000)
Long term portion	$ 721,000	$ 580,000

	For the six months ended, July 2, 2005	July 1, 2006
Warranty Reserve Activity:		
Beginning balance	$ 419,000	$ 491,000
Additions	92,000	68,000
Deductions	(74,000)	(170,000)
Change in estimate relating to previous warranty accruals	141,000	
Ending balance	$ 578,000	$ 389,000
Lease Abandonment Costs:		
Beginning balance	$ 1,336,000	$ 225,000
Additions		
Deductions	(557,000)	(217,000)
Ending balance	$ 779,000	$ 8,000
Product Line Exit Costs:		
Beginning balance	$ 885,000	402,000
Additions		
Deductions	(456,000)	(83,000)
Ending balance	$ 429,000	$ 319,000
Severance Costs:		
Beginning balance	$ 36,000	$ 32,000
Additions	198,000	81,000
Deductions	(202,000)	(113,000)
Ending balance	$ 32,000	$ 0

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
General

We develop, manufacture and market high performance infrastructure products for wireless voice and data applications. Wireless carriers face many challenges in today s competitive marketplace. Minutes of use are skyrocketing, and wireless users now expect the same quality of service from their mobile devices as from their landline phones. We help wireless carriers meet these challenges by doing more with less.

Our products help maximize the performance of wireless telecommunications networks by improving the quality of uplink signals from mobile wireless devices. Our products increase capacity utilization, lower dropped and blocked calls, extend coverage, and enable higher wireless data throughput all while reducing capital and operating costs. SuperLink incorporates patented high-temperature superconductor (HTS) technology to create a receiver front-end that enhances network performance. Today, we are leveraging our expertise and proprietary technology in radio frequency (RF) engineering to expand our product line beyond HTS technology. We believe our RF engineering expertise provides us with a significant competitive advantage in the development of high performance, cost-effective solutions for the front end of wireless telecommunications networks.

We have three product offerings:

SuperLink. In order to receive uplink signals from wireless handsets, base stations require a wireless filter system to eliminate, or filter out, out-of-band interference. SuperLink combines HTS filters with a proprietary cryogenic cooler and a cooled low-noise amplifier. The result is a highly compact and reliable receiver front-end that can simultaneously deliver both high selectivity (interference rejection) and high sensitivity (detection of low level signals). SuperLink delivers significant performance advantages over conventional filter systems.

AmpLink. AmpLink is designed specifically to address the sensitivity requirements of wireless base stations. AmpLink is a ground-mounted unit which includes a high-performance amplifier and up to six dual duplexers. The enhanced uplink provided by AmpLink improves network coverage immediately and avoids the installation and maintenance costs associated with tower mounted alternatives.

SuperPlex. SuperPlex is our line of multiplexers that provides extremely low insertion loss and excellent cross-band isolation. SuperPlex high-performance multiplexers are designed to eliminate the need for additional base station antennas and reduce infrastructure costs. Relative to competing technologies, these products offer increased transmit power delivered to the base station antenna, higher sensitivity to subscriber handset signals, and fast and cost-effective network overlays.

We currently sell most of our commercial products directly to wireless network operators in the United States. Our primary customers to date include ALLTEL, Cingular, Sprint Nextel, T-Mobile, U.S. Cellular and Verizon Wireless. We have a concentrated customer base. Verizon Wireless, ALLTEL and T-Mobile each accounted for more than 10% of our commercial revenues in 2006, and Verizon Wireless and ALLTEL each accounted for more than 10% of our commercial revenues in 2005. We plan to expand our customer base by selling directly to other wireless network operators and manufacturers of base station equipment, but we cannot assure that this effort will be successful.

We also generate significant revenues from government contracts. We primarily pursue government research and development contracts which compliment our commercial product development. We undertake government contract work which has the potential to add to or improve our commercial product line. These contracts often yield valuable intellectual property relevant to our commercial business. We typically own the intellectual property developed under these contracts, and the Federal Government receives a royalty-free, non-exclusive and nontransferable license to use the intellectual property for the United States.

We sell most of our products to a small number of wireless carriers, and their demand for wireless communications equipment fluctuates dramatically and unpredictably. We expect these trends to continue and may cause significant fluctuations in our quarterly and annual revenues.

The wireless communications infrastructure equipment market is extremely competitive and is characterized by rapid technological change, new product development, product obsolescence, evolving industry standards and price erosion over the life of a product. We face constant pressures to reduce prices. Consequently, we expect the average selling prices of our products will continue decreasing over time. We have responded in the past by successfully reducing our product costs, and expect further cost reductions over the next twelve months. However, we cannot predict whether our costs will decline at a rate sufficient to keep pace with the competitive pricing pressures.

Reverse Stock Split

We implemented a one (1) for ten (10) reverse split of our common stock effective as of the open of business on March 13, 2006. In the reverse split, each ten shares of issued and outstanding common stock were converted automatically into one share of common stock. No fractional shares were issued in connection with the reverse stock split, and we paid cash in lieu of fractional shares based on a post-split value of $4.00 per share. The reverse stock split reduced the number of outstanding shares of common stock from approximately 124.8 million shares before the split to approximately 12.5 million shares immediately after the split. The reverse split also had a proportionate affect on all stock options and warrants outstanding on the effective date of the split.

We implemented the reverse stock split in order to meet the Nasdaq Capital Market s maintenance standard that requires listed companies maintain at least a $1.00 per share minimum bid price. Our stock began trading well above the $1.00 level after the split, and Nasdaq subsequently notified us that we had regained compliance for continued listing on the Nasdaq Capital Market

All share and per share information included in this Quarterly Report reflect the reverse stock split.

Critical Accounting Policies and Estimates

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

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of the financial statements. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

Our inventory is valued at the lower of its actual cost or the current estimated market value of the inventory. We review inventory quantities on hand and on order and record a provision for excess and obsolete inventory and/or vendor cancellation charges related to purchase commitments. Such provisions are established based on historical usage, adjusted for known changes in demands for such products, or the estimated forecast of product demand and production requirements. Our business is characterized by rapid technological change, frequent new product development and rapid product obsolescence that could result in an increase in the amount of obsolete inventory quantities on hand. As demonstrated in the past three years, demand for our products can fluctuate significantly. Our estimates of future product demand may prove to be inaccurate and we may understate or overstate the provision required for excess and obsolete inventory.

Our net sales consist of revenue from sales of products net of trade discounts and allowances. We recognize revenue when evidence of an arrangement exists, contractual obligations have been satisfied, title and risk of loss have been transferred to the customer and collection of the resulting receivable is reasonably assured. At the time revenue is recognized, we provide for the estimated cost of product warranties if allowed for under contractual arrangements. Our warranty obligation is effected by product failure rates and service delivery costs incurred in correcting a product failure. Should such failure rates or costs differ from these estimates, accrued warranty costs would be adjusted.

In connection with the sales of its commercial products, the Company indemnifies, without limit or term, its customers against all claims, suits, demands, damages, liabilities, expenses, judgments, settlements and penalties arising from actual or alleged infringement or misappropriation of any intellectual property relating to its products or other claims arising from its products. The Company cannot reasonably develop an estimate of the maximum potential amount of payments that might be made under its guarantee because of the uncertainty as to whether a claim might arise and how much it might total.

Contract revenues are principally generated under research and development contracts. Contract revenues are recognized utilizing the percentage-of-completion method measured by the relationship of costs incurred to total estimated contract costs. If the current contract estimate were to indicate a loss, utilizing the funded amount of the contract, a provision would be made for the total anticipated loss. Revenues from research related activities are derived primarily from contracts with agencies of the United States Government. Credit risk related to accounts receivable arising from such contracts is considered minimal. These contracts include cost-plus, fixed price and cost sharing arrangements and are generally short-term in nature.

All payments to us for work performed on contracts with agencies of the U.S. Government are subject to adjustment upon audit by the Defense Contract Audit Agency. Based on historical experience and review of current projects in process, we believe that the audits will not have a significant effect on our financial position, results of operations or cash flows. The Defense Contract Audit Agency has audited us through 2002.

In connection with the acquisition of Conductus we recognized $20.1 million of goodwill. Goodwill is tested for impairment annually in the fourth quarter after the annual planning process, or earlier if events occur which require an impairment analysis be performed. We operate in a single business segment as a single reporting unit. The first step of the impairment test, used to identify potential impairment, compares the fair value based on market capitalization of the entire Company with the book value of its net assets, including goodwill. The Company s market capitalization is based on the closing price of our common stock as traded on NASDAQ multiplied by our outstanding common shares. If the fair value of the Company exceeds the book value of our net assets, our goodwill is not considered impaired. If the book value of our net assets exceeds our fair value, the second step of the goodwill impairment test shall be performed to measure the amount of impairment loss. The second step of the goodwill impairment test, used to measure the amount of impairment loss, compares the implied fair value of the goodwill with the book value of that goodwill. The implied fair value of goodwill is determined by performing a full evaluation of the fair values of all assets and liabilities of the reporting unit as would be performed in a purchase price allocation under SFAS No. 141, Business Combinations. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess. At December 31, 2005, we tested the goodwill for possible impairment and determined that there was no impairment. The fair value of the Company based on its market capitalization totaled $53.7 million which was in excess of the total book value of the Company. Therefore, our goodwill was not considered impaired.

At July 1, 2006, the fair value of the Company based on its market capitalization had declined to $25.5 million, which is less than the total book value of the Company. We are viewing this decline in the fair value of the Company based on market capitalization as an event as described in FAS 142 and have chosen to test for goodwill impairment as of July 1, 2006. We began step 2 of the impairment analysis by determining the fair values of all the tangible and intangible assets of the Company and applying these values to the fair value of the Company. The Company has not completed this exercise, however, the Company determined that an impairment loss is probable and can be reasonably estimated based on the work performed to date including the continued weakness in the Company s stock price. Our analysis, though not yet complete, has led us to reasonably estimate that the fair market value for the Company is less than its net assets excluding goodwill and a full write down of $20.1 million in goodwill has been taken in the second quarter. Our decision to write-off all the goodwill from the Conductus acquisition is based on preliminary estimates of our net assets and is subject to adjustment after completion of our analysis.

We periodically evaluate the realizability of long-lived assets as events or circumstances indicate a possible inability to recover the carrying amount. Long-lived assets that will no longer be used in business are written off in the period identified since they will no longer generate any positive cash flows for the Company. Periodically, long-lived assets that will continue to be used by the Company need to be evaluated for recoverability. Such evaluation is based on various analyses, including cash flow and profitability projections. The analyses necessarily involve significant management judgment. In the event the projected undiscounted cash flows are less than net book value of the assets, the carrying value of the assets will be written down to their estimated fair value. We completed such an analysis as of the fourth quarter of 2005 and determined that no write down was necessary. Our estimates of future cash flows may prove to be inaccurate, and we may understate or overstate the write down of long lived assets. During the first half of 2006, the market capitalization of the Company declined. If the market capitalization of the Company declines below the Company s book value, and it is deemed other than temporary, then an impairment loss relating to the Company s long lived assets might be recognized. Any future impairment of our long-lived assets could have a material adverse effect on our financial position and results of operations.

Our valuation allowance against the deferred tax assets is based on our assessments of historical losses and projected operating results in future periods. If and when we generate future taxable income in the U.S. against which these tax assets may be applied, some portion or all of the valuation allowance would be reversed and an increase in net income would consequently be reported in future years.

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We have a contract to deliver several custom products to a government contractor. We are unable to manufacture the products for technical reasons. We have discussed the problem with the contractor and its government customer. They are considering the problem, and we expect further discussions. We do not believe that a loss is reasonably estimable at this time and therefore have not recorded any liability relating to this matter. We will periodically reassess our potential liability as additional information becomes available. If we later determine that a loss is probable and the amount reasonably estimable, we would record a liability for the potential loss.

We account for stock-based compensation in accordance with the provisions of SFAS 123R. We use the Black-Scholes option-pricing model, which requires the input of highly subjective assumptions. These assumptions include estimating the length of time an employee will retain their stock options before exercising them (expected term), the estimated volatility of the Company s common stock price over the expected term and the number of options that will ultimately not complete their vesting requirements (forfeitures). Changes in the subjective assumptions can materially affect the estimated fair value of the stock-based compensation and consequently, the related amount recognized on the consolidated statements of operations. See Notes 2 and 6 of the Notes to Consolidated Financial Statements in this Form 10-Q for further discussion of stock-based compensation.

Backlog

Our commercial backlog consists of accepted product purchase orders with scheduled delivery dates during the next twelve months. We had commercial backlog of $800,000 at July 1, 2006, as compared to $250,000 at December 31, 2005.

Results of Operations

Quarter and six months ended July 1, 2006 as compared to the quarter and six months ended July 2, 2005

Total net revenues decreased by $3.5 million, or 41%, from $8.6 million in the second quarter of 2005 to $5.0 million in the second quarter of 2006. Total net revenues decreased by $3.0 million, or 24%, from $12.9 million in the first six months of 2005 to $9.9 million in the same period this year. Total net revenues consist primarily of commercial product revenues and government contract revenues. We also generate some additional revenues from sublicensing our technology.

Net commercial product revenues decreased to $3.9 million in the second quarter of 2006 from $7.6 million in the second quarter of 2005, a decrease of $3.6 million, or 48%. For the first six months of 2006, net commercial product revenues decreased $2.9 million to $8.4 million from $11.3 million in the same period last year, a decrease of 26%. The decrease is primarily the result of lower sales of both our AmpLink and SuperLink products. Our three largest customers accounted for 83% of our total net revenues in the first half of 2006. These customers generally purchase products through non-binding commitments with minimal lead-times. Consequently, our commercial product revenues can fluctuate dramatically from quarter to quarter based on changes in our customers capital spending patterns.

Government contract revenues increased to $1.1 million in the second quarter of 2006 from $972,000 in the second quarter of 2006, an increase of $116,000, or 12%. For the first six months of 2006, government contract revenues decreased to $1.4 million from $1.5 million in the same period last year, a decrease of $113,000, or 7%. The variance is primarily attributable to the completion of contracts in 2005 that were not been replaced until the second quarter of 2006.

Cost of commercial product revenues includes all direct costs, manufacturing overhead, provision for excess and obsolete inventories and restructuring and impairment charges relating to the manufacturing operations. The cost of commercial product revenue totaled $3.7 million for the second quarter of 2006 compared to $5.8 million for the second quarter of 2005, a decrease of $2.1 million, or 37%. For the first six months of 2006, the cost of commercial product revenues totaled $7.5 million as compared to $10.0 million for the first six months of 2005, a decrease of $2.5 million, or 25%. For the quarter and year to date, decreased costs result primarily from decreases in direct costs.

Our cost of sales includes both variable and fixed cost components. The variable component consists primarily of materials, assembly and test labor, overhead, which includes equipment and facility depreciation, transportation costs and warranty costs. The fixed component includes test equipment and facility depreciation, purchasing and procurement expenses and quality assurance costs. Given the fixed nature of such costs, the absorption of our production overhead costs into inventory decreases and the amount of production overhead variances expensed to cost of sales increases as production volumes decline since we have fewer units to absorb our overhead costs against. Conversely, the absorption of our production overhead costs into inventory increases and the amount of production overhead variances expensed to cost of sales decreases as production volumes increase since we have more units to absorb our overhead costs against. As a result, our gross profit margins generally decrease as revenue and production volumes decline due to lower sales volume and higher amounts of production overhead variances expensed to cost of sales; and our gross profit margins generally increase as our revenue and production volumes increase due to higher sales volume and lower amounts of production overhead variances expensed to cost of sales.

The following is an analysis of our commercial product gross profit and margins:

	Three Months Ended				Six Months Ended			
Dollars in thousands	July 2, 2005		July 1, 2006		July 2, 2005		July 1, 2006	
Net commercial product sales	$ 7,581	100%	$ 3,932	100%	$ 11,349	100%	$ 8,422	100%
Cost of commercial product sales	5,801	77%	3,658	93%	10,000	88%	7,516	89%
Gross profit	$ 1,780	23%	$ 274	7%	$ 1,349	12%	$ 906	11%

We had a gross profit of $274,000 in the second quarter of 2006 from the sale of our commercial products as compared to a gross profit of $1,780,000 in the second quarter of 2005. For the six months ended July 1, 2006, we had a gross profit of $906,000 from the sale of our commercial products as compared to a gross profit of $1.3 million in the six months ended July 2, 2005. Our gross margins were also impacted by charges for excess and obsolete inventory of approximately $180,000 in the first half of 2006 and 2005. We regularly review inventory quantities on hand and provided an allowance for excess and obsolete inventory based on numerous factors including sales backlog, historical inventory usage, forecasted product demand and production requirements for the next twelve months.

Contract research and development expenses totaled $703,000 in the second quarter of 2006 as compared to $1.0 million in the second quarter of 2005. These expenses totaled $1.0 million in the first half of 2006 and $1.7 million in the first half of 2005. This decrease was the result of lower expenses associated with performing a fewer number of government contracts in the first quarter and two new contracts added in the second quarter.

Other research and development expenses relate to development of new wireless commercial products. We also incur design expenses associated with reducing the cost and improving the manufacturability of our existing products. These expenses totaled $630,000 million in the second quarter of 2006 as compared to $775,000 in the same quarter of the prior year and totaled $1.9 million in the first half of 2006 and $1.9 million in the first half of 2005. The decrease in the second quarter expenses was due to limited engineering manpower and high initial efforts on new government contracts.

Selling, general and administrative expenses totaled $2.7 million in the second quarter of 2006, as compared to $2.9 million in the second quarter of the prior year. In the first six months of 2006, these expenses totaled $5.4 million as compared to $6.6 million in the same period last year. The lower expenses in 2006 resulted primarily from lower insurance premiums and lower costs for consultants. The first six months of 2005 results included expenses from restructuring activities and expenses related to the retirement benefits that were paid to our former President and Chief Executive Officer.

During the first six months of 2005, we implemented a restructuring program and reduced our workforce. This generated restructuring charges totaling $337,000 for the first half of 2005, including $204,000 for the second quarter of 2005. There were no restructuring charges for the three months or six months ended July 1, 2006.

We recorded a non-cash charge of $20.1 million in the second quarter of this year to write-off the goodwill from our acquisition of Conductus in December 2002. At July 1, 2006, the fair value of the Company based on its market capitalization had declined to $25.5 million, which is less than the total book value of the Company. We are viewing this decline in the fair value of the Company based on market capitalization as an event as described in FAS 142 and have chosen to test for goodwill impairment as of that date. We began step 2 of the impairment analysis by determining the fair values of all the tangible and intangible assets of the Company and applying these values to the fair value of the Company. The Company has not completed this exercise, however, the Company determined that an impairment loss is probable and can be reasonably estimated based on the work performed to date including the continued weakness in the Company s stock price. Our analysis, though not yet complete, has led us to reasonably estimate that the fair market value for the Company is less than its net assets excluding the Conductus goodwill and a full write down of $20.1 million in goodwill has been taken in the second quarter. Our decision to write-off all the goodwill from the Conductus acquisition is based on preliminary estimates of our net assets and is subject to adjustment after completion of our analysis.

Interest income increased in the second quarter and first half of 2006, as compared to the prior year, primarily because we had more cash available for investment and higher interest rates.

Interest expense in the three months and six months ended July 1, 2006 amounted to $11,000 and $24,000, as compared to $34,000 and $73,000 in the three months and six months ended July 2, 2005. Interest expense was lower in the current year periods because of lower borrowings.

We had a net loss of $22.7 million for the quarter ended July 1, 2006, as compared to a net loss of $2.0 million in the same period last year. For the six months ended July 1, 2006, our loss totaled $25.9 million as compared to $7.6 million in the same period last year. Excluding the $20.1 million goodwill impairment charge discussed above, our net loss for the second quarter of 2006 was $2.6 million and for the first half of 2006 was $5.8 million.

The net loss available to common shareholders totaled $1.82 per common share in the second quarter of 2006, as compared to a net loss of $0.19 per common share in the same period last year. The net loss available to common shareholders totaled $2.07 per common share in the first half of 2006, as compared to a net loss of $0.70 per common share in the same period last year.

Liquidity and Capital Resources

Cash Flow Analysis

As of July 1, 2006, we had working capital of $12.6 million, including $7.1 million in cash and cash equivalents, as compared to working capital of $17.2 million at December 31, 2005, which included $13.0 million in cash and cash equivalents. We currently invest our excess cash in short-term, investment-grade, money-market instruments with maturities of three months or less. We believe that all of our cash investments would be readily available to us should the need arise.

Cash and cash equivalents decreased by $5.9 million from $13.0 million at December 31, 2005 to $7.1 million at July 1, 2006. Cash during this period was used in operations, for the purchase of property and equipment and for the payment of long-term borrowings.

Cash and cash equivalents decreased by $6.1 million from $12.8 million at December 31, 2004 to $6.7 million at July 2, 2005. Cash was used in operations, for the purchase of property and equipment, for the payment of short and long-term borrowings and the payment of common stock offering expenses. These uses were partially offset by cash proceeds received from new borrowings on our line of credit.

Cash used in operations totaled $5.7 million in the first half of 2006. We used $4.1 million to fund the cash portion of our net loss. We also used cash to fund a $3.0 million increase in inventory, patents and licenses, and accounts payable payments. These uses were partially offset by cash generated from the collection of accounts receivable, prepaid expenses and other assets totaling $1.4 million. Cash used in operations totaled $4.2 million in the first half of 2005. We used $5.7 million to fund the cash portion of our net loss. We also used cash to fund a $1.9 million increase in patents and licenses, other assets and accounts payable payments. These uses were partially offset by cash generated from the collection of accounts receivable, as well as lower inventory and prepaid expense balances totaling $3.3 million.

Net cash used in investing activities totaled $170,000 in the first half of 2006 as compared to $64,000 in the first half of last year. These expenditures related primarily to purchases of manufacturing equipment and facilities improvements to increase our production capacity.

Net cash used in financing activities totaled $9,000 in the first quarter of 2006. Cash used to pay down our long term debt totaled $9,000. Net cash used in financing activities totaled $1.8 million in the first quarter of 2005. Cash used to pay down our line of credit and long term debt totaled $970,000. Cash was also used to pay $797,000 of offering expenses related to the sale of common stock in November 2004.

Financing Activities

We have historically financed our operations through a combination of cash on hand, cash provided from operations, equipment lease financings, available borrowings under bank lines of credit and both private and public equity offerings. We have effective registration statements on file with the SEC covering the public resale by investors of all the common stock issued in our private placements, as well as any common stock acquired upon exercise of their warrants.

We have an existing line of credit from a bank. It is a material source of funds for our business. The line of credit was renewed June 15, 2006 for a term of one year. The line of credit expires June 15, 2007. The loan agreement is structured as a sale of our accounts receivable and provides for the sale of up to $5.0 million of eligible accounts receivable, with advances to us totaling 80% of the receivables sold. Advances bear interest at the prime rate (8.25% at July 1, 2006) plus 2.50% subject to a minimum monthly charge. There was no amount outstanding under this borrowing facility at July 1, 2006. Advances are collateralized by a lien on all of our assets. Under the terms of the agreement, we continue to service the sold receivables and are subject to recourse provisions.

Contractual Obligations and Commercial Commitments

We incur various contractual obligations and commercial commitments in our normal course of business. They consist of the following:

Capital Lease Obligations

Our capital lease obligations are for property and equipment and total $26,000 at July 1, 2006.

Operating Lease Obligations

Our operating lease obligations consist of facility leases in Santa Barbara and Sunnyvale, California. We assumed the Sunnyvale leases in connection with our acquisition of Conductus, Inc. in 2002. At July 1, 2006, the remaining

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Sunnyvale lease obligations totaled $8,000. We consolidated the Sunnyvale operations into our Santa Barbara facility in 2004 and recorded a liability for the present value of the remaining obligations under the Sunnyvale leases. We included these liabilities in the financial statements under Accrued Liabilities and Other Long Term Liabilities.

Patents and Licenses

We have entered into various licensing agreements requiring royalty payments ranging from 0.13% to 2.5% of specified product sales. Some of these agreements contain provisions for the payment of guaranteed or minimum royalty amounts. Typically, the licensor can terminate our license if we fail to pay minimum annual royalties.

Purchase Commitments

In the normal course of business, we incur purchase obligations with vendors and suppliers for the purchase of inventory, as well as other goods and services. These obligations are generally evidenced by purchase orders that contain the terms and conditions associated with the purchase arrangements. We are committed to accept delivery of such material pursuant to the purchase orders subject to various contract provisions which allow us to delay receipt of such orders or cancel orders beyond certain agreed upon lead times. Cancellations may result in cancellation costs payable by us.

Quantitative Summary of Contractual Obligations and Commercial Commitments

At July 1, 2006, we had the following contractual obligations and commercial commitments:

	Payments Due by Period				
Contractual Obligations	**Total**	**Less than 1 year**	**2-3 years**	**4-5 years**	**After 5 years**
Capital lease obligations	$ 26,000	$ 22,000	$ 4,000	$	$
Operating leases	7,196,000	1,239,000	2,591,000	2,772,000	594,000
Minimum license commitment	2,100,000	150,000	300,000	300,000	1,350,000
Fixed asset and inventory purchase commitments	2,335,000	2,306,000	29,000		
Total contractual cash obligations	$ 11,657,000	$ 3,717,000	$ 2,924,000	$ 3,072,000	$ 1,944,000

Capital Expenditures

We plan to invest approximately $100,000 in fixed assets during the remainder of 2006.

Future Liquidity

Our principal sources of liquidity consist of existing cash balances and funds expected to be generated from future operations. We believe our existing cash resources, together with our line of credit, will be sufficient to fund our planned operations for at least the next twelve months if we can achieve our internally forecasted sales levels. We believe the key factor to our future liquidity is successfully executing on our plan to increase sales levels. There is no assurance that we can increase sales levels. Our cash requirements will also depend on numerous other variable factors, including the rate of growth of sales, the timing and levels of products purchased, payment terms and credit limits from manufacturers, and the timing and level of accounts receivable collections.

If we do not significantly increase sale levels in the next two quarters, we will require additional financing in the first half of 2007. We cannot assure you that additional financing (public or private) will be available on acceptable terms or at all. If we issue additional equity securities to raise funds, the ownership percentage of our existing stockholders would be reduced. New investors may demand rights, preferences or privileges senior to those of existing holders of common stock. If we cannot raise any needed funds, we might be forced to make further substantial reductions in our operating expenses, which could adversely affect our ability to implement our current business plan and ultimately our viability as a company.

Our independent registered public accounting firm has included in their audit report for fiscal 2005 an explanatory paragraph expressing doubt about our ability to continue as a going concern. They included a similar explanatory paragraph in their audit report for 2003 and 2004. In 2005, we incurred a net loss of $14.2 million and had negative cash flows from operations of $9.4 million. In the second quarter of 2006, we incurred a net loss of $22.7 million and had negative cash flows from operations of $5.7 million.

Our financial statements have been prepared assuming that the Company will continue as a going concern. The factors described above raise substantial doubt about our ability to continue as a going concern. Our financial statements do not include any adjustments that might result from this uncertainty.

Net Operating Loss Carryforward

As of December 31, 2005, we had net operating loss carryforwards for federal and state income tax purposes of approximately $255.1 million and $128 million, respectively, which expire in the years 2006 through 2025. Of these amounts $89.4 million and $30.2 million, respectively resulted from the acquisition of Conductus. Included in the net operating loss carryforwards are deductions related to stock options of approximately $24.1 million and $13.1 million for federal and California income tax purposes, respectively. To the extent net operating loss carryforwards are recognized for accounting purposes the resulting benefits related to the stock options will be credited to stockholders equity. In addition, we have research and development and other tax credits for federal and state income tax purposes of approximately $2.5 million and $1.2 million, respectively, which expire in the years 2006 through 2025. Of these amounts $774,000 and $736,000, respectively resulted from the acquisition of Conductus.

Due to the uncertainty surrounding their realization, we have recorded a full valuation allowance against our net deferred tax assets. Accordingly, no deferred tax asset has been recorded in the accompanying balance sheet.

Section 382 of the Internal Revenue Code imposes an annual limitation on the utilization of net operating loss carryforwards based on a statutory rate of return (usually the applicable federal funds rate , as defined in the Internal Revenue Code) and the value of the corporation at the time of a change of ownership as defined by Section 382. We completed an analysis of our equity transactions and determined that we had a change in ownership in August 1999 and December 2002. Therefore, the ability to utilize net operating loss carryforwards incurred prior to the change of ownership totaling $99.9 million will be subject in future periods to an annual limitation of $1.3 million. In addition, we acquired the right to Conductus net operating losses, which are also subject to the limitations imposed by Section 382. Conductus underwent three ownership changes, which occurred in February 1999, February 2001 and December 2002. Therefore, the ability to utilize Conductus net operating loss carryforwards of $89.4 million incurred prior to the ownership changes will be subject in future periods to annual limitation of $700,000. Net operating losses incurred by us subsequent to the ownership changes totaled $65.8 million and are not subject to this limitation.

Recent Accounting Requirements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation Number 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. The interpretation contains a two step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions are effective for the company beginning in the first quarter of 2007. The company is evaluating the impact this statement will have on its financial statements.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs , and amendment of ARB No. 43, Chapter 4. This statement amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB No. 43, Chapter 4, previously stated that ...under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges.... SFAS No. 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal. In addition, this statement requires that allocation of fixed production overheads to the cost of conversion be based on the normal capacity of the production facilities. The provisions of SFAS 151 shall be applied prospectively and are effective for inventory costs incurred during fiscal years beginning after June 15, 2005, with earlier application permitted for inventory costs incurred during fiscal years beginning after the date this Statement was issued. We adopted SFAS No. 151 and it has not had an impact on our financial position and results of operations.

Forward-Looking Statements

This report contains forward-looking statements that involve risks and uncertainties. We have made these statements in reliance on the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Our forward-looking statements relate to future events or our future performance and include, but are not limited to, statements concerning our business strategy, future commercial revenues, market growth, capital requirements, new product introductions, expansion plans and the adequacy of our funding. Other statements contained in this report that are not historical facts are also forward-looking statements. We have tried, wherever possible, to identify forward-looking statements by terminology such as may, will, could, should, expects, anticipates, intends, believes, seeks, estimates and other comparable terminology.

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Forward-looking statements are not guarantees of future performance and are subject to various risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially from those expressed in forward-looking statements. They can be affected by many factors, including, but not limited to the following:

- fluctuations in product demand from quarter to quarter which can be significant,
- the impact of competitive filter products, technologies and pricing,
- manufacturing capacity constraints and difficulties,
- market acceptance risks, and
- general economic conditions.

Please read the section in our 2005 Annual Report on Form 10-K entitled Item 1A *Risk Factors* for a description of additional uncertainties and factors that may affect our forward-looking statements. Forward-looking statements are based on information presently available to senior management, and we do not assume any duty to update our forward-looking statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

There was no material change in our exposure to market risk at July 1, 2006 as compared with our market risk exposure on December 31, 2005. See *Management s Discussion and Analysis of Financial Condition and Results of Operations Market Risk* in our 2005 Annual Report on Form 10-K.

Item 4. Disclosure Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit, is recorded, processed, summarized and reported, within the time periods specified in the U.S. Securities and Exchange Commission s rules and forms, and such information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosures..

Our Chief Executive Officer and Controller have evaluated our disclosure controls and procedures and have concluded, as of July 1, 2006, that they are effective as described above.

Changes in Internal Controls

There have been no changes in our internal control over financial reporting during the second quarter of 2006 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PART II
OTHER INFORMATION

Item 1. Legal Proceedings.

Shalvoy Litigation

Mr. Shalvoy, a director and stockholder, owed us a total of $820,244 of principal, plus accrued interest of more than $236,000, under two, full recourse promissory notes as of July 1, 2006. The notes are partially secured by 15,176 shares of the Company s common stock with a market value of approximately $31,000 as of July 1, 2006.

The Company acquired the notes in connection with the acquisition of Conductus, Inc. in December 2002. Conductus made these two loans to Mr. Shalvoy, its then President and Chief Executive Officer, prior to the acquisition. Mr. Shalvoy issued the notes to Conductus as payment for the purchase price on the exercise of stock options in December 2000. The first note was due on December 28, 2005 ($460,244 principal amount), and the second note is due on August 21, 2006 ($360,000 principal amount).

Mr. Shalvoy notified the Company in December 2005 of his intention not to repay either of the loans. Mr. Shalvoy alleges, among other things, that the Conductus board committed to forgive the loans should the stock purchase turn out to have negative financial consequences to him. Mr. Shalvoy had not previously disclosed this alleged agreement to the Company, and the Company has not found (and is not aware) of any documentation to support his allegation. The Company does not believe that any agreement to forgive the notes ever existed, and it believes that the notes are valid and binding debt obligations of Mr.

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Shalvoy. Consequently, the Company filed a lawsuit against Mr. Shalvoy on December 21, 2005 in the California Superior Court (Case No. 1186812) to collect payment in full of all principal and interest due under both notes.

Routine Litigation

We are also involved in routine litigation arising in the ordinary course of our business, and, while the results of the proceedings cannot be predicted with certainty, we believe that the final outcome of such matters will not have a material adverse effect on our financial position, operating results or cash flow.

Item 1A. Risk Factors.

A description of the risk factors associated with our business is contained in Item 1A, Risk Factors, of our 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 8, 2006 and incorporated herein by reference. These cautionary statements are to be used as a reference in connection with any forward-looking statements. The factors, risks and uncertainties identified in these cautionary statements are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission.

Item 2. Unregistered Sales of Equity Securities.

We did not conduct any offerings of equity securities during the second quarter of this year that were not registered under the Securities Act of 1933.

We did not repurchase any shares of our common stock during the second quarter of this year.

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

The following matters were submitted to the shareholders at the Company s Annual Meeting of Shareholders held May 24, 2006:

(1) The three (3) Class 2 nominated directors were elected to serve for the ensuing three years and until their successors are duly elected and qualified.

	NUMBER OF SHARES FOR	% OF SHARES VOTING	NUMBER OF SHARES WITHHELD	% OF SHARES VOTING
Lynn J. Davis	11,153,924	98.7	141,669	1.3
Dennis J. Horowitz	11,166,163	98.9	129,430	1.1
Martin A. Kaplan	11,165,900	98.9	129,693	1.1

(2) The appointment of PricewaterhouseCoopers LLP as independent auditors of the Company was ratified for the year ending December 31, 2006.

	NUMBER OF SHARES FOR	% OF SHARES VOTING
Votes For	11,232,335	99.4
Votes Against	30,036	0.3
Votes Abstaining	33,222	0.3

Item 5. Other Information.

(a) Additional Disclosures.

None.

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(b) Stockholder Nominations.

There have been no material changes to the procedures by which stockholders may recommend nominees to our board of directors. Please see the discussion of our procedures under the heading Board Meetings and Committees on pages 4 thru 6 of our 2006 Proxy Statement available online at www.sec.gov.

Item 6. Exhibits.

Number	Description of Document
3.1	Amended and Restated Certificate of Incorporation of the Company (1)
3.2	Certificate of Amendment of Restated Certificate of Incorporation (2)
3.3	Amended and Restated Bylaws of the Registrant (3)
4.1	Form of Common Stock Certificate (4)
4.2	Third Amended and Restated Stockholders Rights Agreement (5)
4.3	Warrant Issued to PNC Bank, National Association in connection with Credit Agreement (5)
4.4	Warrant Purchase Agreement dated December 1, 1999 with PNC Bank (6)
4.5	Warrant Purchase Agreement dated January 12, 2000 with PNC Bank (6)
4.6	Certificate of Designations, Preferences and Rights of Series E Convertible Stock (7)
4.7	Securities Purchase Agreement dated as of September 29, 2000 between the Company and RGC International Investors, LDC. (Exhibits and Schedules Omitted) (7)
4.8	Registration Rights Agreement dated as of September 29, 2000 between the Company and RGC International Investors, LDC. (7)
4.9	Initial Stock Purchase Warrant dated as of September 29, 2000 between the Company and RGC International Investors, LDC. (7)
4.10	Incentive Stock Purchase Warrant dated as of September 29, 2000 between the Company and RGC International Investors, LDC. (7)
4.11	Registration Rights Agreement, dated March 6, 2002 (8)
4.12	Warrants to Purchase Shares of Common Stock, dated March 11, 2002 (8)
4.13	Registration Rights Agreement dated October 10, 2002 (9)
4.14	Warrants to Purchase Common Stock dated October 10, 2002 (9)
4.15	Common Stock Purchase Agreement, dated March 8, 2002 between Conductus, Inc. and the investors signatory thereto (10)

4.16	Warrant to Purchase Common Stock, dated March 8, 2002 by Conductus, Inc. to certain investors (11)
4.17	Registration Rights Agreement, dated March 26, 2002, between Conductus, Inc. and certain investors (11)
4.18	Warrant to Purchase Common Stock, dated August 7, 2000, issued by Conductus to Dobson Communications Corporation (12) *
4.19	Form of Series B Preferred Stock and Warrant Purchase Agreement dated September 11, 1998 and September 22, 1998 between Conductus and Series B Investors (13)
4.20	Form of Warrant to Purchase Common Stock between Conductus and Series B investors, dated September 28, 1998, issued by Conductus in a private placement (13)
4.21	Form of Series C Preferred Stock and Warrant Purchase Agreement, dated December 10, 1999, between Conductus and Series C Investors (14)
4.22	Form of Warrant Purchase Common Stock between Conductus and Series C investors, dated December 10, 1999, issued by Conductus in a private placement (14)
4.23	Form of Warrant to Purchase Common Stock dated March 28, 2003, issued to Silicon Valley Bank (15)
4.24	Form of Warrant (16)
4.25	Form of Registration Rights Agreement (16)
4.26	Agility Capital Warrant dated May 2004 (17)
4.27	Silicon Valley Bank Warrant dated May 2004 (17)
4.28	Form of Warrant dated August 2005 (18)
10.1	Management Incentive Plan (19)

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Number	Description of Document
31.1	Statement of CEO Pursuant to 302 of the Sarbanes-Oxley Act of 2002 (*)
31.2	Statement of Principal Financial Officer Pursuant to 302 of the Sarbanes-Oxley Act of 2002 (*)
32.1	Statement of CEO Pursuant to 906 of the Sarbanes-Oxley Act of 2002 (*)
32.2	Statement of Principal Financial Officer Pursuant to 906 of the Sarbanes-Oxley Act of 2002 (*)

(1) Incorporated by reference from the Registrant s Quarterly Report on Form 10-Q filed for the quarter ended April 3, 1999.

(2) Incorporated by reference from the Registrant s Quarterly Report on Form 10-Q filed for the quarter ended June 30, 2001.

(3) Incorporated by reference from Registrant s Form 8-K dated May 25, 2005.

(4) Incorporated by reference from the Registrant s Registration Statement on Form S-1 (Reg. No. 33-56714).

(5) Incorporated by reference from the Registrant s Quarterly

Report on Form 10-Q filed for the quarter ended July 3, 1999.

(6) Incorporated by reference from the Registrant s Registration Statement on Form S-8 (Reg. No. 333-90293).

(7) Incorporated by reference from the Registrant s Annual Report on Form 10-K for the year ended December 31, 1999.

(8) Incorporated by reference from Registrant s Annual Report on Form 10-K for the year ended December 31, 2001.

(9) Incorporated by reference from the Registrant s Current Report on Form 8-K, filed October 2, 2002.

(10) Incorporated by reference from the Registrant s Annual Report on Form 10-K filed for the year ended December 31, 1997.

(11) Incorporated by reference from the Conductus, Inc. s Registration Statement on Form S-3 (Reg. No. 333-85928) filed on April 9, 2002.

(12) Incorporated by reference from Conductus, Inc. s Quarterly Report on Form 10-Q, filed with the SEC on November 16, 1998.

(13) Incorporated by reference from Conductus, Inc. s Annual Report on Form 10-K for the year ended December 31, 1999.

(14) Incorporated by reference from Conductus, Inc. s Annual Report on Form 10-K for the year ended December 31, 1999.

(15) Incorporate by reference from Registrant s Quarterly Report on Form 10-Q for the quarter ended March 29, 2003.

(16) Incorporated by reference from Registrant s Current Report on Form 8-K filed June 25, 2003.

(17) Incorporated by reference from Registrants Registration Statement of Form S-3 (Reg. 333-89184).

(18) Incorporated by reference from Registrant s Form 8-K filed August 11, 2005.

(19) Incorporated by reference from Registrant s Form 8-K filed July 28, 2006.

* Filed herewith.

** Confidential treatment has been previously granted for certain portions of these exhibits.

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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.

SUPERCONDUCTOR TECHNOLOGIES INC.

Dated: August 10, 2006

/s/ William J. Buchanan

William J. Buchanan
Controller (Principal Financial Officer)

/s/ Jeffrey A. Quiram

Jeffrey A. Quiram
President and Chief Executive Officer

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