

MTS SYSTEMS CORP
Form 10-Q
February 03, 2011

United States
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the Quarterly period ended January 1, 2011

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from _____ to _____

Commission File Number 0-2382

MTS SYSTEMS CORPORATION
(Exact name of Registrant as specified in its charter)

MINNESOTA
(State or other jurisdiction of incorporation or organization)

41-0908057
(I.R.S. Employer Identification No.)

14000 Technology Drive, Eden Prairie, MN 55344
(Address of principal executive offices) (Zip Code)

Registrant's telephone number: (952) 937-4000

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

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company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

Yes No

The number of shares outstanding of the Registrant’s common stock as of February 1, 2011 was 15,339,542 shares.

MTS SYSTEMS CORPORATION
 REPORT ON FORM 10-Q
 FOR THE THREE MONTHS ENDED JANUARY 1, 2011

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PART 1 – FINANCIAL INFORMATION

Item 1. Financial Statements

MTS SYSTEMS CORPORATION
Consolidated Balance Sheets
(unaudited - in thousands, except per share data)

| | January 1, 2011 | October 2, 2010 |
|--|--------------------|--------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$80,281 | \$76,611 |
| Accounts receivable, net of allowances for doubtful accounts of \$1,342 and \$1,358 respectively | 62,908 | 66,369 |
| Unbilled accounts receivable | 26,562 | 26,389 |
| Inventories | 55,329 | 51,792 |
| Prepaid expenses and other current assets | 10,357 | 10,799 |
| Deferred income taxes | 12,635 | 12,742 |
| Total current assets | 248,072 | 244,702 |
| | | |
| Property and equipment, net | 55,881 | 56,444 |
| Goodwill | 15,550 | 15,429 |
| Other intangible assets, net | 24,811 | 24,753 |
| Other assets | 3,347 | 3,368 |
| Deferred income taxes | 1,675 | 1,709 |
| Total Assets | \$349,336 | \$346,405 |
| | | |
| LIABILITIES AND SHAREHOLDERS' INVESTMENT | | |
| Current Liabilities: | | |
| Short-term borrowings | \$40,243 | \$40,229 |
| Accounts payable | 20,302 | 21,818 |
| Accrued payroll and related costs | 25,688 | 32,725 |
| Advance payments from customers | 42,729 | 44,000 |
| Accrued warranty costs | 6,735 | 7,505 |
| Accrued income taxes | 2,015 | 2,642 |
| Deferred income taxes | 1,631 | 996 |
| Other accrued liabilities | 14,211 | 11,925 |
| Total current liabilities | 153,554 | 161,840 |
| | | |
| Deferred income taxes | 5,987 | 6,057 |
| Non-current accrued income taxes | 4,604 | 4,181 |
| Pension benefit plan | 3,548 | 3,080 |
| Other long-term liabilities | 4,944 | 5,141 |
| Total Liabilities | 172,637 | 180,299 |
| | | |
| Shareholders' Investment: | | |

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| | | |
|--|-----------|-----------|
| Common stock, \$.25 par; 64,000 shares authorized: 15,304 and 15,264 shares issued and outstanding, respectively | 3,826 | 3,816 |
| Retained earnings | 159,588 | 147,609 |
| Accumulated other comprehensive income | 13,285 | 14,681 |
| Total Shareholders' Investment | 176,699 | 166,106 |
| Total Liabilities and Shareholders' Investment | \$349,336 | \$346,405 |

The accompanying condensed notes to consolidated financial statements are an integral part of these statements.

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MTS SYSTEMS CORPORATION
 Consolidated Statements of Income
 (unaudited - in thousands, except per share data)

| | Three Fiscal Months Ended | |
|--|---------------------------|--------------------|
| | January 1, 2011 | January 2, 2010 |
| Revenue: | | |
| Product | \$ 89,901 | \$ 74,785 |
| Service | 15,975 | 14,175 |
| Total revenue | 105,876 | 88,960 |
| Cost of sales: | | |
| Product | 50,899 | 46,827 |
| Service | 8,305 | 6,951 |
| Total cost of sales | 59,204 | 53,778 |
| Gross profit | 46,672 | 35,182 |
| Operating expenses: | | |
| Selling and marketing | 16,579 | 15,986 |
| General and administrative | 8,491 | 9,398 |
| Research and development | 3,128 | 3,370 |
| Total operating expenses | 28,198 | 28,754 |
| Income from operations | 18,474 | 6,428 |
| Interest expense | (470) | (471) |
| Interest income | 43 | 63 |
| Other income (expense), net | 57 | (319) |
| Income before income taxes | 18,104 | 5,701 |
| Provision for income taxes | 4,815 | 1,864 |
| Net income | \$ 13,289 | \$ 3,837 |
| Earnings per share: | | |
| Basic- | | |
| Earnings per share | \$ 0.87 | \$ 0.23 |
| Weighted average number of common shares outstanding - basic | 15,305 | 16,579 |
| Diluted- | | |
| Earnings per share | \$ 0.86 | \$ 0.23 |
| Weighted average number of common shares outstanding - diluted | 15,526 | 16,617 |

The accompanying condensed notes to consolidated financial statements are an integral part of these statements.

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MTS SYSTEMS CORPORATION
Consolidated Statements of Cash Flows
(unaudited - in thousands)

| | Three Fiscal Months Ended | |
|---|---------------------------|--------------------|
| | January 1, 2011 | January 2, 2010 |
| Cash flows from operating activities: | | |
| Net income | \$ 13,289 | \$ 3,837 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Stock-based compensation | 693 | 610 |
| Net periodic pension benefit cost | 176 | 109 |
| Depreciation and amortization | 3,155 | 3,259 |
| Deferred income taxes | 726 | 284 |
| Bad debt provision | 295 | (318) |
| Changes in operating assets and liabilities: | | |
| Accounts and unbilled contracts receivable | 2,333 | (8,707) |
| Inventories | (3,569) | (839) |
| Prepaid expenses | (867) | (1,223) |
| Other assets | 1,147 | 1 |
| Accounts payable | (1,517) | (496) |
| Accrued payroll and related costs | (7,465) | 189 |
| Advance payments from customers | (1,614) | 4,216 |
| Accrued warranty costs | (696) | 277 |
| Other | (315) | 486 |
| Net cash provided by operating activities | 5,771 | 1,685 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (2,250) | (1,782) |
| Cash flows from financing activities: | | |
| Net receipts (repayments) under short-term borrowings | 9 | (40) |
| Cash dividends | (80) | (2,484) |
| Proceeds from exercise of stock options and employee stock purchase plan | 1,123 | 343 |
| Payments to purchase and retire common stock | - | (1,433) |
| Net cash provided by (used in) financing activities | 1,052 | (3,614) |
| Effect of exchange rate on changes in cash | (903) | (1,493) |
| Net increase (decrease) in cash and cash equivalents | 3,670 | (5,204) |
| Cash and cash equivalents, at beginning of period | 76,611 | 118,885 |
| Cash and cash equivalents, at end of period | \$ 80,281 | \$ 113,681 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the period for - | | |
| Interest | \$ 399 | \$ 389 |

| | | |
|--------------|---------|---------|
| Income taxes | \$3,176 | \$1,964 |
|--------------|---------|---------|

The accompanying condensed notes to consolidated financial statements are an integral part of these statements.

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MTS SYSTEMS CORPORATION
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Basis of Presentation

The consolidated financial statements include the accounts of MTS Systems Corporation and its wholly owned subsidiaries (the "Company"). All significant intercompany balances and transactions have been eliminated.

The interim consolidated financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). The information furnished in these consolidated financial statements includes normal recurring adjustments and reflects all adjustments which are, in the opinion of management, necessary for a fair presentation of such financial statements. The consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP"), which require the Company to make estimates and assumptions that affect amounts reported. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to SEC rules and regulations. The accompanying consolidated financial statements of the Company should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended October 2, 2010 filed with the SEC. Interim results of operations for the three-month period ended January 1, 2011 are not necessarily indicative of the results to be expected for the full year.

Summary of Significant Accounting Policies

The Company believes that of its significant accounting policies, the following are particularly important to the portrayal of the Company's results of operations and financial position and may require the application of a higher level of judgment by the Company's management and, as a result, are subject to an inherent degree of uncertainty.

Revenue Recognition. The Company recognizes revenue on a sales arrangement when it is realized or realizable and earned, which occurs when all of the following criteria have been met: persuasive evidence of an arrangement exists; delivery and title transfer has occurred or services have been rendered; the sales price is fixed and determinable; collectibility is reasonably assured; and all significant obligations to the customer have been fulfilled.

Orders that are manufactured and delivered in less than six months with routine installations and no special acceptance protocols may contain multiple elements for revenue recognition purposes. The Company considers each deliverable that provides value to the customer on a standalone basis a separable element. Separable elements in these arrangements may include the design and manufacture of hardware and essential software, installation services, training and/or post contract software maintenance and support. The Company initially allocates consideration to each separable element using the relative selling price method. Selling prices are determined by the Company based on either vendor-specific objective evidence ("VSOE") (the actual selling prices of similar products and services sold on a standalone basis) or, in the absence of VSOE, the Company's best estimate of the selling price. Factors considered by the Company in determining estimated selling prices for applicable elements generally include overall economic conditions, customer demand, costs incurred by the Company to provide the deliverable, as well as the Company's historical pricing practices. Under these arrangements, revenue associated with each delivered element is recognized in an amount equal to the lesser of the consideration initially allocated to the delivered element or the amount for which payment is not deemed contingent upon future delivery of other elements in the arrangement. Under arrangements where special acceptance protocols exist, installation services and training are not considered separable. Accordingly, revenue for the entire arrangement is recognized upon the completion of installation, training and fulfillment of any other significant obligations specific to the terms of the arrangement. Arrangements that do not

contain any separable elements are typically recognized when the products are shipped and title has transferred to the customer.

Certain contractual arrangements require longer production periods, generally longer than six months (long-term contracts), and may contain non-routine installations and special acceptance protocols. These arrangements often include hardware and essential software, installation services, training and support. Long-term contractual arrangements involving essential software typically include significant production, modification, and customization. For long-term arrangements with essential software and all other long-term arrangements with complex installations and/or unusual acceptance protocols, revenue is recognized using the percentage-of-completion method, based on the cost incurred to-date relative to estimated total cost of the contract. Elements of an arrangement that do not separately fall within the scope of the percentage of completion method (e.g. training and post contract software maintenance and support) are recognized as the service is provided in amounts determined based on VSOE.

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Under the terms of the Company's long-term contracts, revenue recognized using the percentage-of-completion method may not, in certain circumstances, be invoiced until completion of contractual milestones, upon shipment of the equipment, or upon installation and acceptance by the customer. Unbilled amounts for these contracts appear in the Consolidated Balance Sheets as Unbilled Accounts Receivable.

Revenue from arrangements for services such as maintenance, repair, consulting and technical support are recognized either as the service is performed or ratably over a defined contractual period for service maintenance contracts. Revenue from post contract software maintenance and support services is recognized ratably over the defined contractual period of the maintenance agreement.

The Company's sales arrangements typically do not include specific performance-, cancellation-, termination-, or refund-type provisions. In the event a customer cancels a contractual arrangement, the Company would typically be entitled to receive reimbursement from the customer for actual costs incurred under the arrangement plus a reasonable margin.

Revenue is recorded net of taxes collected from customers that are remitted to governmental authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

Inventories. Inventories consist of material, labor and overhead costs and are stated at the lower of cost or market, determined under the first-in, first-out accounting method. Inventories at January 1, 2011 and October 2, 2010 were as follows:

| | January 1, 2011 | October 2, 2010 |
|---|--------------------------|-----------------|
| | (expressed in thousands) | |
| Customer projects in various stages of completion | \$ 16,913 | \$ 16,126 |
| Components, assemblies and parts | 38,416 | 35,666 |
| Total | \$ 55,329 | \$ 51,792 |

Software Development Costs. The Company capitalizes certain software development costs related to software to be sold, leased, or otherwise marketed. Capitalized software development costs include purchased materials and services, salary and benefits of the Company's development and technical support staff, and other costs associated with the development of new products and services. Software development costs are expensed as incurred until technological feasibility has been established, at which time future costs incurred are capitalized until the product is available for general release to the public. Based on the Company's product development process, technological feasibility is generally established once product and detailed program designs have been completed, uncertainties related to high-risk development issues have been resolved through coding and testing, and the Company has established that the necessary skills, hardware, and software technology are available for production of the product. Once a software product is available for general release to the public, capitalized development costs associated with that product will begin to be amortized to cost of sales over the product's estimated economic life, using the greater of straight-line or a method that results in cost recognition in future periods that is consistent with the anticipated timing of product revenue recognition.

The Company's capitalized software development costs are subject to an ongoing assessment of recoverability, which is impacted by estimates and assumptions of future revenues and expenses for these software products, as well as other factors such as changes in product technologies. Any portion of unamortized capitalized software development costs that are determined to be in excess of net realizable value will be expensed in the period such a determination is made. Amortization expense for software development costs for both of the three-month periods ended January 1, 2011 and January 2, 2010 was \$0.4 million. See Note 3 to the Consolidated Financial Statements for additional information on capitalized software development costs.

Impairment of Long-Lived Assets. The Company reviews the carrying value of long-lived assets or asset groups, such as property and equipment and intangibles subject to amortization, when events or changes in circumstances such as market value, asset utilization, physical change, legal factors, or other matters indicate that the carrying value may not be recoverable. When this review indicates the carrying value of an asset or asset group exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or asset group, the Company recognizes an asset impairment charge against operations. The amount of the impairment loss recorded is the amount by which the carrying value of the impaired asset or asset group exceeds its fair value.

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Goodwill. Goodwill represents the excess of acquisition costs over the fair value of the net assets of businesses acquired. Goodwill is not amortized to income, but instead tested for impairment at least annually, during the fourth quarter of each fiscal year. Goodwill is also tested for impairment as changes in circumstances occur indicating that the carrying value may not be recoverable. Goodwill impairment testing first requires a comparison of the fair value of each reporting unit to the carrying value. If the carrying value of the reporting unit exceeds fair value, goodwill is considered impaired.

Warranty Obligations. Sales of the Company's products and systems are subject to limited warranty obligations that are included in customer contracts. For sales that include installation services, warranty obligations typically extend for a period of twelve to twenty-four months from the date of either shipment or acceptance. Product obligations typically extend for a period of twelve to twenty-four months from the date of purchase. Under the terms of these warranties, the Company is obligated to repair or replace any components or assemblies it deems defective due to workmanship or materials. The Company reserves the right to reject warranty claims where it determines that failure is due to normal wear, customer modifications, improper maintenance, or misuse. The Company records general warranty provisions based on an estimated warranty expense percentage applied to current period revenue. The percentage applied reflects historical warranty claims experience over the preceding twelve-month period. Both the experience percentage and the warranty liability are evaluated on an ongoing basis for adequacy. In addition, warranty provisions are also recognized for certain nonrecurring product claims that are individually significant. Warranty provisions and claims for the three-month periods ended January 1, 2011 and January 2, 2010 were as follows:

| | Three Months Ended | |
|---------------------------------------|--------------------------|--------------------|
| | January 1, 2011 | January 2, 2010 |
| | (expressed in thousands) | |
| Beginning balance | \$ 7,505 | \$ 9,774 |
| Warranty provisions | 513 | 2,277 |
| Warranty claims | (1,448) | (1,999) |
| Adjustments to preexisting warranties | 239 | - |
| Currency translation | (74) | (51) |
| Ending balance | \$ 6,735 | \$ 10,001 |

Income Taxes. The Company records a tax provision for the anticipated tax consequences of the reported results of operations. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable income in effect for the years in which those deferred tax assets and liabilities are expected to be realized or settled. The Company records a valuation allowance to reduce deferred tax assets to the amount that is believed more likely than not to be realized. The Company believes it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with the tax effects of the deferred tax liabilities, will be sufficient to fully recover the remaining net realizable value of its deferred tax assets. In the event that all or part of the net deferred tax assets are determined not to be realizable in the future, an adjustment to the valuation allowance would be charged to earnings in the period such determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with management's expectations could have a material impact on the Company's financial condition and operating results. See Note 11 in the Condensed Notes to Consolidated Financial Statements for additional information on income taxes.

2. Recent Accounting Pronouncements

In October 2009, the FASB issued ASU 2009-14, Software (Topic 985) – "Certain Revenue Arrangements that Include Software Elements." ASU 2009-14 changes the accounting model for revenue arrangements that include both tangible

products and software elements. Specifically, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the software revenue guidance in Accounting Standards Codification ("ASC") Subtopic 985-605, "Software-Revenue Recognition." In addition, ASU 2009-14 requires that hardware components of a tangible product containing software components be excluded from the software revenue guidance. The provisions of ASU 2009-14 are effective prospectively for revenue arrangements entered into or materially modified by the Company as of the beginning of the current fiscal year. The Company's adoption of the provisions of ASU 2009-14 during the three-month period ended January 1, 2011 did not have a material impact on its consolidated financial statements. The Company incorporated the appropriate disclosure provisions of ASU 2009-14 upon adoption.

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In October 2009, the FASB issued ASU 2009-13, "Revenue Recognition (Topic 605) - Multiple-Deliverable Revenue Arrangements." ASU 2009-13 amends the criteria established in ASC 605-25, "Revenue Recognition – Multiple Element Arrangements," for separating consideration in multiple-deliverable arrangements. This guidance establishes a selling price hierarchy for determining the selling price of a deliverable. Specifically, the selling price used for each deliverable is based on: (a) vendor-specific objective evidence if available; (b) third-party evidence if vendor-specific objective evidence is not available; or (c) estimated selling price if neither vendor-specific objective evidence nor third-party evidence is available. In addition, ASU 2009-13 eliminates the residual method of allocation and requires that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. Also, ASU 2009-13 significantly expands required disclosures related to a vendor's multiple-deliverable revenue arrangements. The provisions of ASU 2009-13 were effective prospectively for revenue arrangements entered into or materially modified by the Company as of the beginning of the current fiscal year. The Company's adoption of the provisions of ASU 2009-13 during the three-month period ended January 1, 2011 did not have a material impact on its consolidated financial statements. The Company incorporated the appropriate disclosure provisions of ASU 2009-13 upon adoption.

3. Capital Assets

Property and Equipment

Property and equipment at January 1, 2011 and October 2, 2010 consist of the following:

| | January 1, 2011 | October 2, 2010 |
|-------------------------------|--------------------------|--------------------|
| | (expressed in thousands) | |
| Land and improvements | \$ 1,712 | \$ 1,714 |
| Buildings and improvements | 52,161 | 52,535 |
| Machinery and equipment | 105,371 | 104,405 |
| Total | 159,244 | 158,654 |
| Less accumulated depreciation | (103,363) | (102,210) |
| Property and equipment, net | \$ 55,881 | \$ 56,444 |

Goodwill

The changes to the carrying amount of goodwill for the three-month period ended January 1, 2011 were as follows:

| | Three Months Ended | |
|----------------------|--------------------------|--------------------|
| | January 1, 2011 | January 2, 2010 |
| | (expressed in thousands) | |
| Beginning balance | \$ 15,429 | \$ 15,206 |
| Currency translation | 121 | (32) |
| Ending balance | \$ 15,550 | \$ 15,174 |

At January 1, 2011, \$14.0 million and \$1.6 million of goodwill was associated with the Test and Sensors segments, respectively. At January 2, 2010, \$13.5 million and \$1.7 million of goodwill was associated with the Test and Sensors segments, respectively.

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Other Intangible Assets

Other intangible assets at January 1, 2011 and October 2, 2010 consist of the following:

| | January 1, 2011 | | | Weighted Average Useful Life (in Years) |
|----------------------------|-----------------------------|-----------------------------|--------------------------|--|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value | |
| | (expressed in thousands) | | | |
| Software development costs | \$12,344 | \$ (2,439) | \$9,905 | 6.0 |
| Patents | 9,587 | (1,533) | 8,054 | 15.3 |
| Trademarks and trade names | 5,748 | (655) | 5,093 | 30.2 |
| Non-compete agreements | 2,512 | (1,884) | 628 | 3.0 |
| Land-use rights | 1,180 | (49) | 1,131 | 47.8 |
| Total | \$31,371 | \$ (6,560) | \$24,811 | 14.5 |

| | October 2, 2010 | | | Weighted Average Useful Life (in Years) |
|----------------------------|-----------------------------|-----------------------------|--------------------------|--|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value | |
| | (expressed in thousands) | | | |
| Software development costs | \$11,640 | \$ (2,062) | \$9,578 | 6.0 |
| Patents | 9,484 | (1,347) | \$8,137 | 15.3 |
| Trademarks and trade names | 5,689 | (603) | \$5,086 | 30.2 |
| Non-compete agreements | 2,485 | (1,657) | \$828 | 3.0 |
| Land-use rights | 1,167 | (43) | \$1,124 | 47.8 |
| Total | \$30,465 | \$ (5,712) | \$24,753 | 14.7 |

Amortization expense recognized during both the three-month periods ended January 1, 2011 and January 2, 2010 was \$0.8 million.

4. Stock Purchases

During the fourth quarter of fiscal year 2010, the Company entered into an accelerated share purchase agreement with an unrelated third party investment bank. This forward contract is indexed to, and potentially settled in, the Company's common stock. This forward contract meets the requirements of ASC 815-40 to be classified as permanent equity. In connection with the agreement, the Company made an initial \$25.0 million payment to the investment bank and immediately received approximately 0.9 million shares of its common stock. Effective as of the date of the initial stock purchase, the transaction was accounted for as a share retirement resulting in a reduction of common stock and retained earnings of \$0.2 million and \$24.8 million, respectively. As long as the forward contract continues to meet the requirements to be classified as permanent equity, the Company will not record future changes in its fair value. The contract continued to meet those requirements as of January 1, 2011 and the Company expects it will continue to meet those requirements through the settlement date. The agreement expires in the third quarter of fiscal year 2011, however the investment bank has the right to accelerate the end of the purchase period. Upon settlement of the contract, the Company will adjust common stock and retained earnings to reflect the final settlement amount.

The specific number of shares that the Company will ultimately purchase under the accelerated share purchase agreement will be based on the volume weighted average price ("VWAP") of the Company's common stock during the

purchase period, less an agreed upon discount, unless such discounted VWAP were to fall below a specified floor price, in which case the floor price would be in effect. Because the floor price exceeds the initial share purchase price in effect at the inception of the agreement, the Company will, at a minimum, be required to deliver, at its option, either approximately 126,000 additional shares of its common stock or \$4.0 million to the investment bank in order to settle this loss position. The maximum amount of shares of common stock the Company can be required to issue to settle a loss position cannot exceed 2.7 million. At January 1, 2011, the Company's VWAP exceeded the floor price. As a result, if the accelerated share purchase agreement had been settled on that date, the Company would have been required to deliver to the investment bank either approximately 148,000 shares of its common stock or \$4.9 million. For every \$1.00 increase in the Company's VWAP, the settlement amount changes by approximately 30,000 shares of the Company's common stock or \$0.9 million.

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5. Earnings Per Common Share

Basic earnings per share are computed by dividing net earnings by the daily weighted average number of common shares outstanding during the applicable periods. Diluted earnings per share include the potentially dilutive effect of common shares issued in connection with outstanding stock-based compensation options and grants, using the treasury stock method. Under the treasury stock method, shares associated with certain stock options have been excluded from the diluted weighted average shares outstanding calculation because the exercise of those options would lead to a net reduction in common shares outstanding. As a result, stock options to acquire 0.8 million and 1.2 million weighted common shares have been excluded from diluted weighted shares outstanding for the three-month periods ended January 1, 2011 and January 2, 2010, respectively. The potentially dilutive effect of common shares issued in connection with outstanding stock options is determined based on net income. A reconciliation of these amounts is as follows:

| | Three Months Ended | |
|--|--|--------------------|
| | January 1, 2011 | January 2, 2010 |
| | (expressed in thousands, except per share data) | |
| Net income | \$ 13,289 | \$ 3,837 |
| Weighted average common shares outstanding | 15,305 | 16,579 |
| Dilutive potential common shares | 221 | 38 |
| Total diluted weighted shares outstanding | 15,526 | 16,617 |
| Earnings per share: | | |
| Basic | \$ 0.87 | \$ 0.23 |
| Diluted | \$ 0.86 | \$ 0.23 |

6. Business Segment Information

The Company's Chief Executive Officer and management regularly review financial information for the Company's three discrete operating segments. Based on similarities in the economic characteristics, nature of products and services, production processes, type or class of customer served, method of distribution and regulatory environments, the operating segments have been aggregated for financial statement purposes and categorized into two reportable segments, "Test" and "Sensors." The Test segment provides testing equipment, systems, and services to the ground vehicles, aerospace, and infrastructure markets. The Sensors segment provides high-performance position sensors for a variety of industrial and vehicular applications.

The accounting policies of the reportable segments are the same as those described in Note 1 to the Consolidated Financial Statements found in the Company's Annual Report on Form 10-K for the fiscal year ended October 2, 2010. In evaluating each segment's performance, management focuses on income from operations. This measure excludes interest income and expense, income taxes and other non-operating items. Corporate expenses, including costs associated with various support functions such as human resources, information technology, finance and accounting, and general and administrative costs, are allocated to the reportable segments primarily on the basis of revenue.

Financial information by reportable segment for the three-month periods ended January 1, 2011 and January 2, 2010 was as follows:

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Three Months Ended
 January 1, January 2,
 2011 2010
 (expressed in thousands)

| | | |
|------------------------------------|------------|-----------|
| Revenue by Segment: | | |
| Test | \$ 82,542 | \$ 71,873 |
| Sensors | 23,334 | 17,087 |
| Total revenue | \$ 105,876 | \$ 88,960 |
| Income from Operations by Segment: | | |
| Test | \$ 12,753 | \$ 3,237 |
| Sensors | 5,721 | 3,191 |
| Total income from operations | \$ 18,474 | \$ 6,428 |

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7. Derivative Instruments and Hedging Activities

The Company's results of operations could be materially impacted by changes in foreign currency exchange rates, as well as interest rates on its floating rate indebtedness. In an effort to manage exposure to these risks, the Company periodically enters into forward and option currency exchange contracts and interest rate swaps. Because the market value of these hedging contracts is derived from current market rates, they are classified as derivative financial instruments. The Company does not use derivatives for speculative or trading purposes. The derivative contracts contain credit risk to the extent that the Company's bank counterparties may be unable to meet the terms of the agreements. The amount of such credit risk is generally limited to the unrealized gains, if any, in such contracts. Such risk is minimized by limiting those counterparties to major financial institutions of high credit quality. For derivative instruments executed under master netting arrangements, the Company has the contractual right to offset fair value amounts recognized for the right to reclaim cash collateral with obligations to return cash collateral. The Company does not offset fair value amounts recognized on these derivative instruments. As of January 1, 2011, the Company does not have any foreign exchange contracts with credit-risk related contingent features.

The Company's foreign exchange cash flow hedges and interest rate swaps are designated and qualify as hedging instruments pursuant to ASC 815. The Company also has derivatives which are accounted for and reported under the guidance of ASC 830-20-10. Regardless of designation for accounting purposes, the Company believes that all of its derivative instruments are hedges of transactional risk exposures. The fair value of the Company's outstanding designated and undesignated derivative assets and liabilities were reported in the January 1, 2011 and October 2, 2010 Consolidated Balance Sheet as follows:

| | January 1, 2011 | |
|--|--|---------------------------------|
| | Prepaid Expenses and Other Current Assets | Other Accrued Liabilities |
| | (expressed in thousands) | |
| Designated hedge derivatives: | | |
| Foreign exchange cash flow hedges | \$ 93 | \$ 580 |
| Interest rate swaps | - | 1,101 |
| Total designated hedge derivatives | 93 | 1,681 |
| Derivatives not designated as hedges: | | |
| Foreign exchange balance sheet derivatives | - | 56 |
| Total hedge and other derivatives | \$ 93 | \$ 1,737 |
| | | |
| | October 2, 2010 | |
| | Prepaid Expenses and Other Current Assets | Other Accrued Liabilities |
| | (expressed in thousands) | |
| Designated hedge derivatives: | | |
| Foreign exchange cash flow hedges | \$ 126 | \$ 547 |
| Interest rate swaps | - | 1,406 |
| Total designated hedge derivatives | 126 | 1,953 |
| Derivatives not designated as hedges: | | |
| Foreign exchange balance sheet derivatives | - | 1,023 |
| Total hedge and other derivatives | \$ 126 | \$ 2,976 |

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Foreign Exchange Cash Flow Hedges

Currency exchange contracts utilized to maintain the functional currency value of expected financial transactions denominated in foreign currencies are designated as cash flow hedges. Qualifying gains and losses related to changes in the market value of these contracts are reported as a component of Accumulated Other Comprehensive Income (“AOCI”) within Shareholders’ Investment on the Consolidated Balance Sheets and reclassified into earnings in the same period during which the underlying hedged transaction affects earnings. The effective portion of the cash flow hedges represents the change in fair value of the hedge that offsets the change in the functional currency value of the hedged item. The Company periodically assesses whether its currency exchange contracts are effective and, when a contract is determined to be no longer effective as a hedge, the Company discontinues hedge accounting prospectively. Subsequent changes in the market value of ineffective currency exchange contracts are recognized as an increase or decrease in Revenue on the Consolidated Statement of Income, as that is the same line item upon which the underlying hedged transaction is reported.

At January 1, 2011 and January 2, 2010, the Company had outstanding cash flow hedge currency exchange contracts with gross notional U.S. dollar equivalent amounts of \$28.2 million and \$10.5 million, respectively. Upon netting offsetting contracts to sell foreign currencies against contracts to purchase foreign currencies, irrespective of contract maturity dates, the net notional U.S. dollar equivalent amount of contracts outstanding were \$24.0 million and \$10.4 million at January 1, 2011 and January 2, 2010, respectively. At January 1, 2011 the net market value of the foreign currency exchange contracts was a net liability of \$0.5 million, consisting of \$0.6 million in liabilities and \$0.1 million in offsetting assets. At January 2, 2010 the net market value of the foreign currency exchange contracts was a net asset of less than \$0.1 million, consisting of \$0.1 million in assets and less than \$0.1 million in offsetting liabilities.

The pretax amounts recognized in AOCI on currency exchange contracts for the three-month periods ended January 1, 2011 and January 2, 2010, including gains (losses) reclassified into earnings in the Consolidated Statements of Income and gains (losses) recognized in other comprehensive income (“OCI”), are as follows:

| | Three Months Ended | |
|---|--------------------------|--------------------|
| | January, 1 2011 | January, 2 2010 |
| | (expressed in thousands) | |
| Beginning unrealized net loss in AOCI | \$ (384) | \$ (519) |
| Net loss reclassified into Revenue (effective portion) | 159 | 354 |
| Net loss reclassified into Revenue upon the removal of a hedge designation on an underlying foreign currency transaction that was cancelled | 7 | - |
| Net (loss) gain recognized in OCI (effective portion) | (51) | 173 |
| Ending unrealized net (loss) gain in AOCI | \$ (269) | \$ 8 |

The amount recognized in earnings as a result of the ineffectiveness of cash flow hedges was less than \$0.1 million in each of the three-month periods ended January 1, 2011 and January 2, 2010. At January 1, 2011 and January 2, 2010, the amount projected to be reclassified from AOCI into earnings in the next 12 months was a net loss of \$0.4 million and a net gain of less than \$0.1 million, respectively. The maximum remaining maturity of any forward or optional contract at January 1, 2011 and January 2, 2010 was 3.6 years and 0.8 years, respectively.

Interest Rate Swaps

The Company also uses floating to fixed interest rate swaps to mitigate its exposure to changes in interest rates related to a portion of its floating rate indebtedness. The Company has designated these interest rate swaps as cash flow hedges. As a result, changes in the fair value of the interest rate swap are recorded in AOCI within Shareholders’

Investment on the Consolidated Balance Sheets.

At January 1, 2011 and January 2, 2010, the Company had outstanding interest rate swaps with total notional amounts of \$24.0 million and \$40.0 million, respectively. Every month, the Company pays fixed interest on these interest rate swaps in exchange for interest received at monthly U.S. LIBOR. At January 1, 2011 and January 2, 2010, the weighted-average fixed interest rate payable by the Company under the terms of the interest rate swap arrangements was 3.94% and 3.31%, respectively. Because there is a 45 basis-point differential between the variable-rate interest paid by the Company on its outstanding credit facility borrowings and the variable-rate interest received on the interest rate swaps, the overall effective interest rate applicable to outstanding credit facility borrowings at January 1, 2011 and January 2, 2010, covered under both the terms of the credit facility borrowings as well as the corresponding interest rate swap agreements, was 4.39% and 3.76%, respectively. The total market value of the interest rate swaps at January 1, 2011 and January 2, 2010 was a liability of \$1.1 million and \$1.6 million, respectively.

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The pretax amounts recognized in AOCI on interest rate swaps for the three-month periods ended January 1, 2011 and January 2, 2010 are as follows:

| | Three Months Ended | |
|---|--------------------------|--------------------|
| | January, 1 2011 | January, 2 2010 |
| | (expressed in thousands) | |
| Beginning unrealized net loss in AOCI | \$ (1,406) | \$ (1,894) |
| Net loss reclassified into Interest expense (effective portion) | 297 | 311 |
| Net gain (loss) recognized in OCI (effective portion) | 8 | (63) |
| Ending unrealized net loss in AOCI | \$ (1,101) | \$ (1,646) |

Foreign Exchange Balance Sheet Derivatives

The Company also uses foreign exchange derivative contracts to maintain the functional currency value of monetary assets and liabilities denominated in non-functional foreign currencies. The gains and losses related to the changes in the market value of these derivative contracts are included in Other Income (Expense), net on the Consolidated Statement of Income in the current period.

At January 1, 2011 and January 2, 2010, the Company had outstanding balance sheet foreign exchange balance sheet derivative contracts with gross notional U.S. dollar equivalent amounts of \$39.0 million and \$30.6 million, respectively. Upon netting offsetting contracts by counterparty banks to sell foreign currencies against contracts to purchase foreign currencies, irrespective of contract maturity dates, the net notional U.S. dollar equivalent amount of contracts outstanding at January 1, 2011 and January 2, 2010 was less than \$0.1 million and \$4.8 million, respectively. At January 1, 2011, the net market value of the balance sheet foreign currency exchange derivative contracts was a net liability of less than \$0.1 million. At January 2, 2010, the net market value of the balance sheet foreign currency exchange derivative contracts was a net liability of \$0.5 million, consisting of \$0.6 million in liabilities and \$0.1 million in offsetting assets.

The net gains (losses) recognized in the Consolidated Statements of Income on balance sheet currency exchange derivative contracts for the three-month periods ended January 1, 2011 and January 2, 2010 are as follows:

| | Three Months Ended | |
|--|--------------------------|--------------------|
| | January, 1 2011 | January, 2 2010 |
| | (expressed in thousands) | |
| Net gain recognized in Other income (expense), net | \$ 129 | \$ 97 |

8. Fair Value Measurements

In determining the fair value of financial assets and liabilities, the Company currently utilizes market data or other assumptions that it believes market participants would use in pricing the asset or liability, and adjusts for non-performance and/or other risk associated with the Company as well as counterparties, as appropriate.

ASC 820-10 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels of the fair value hierarchy are as follows:

Level 1: Inputs are unadjusted quoted prices which are available in active markets for identical assets or liabilities.

Level 2: Inputs are other-than-quoted prices in active markets included in Level 1, which are either directly or indirectly observable, such as quoted prices for similar assets or liabilities in active markets, or for identical assets or liabilities in inactive markets. Level 2 includes those financial assets and liabilities that are valued using models or other valuation methodologies. The models used are primarily industry-standard, and consider various assumptions, including quoted forward prices, time value, volatility factors, and current contractual prices for the underlying instruments, as well as other relevant economic measures. Substantially all of the assumptions used in these valuation models are observable in the marketplace.

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Level 3: Inputs are unobservable and reflect the Company's own assumptions used to measure assets and liabilities at fair value.

The hierarchy gives the highest priority to Level 1, as this level provides the most reliable measure of fair value, while giving the lowest priority to Level 3.

Financial Instruments Measured at Fair Value on a Recurring Basis

As of January 1, 2011 and October 2, 2010, financial assets and liabilities subject to fair value measurements on a recurring basis are as follows:

| | January 1, 2011 | | | |
|------------------------|--------------------------|----------|---------|----------|
| | Level 1 | Level 2 | Level 3 | Total |
| | (expressed in thousands) | | | |
| Assets: | | | | |
| Currency contracts(1) | \$ - | \$ 93 | \$ - | \$ 93 |
| Total assets | \$ - | \$ 93 | \$ - | \$ 93 |
| Liabilities: | | | | |
| Currency contracts(1) | \$ - | \$ 636 | \$ - | \$ 636 |
| Interest rate swaps(2) | | 1,101 | - | 1,101 |
| Total liabilities | \$ - | \$ 1,737 | \$ - | \$ 1,737 |
| | | | | |
| | October 2, 2010 | | | |
| | Level 1 | Level 2 | Level 3 | Total |
| | (expressed in thousands) | | | |
| Assets: | | | | |
| Currency contracts(1) | \$ - | \$ 126 | \$ - | \$ 126 |
| Total assets | \$ - | \$ 126 | \$ - | \$ 126 |
| Liabilities: | | | | |
| Currency contracts(1) | \$ - | \$ 1,570 | \$ - | \$ 1,570 |
| Interest rate swaps(2) | | 1,406 | - | 1,406 |
| Total liabilities | \$ - | \$ 2,976 | \$ - | \$ 2,976 |

(1) Based on observable market transactions of spot currency rates and forward currency rates on equivalently-termed instruments.

(2) Based on LIBOR and swap rates.

Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis

The Company's goodwill, intangible assets and other long-lived assets are nonfinancial assets that were acquired either as part of a business combination, individually or with a group of other assets. These nonfinancial assets were initially, and are currently, measured and recognized at amounts equal to the fair value determined as of the date of acquisition. Periodically, these nonfinancial assets are tested for impairment, by comparing their respective carrying values to the estimated fair value of the reporting unit or asset group in which they reside. In the event any of these nonfinancial assets were to become impaired, the Company would recognize an impairment loss equal to the amount by which the carrying value of the reporting unit, impaired asset or asset group exceeds its estimated fair value. Fair value measurements of reporting units are estimated using an income approach involving discounted or undiscounted cash flow models that contain certain Level 3 inputs requiring management judgment, including projections of economic conditions and customer demand, revenue and margins, changes in competition, operating costs, working capital requirements, and new product introductions. Fair value measurements of the reporting units associated with the

Company's goodwill balances are estimated at least annually in the fourth quarter of each fiscal year for purposes of impairment testing. Fair value measurements associated with the Company's intangible assets and other long-lived assets are estimated when events or changes in circumstances such as market value, asset utilization, physical change, legal factors, or other matters indicate that the carrying value may not be recoverable.

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Financial Instruments not Measured at Fair Value

Certain of the Company's financial instruments are not measured at fair value but nevertheless are recorded at carrying amounts approximating fair value, based on their short-term nature or variable interest rate. These financial instruments include cash and cash equivalents, accounts receivable, accounts payable and short-term borrowings.

9. Comprehensive Income

Comprehensive Income, a component of Shareholders' Investment, consists of net income, pension benefit plan adjustments, derivative instrument gains or losses, and foreign currency translation adjustments.

Comprehensive Income for the periods ended January 1, 2011 and January 2, 2010 was as follows:

| | Three Months Ended | |
|---|--------------------------|--------------------|
| | January 1, 2011 | January 2, 2010 |
| | (expressed in thousands) | |
| Net income | \$ 13,289 | \$ 3,837 |
| Change in cumulative translation adjustment | (1,331) | (2,200) |
| Pension benefit plan adjustments | (326) | 57 |
| Change in unrealized loss on derivative instruments | 261 | 484 |
| Comprehensive income | \$ 11,893 | \$ 2,178 |

10. Financing

Short-term borrowings at January 1, 2011 and October 2, 2010 consist of the following:

| | January 1, 2011 | October 2, 2010 |
|--|--------------------------|--------------------|
| | (expressed in thousands) | |
| Bank line of credit, monthly U.S. LIBOR plus 45 basis points (0.76% rate in effect at January 1, 2011), maturing January 2011, with optional month-to-month term renewal and loan repricing until 2012 | \$ 40,000 | \$ 40,000 |
| Notes payable, non-interest bearing | 243 | 229 |
| Total short-term borrowings | \$ 40,243 | \$ 40,229 |

The Company's credit facility provides for up to \$75.0 million for working capital financing, acquisitions, share purchases, or other general corporate purposes and expires in December 2012. At January 1, 2011 and October 2, 2010, outstanding borrowings under the credit facility were \$40.0 million. At January 1, 2011, the Company had outstanding letters of credit drawn from the credit facility totaling \$13.1 million, leaving approximately \$21.9 million of unused borrowing capacity. In order to mitigate its exposure to interest rate increases on certain of its floating rate indebtedness, the Company has entered into floating to fixed interest rate swaps. At January 1, 2011 and October 2, 2010, the Company had outstanding interest rate swaps with total notional amounts of \$24.0 and \$40.0 million, respectively. The Company intends to renew each of the applicable outstanding borrowings on the credit facility monthly throughout the entire term of the interest rate swap arrangement directly associated with the borrowing. Subsequent to January 1, 2011, the Company renewed each of the outstanding borrowings on the credit facility for an

additional month. See Note 7 in the Condensed Notes to Consolidated Financial Statements for additional information on the interest rate swaps.

11. Income Taxes

As of January 1, 2011, the Company's liability for unrecognized tax benefits was \$4.6 million, of which \$1.7 million would favorably affect the Company's effective tax rate if recognized. At October 2, 2010, the Company's liability for unrecognized tax benefits was \$4.2 million, of which \$1.3 million would favorably affect the Company's effective tax rate if recognized. As of January 1, 2011, the Company does not expect significant changes in the amount of unrecognized tax benefits during the next twelve months.

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Legislation was enacted in December of fiscal year 2011 that extended United States research and development credits, with an effective date that is retroactive to January 1, 2010. As a result of this legislation, the Company recognized a tax benefit of approximately \$1.0 million during the three-month period ended January 1, 2011.

12. Retirement Benefit Plan

One of the Company's German subsidiaries has a non-contributory, defined benefit retirement plan for eligible employees. This plan provides benefits based on the employee's years of service and compensation during the years immediately preceding retirement, early retirement, termination, disability, or death, as defined in the plan.

The cost for the plan for the periods ended January 1, 2011 and January 2, 2010 included the following components:

| | Three Months Ended | |
|--------------------------------|--------------------------|--------------------|
| | January 1, 2011 | January 2, 2010 |
| | (expressed in thousands) | |
| Service cost | \$ 117 | \$ 95 |
| Interest cost | 194 | 213 |
| Expected return on plan assets | (172) | (203) |
| Net amortization and deferral | 37 | 4 |
| Net periodic benefit cost | \$ 176 | \$ 109 |

The weighted average expected long-term rate of return on plan assets used to determine the net periodic benefit cost for the three-month periods ended January 1, 2011 and January 2, 2010 was 5.2% and 5.9%, respectively.

13. Subsequent Events

In January 2011, the Company was informed that the United States Department of Commerce and the United States Attorney's Office for the District of Minnesota were investigating whether the Company had accurately certified to a certain Federal Acquisition Regulation (FAR) since March 2008. The Company received an administrative subpoena from the United States Department of Commerce requesting, among other items, that all documents related to the certification made on the government's Online Representations and Certifications Application (ORCA) web site be preserved, retained and produced. We are cooperating with the government's investigation. At this point, the outcome or range of loss, if any, to resolve this matter cannot be determined.

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

Forward-Looking Statements

Statements contained in this Quarterly Report on Form 10-Q that are not statements of historical fact should be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the “Act”). In addition, certain statements in our future filings with the SEC, in press releases, and in oral and written statements made by us or with our approval that are not statements of historical fact constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenue, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other statements concerning future financial performance; (ii) statements of our plans and objectives by our management or Board of Directors, including those relating to products or services; (iii) statements of assumptions underlying such statements; (iv) statements regarding business relationships with vendors, customers or collaborators; and (v) statements regarding products, their characteristics, performance, sales potential or effect in the hands of customers. Words such as “believes,” “anticipates,” “expects,” “intends,” “targeted,” “should,” “potential,” “goals,” “strategy,” similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to, those factors described in Part I, Item 1A, “Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended October 2, 2010. Such important factors include:

- The Company’s business is significantly international in scope, which poses multiple unique risks
 - Volatility in the global economy could adversely affect results
 - The Company’s business is subject to strong competition
 - The Company may not achieve its growth plans for the expansion of the business
 - The Company may experience difficulties obtaining the services of skilled employees
- The Company may fail to protect its intellectual property effectively, or may infringe upon the intellectual property of others
 - The business could be adversely affected by product liability and commercial litigation
 - The Company may experience difficulty obtaining materials or components for its products
 - Government regulation could impose significant costs and other constraints
- The sales, delivery and acceptance cycle for many of the Company’s products is irregular and may not develop as anticipated
 - The Company’s customers are in cyclical industries
 - Interest rate fluctuations could adversely affect results
 - The Company may be required to recognize impairment charges for long-lived assets

The performance of the Company’s business and its securities may be adversely affected by these factors and by other factors common to other businesses and investments, or to the general economy. Forward-looking statements are qualified by some or all of these risk factors. Therefore, you should consider these risk factors with caution and form your own critical and independent conclusions about the likely effect of these risk factors on our future performance. Forward-looking statements speak only as of the date on which such statements are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made to reflect the occurrence of unanticipated events or circumstances. Readers should carefully review the disclosures and the risk factors described in this and other documents we file from time to time with the SEC, including our reports on Forms 10-Q and 8-K to be filed by the Company in fiscal year 2011.

About MTS Systems Corporation

MTS Systems Corporation is a leading global supplier of test systems and industrial position sensors. The Company's testing hardware and software solutions help customers accelerate and improve their design, development, and manufacturing processes and are used for determining the mechanical behavior of materials, products, and structures. MTS' high-performance position sensors provide controls for a variety of industrial and vehicular applications. MTS had 1,948 employees and revenue of \$374 million for the fiscal year ended October 2, 2010.

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Summary of Financial Results

Three Months Ended January 1, 2011 (“First Quarter of Fiscal 2011”) Compared to Three Months Ended January 2, 2010 (“First Quarter of Fiscal 2010”)

Highlights for the First Quarter of Fiscal 2011 compared to the First Quarter of Fiscal 2010 include:

- Orders increased 29.6% to \$139.6 million, compared to \$107.7 million for the First Quarter of Fiscal 2010. This increase is comprised of 28.5% worldwide growth in the Test segment and 35.4% worldwide growth in the Sensors segment, partially offset by an estimated 2% unfavorable impact of currency translation. Orders in the quarter included two large (in excess of \$5.0 million) Test segment orders totaling approximately \$29 million, an increase of \$9 million compared to large Test segment order bookings in the First Quarter of Fiscal 2010.
- Backlog of undelivered orders was \$246.6 million, an increase of 33.8% compared to \$184.3 million at the end of the First Quarter of Fiscal 2010.
- Revenue increased 19.0% to \$105.9 million, compared to \$89.0 million for the First Quarter of Fiscal 2010. This increase was comprised of 14.9% growth in the Test Segment, resulting primarily from a 26.7% higher beginning backlog, and 36.3% growth in Sensors due to increased order volume in the quarter. In addition, currency translation unfavorably impacted revenue by an estimated 1%.
- Income from operations was \$18.5 million, compared to \$6.4 million for the First Quarter of Fiscal 2010. This increase was primarily driven by higher gross profit from increased volume, favorable product mix, and lower warranty expense.
- The effective tax rate for the First Quarter of Fiscal 2011 was 26.6%, a decrease of 6.1 percentage points compared to a tax rate of 32.7% for the First Quarter of Fiscal 2010. This decrease was primarily due to the enactment of tax legislation in the First Quarter of Fiscal 2011 that extended the United States research and development credits, with an effective date that is retroactive to January 1, 2010. The enactment of the research and development credits provided an additional tax benefit of \$1.0 million.
- Earnings per diluted share for the First Quarter of Fiscal 2011 increased \$0.63 to \$0.86, compared to \$0.23 for the First Quarter of Fiscal 2010. A lower tax rate, as well as reduced shares outstanding in the First Quarter of Fiscal 2011 favorably impacted earnings per diluted share by \$0.07 and \$0.06, respectively.

Detailed Financial Results

Total Company

Orders and Backlog

First Quarter of Fiscal 2011 Compared to First Quarter of Fiscal 2010

The following is a comparison of First Quarter of Fiscal 2011 and First Quarter of Fiscal 2010 orders, separately identifying the estimated impact of currency translation (in millions):

| Three Months Ended | Business | Estimated Currency | Three Months Ended |
|-----------------------|----------|-----------------------|-----------------------|
|-----------------------|----------|-----------------------|-----------------------|

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| | January 1, 2011 | Change | Translation | January 2, 2010 |
|--------|--------------------|---------|-------------|--------------------|
| Orders | \$ 139.6 | \$ 34.2 | \$ (2.3) | \$ 107.7 |

Orders totaled \$139.6 million, an increase of \$31.9 million, or 29.6%, compared to orders of \$107.7 million for the First Quarter of Fiscal 2010. This increase was primarily due to higher order volume across all geographies in both segments, including the previously mentioned \$9 million increase in large Test segment orders, partially offset by an estimated \$2.3 million unfavorable impact of currency translation.

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Backlog of undelivered orders at the end of the quarter was \$246.6 million, an increase of 33.8% from backlog of \$184.3 million at the end of the First Quarter of Fiscal 2010. While the Company's backlog is subject to order cancellations, the Company seldom experiences order cancellations larger than \$1.0 million.

Results of Operations

First Quarter of Fiscal 2011 Compared to First Quarter of Fiscal 2010

The following is a comparison of First Quarter of Fiscal 2011 and First Quarter of Fiscal 2010 statements of operations (in millions, except per share data):

| | Three Months Ended | | | | |
|-----------------------------|--------------------|--------------------|----------|------------|-----|
| | January 1, 2011 | January 2, 2010 | Variance | % Variance | |
| Revenue | \$ 105.9 | \$ 89.0 | \$ 16.9 | 19.0 | % |
| Cost of sales | 59.2 | 53.8 | 5.4 | 10.0 | % |
| Gross profit | 46.7 | 35.2 | 11.5 | 32.7 | % |
| Gross margin | 44.1 | % 39.5 | % 4.6 | | pts |
| Operating expenses: | | | | | |
| Selling and marketing | 16.6 | 16.0 | 0.6 | 3.8 | % |
| General administrative | 8.5 | 9.4 | (0.9) | -9.6 | % |
| Research and development | 3.1 | 3.4 | (0.3) | -8.8 | % |
| Total operating expenses | 28.2 | 28.8 | (0.6) | -2.1 | % |
| Income from operations | 18.5 | 6.4 | 12.1 | 189.1 | % |
| Interest expense | (0.5) | (0.5) | - | | NM |
| Interest income | - | 0.1 | (0.1) | | NM |
| Other income (expense), net | 0.1 | (0.3) | 0.4 | | NM |
| Income before income taxes | 18.1 | 5.7 | 12.4 | 217.5 | % |
| Income tax provision | 4.8 | 1.9 | 2.9 | 152.6 | % |
| Net income | \$ 13.3 | \$ 3.8 | \$ 9.5 | 250.0 | % |
| Diluted earnings per share | \$ 0.86 | \$ 0.23 | \$ 0.63 | 273.9 | % |

“NM” represents comparisons that are not meaningful to this analysis.

The following is a comparison of First Quarter of Fiscal 2011 and First Quarter of Fiscal 2010 results of operations, separately identifying the estimated impact of currency translation (in millions):

| | Three Months Ended January 1, 2011 | Estimated Business Change | Estimated Currency Translation | Three Months Ended January 2, 2010 |
|---------|---|---------------------------------|--------------------------------------|---|
| Revenue | \$ 105.9 | \$ 17.8 | \$ (0.9) | \$ 89.0 |

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| | | | | |
|--------------------------|---------|---------|-----------|--------|
| Cost of sales | 59.2 | 5.9 | (0.5) | 53.8 |
| Gross profit | 46.7 | 11.9 | (0.4) | 35.2 |
| Gross margin | 44.1 % | | | 39.5 % |
| Operating expenses: | | | | |
| Selling and marketing | 16.6 | 0.8 | (0.2) | 16.0 |
| General administrative | 8.5 | (0.8) | (0.1) | 9.4 |
| Research and development | 3.1 | (0.3) | - | 3.4 |
| Total operating expenses | 28.2 | (0.3) | (0.3) | 28.8 |
| Income from operations | \$ 18.5 | \$ 12.2 | \$ (0.1) | \$ 6.4 |

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Revenue was \$105.9 million, an increase of \$16.9 million, or 19.0%, compared to revenue of \$89.0 million for the First Quarter of Fiscal 2010. The increase was driven by a 27.8% increase in opening backlog as well as increased order volume in both segments, partially offset by an estimated \$0.9 million unfavorable impact of currency translation. Test segment revenue increased 14.9% \$82.6 million, while Sensors segment revenue increased 36.3% to \$23.3 million.

Gross profit was \$46.7 million, an increase of \$11.5 million, or 32.7%, compared to gross profit of \$35.2 million for the First Quarter of Fiscal 2010. Gross profit as a percentage of revenue was 44.1%, an increase of 4.6 percentage points from 39.5% for the First Quarter of Fiscal 2010. This increase was driven by favorable product mix in the Test segment, higher volume, and includes a 1.4 percentage point increase due to lower warranty expense in the Test segment.

Selling and marketing expense was \$16.6 million, an increase of \$0.6 million, or 3.8%, compared to \$16.0 million for the First Quarter of Fiscal 2010. This increase was primarily due to expenditures on selling and marketing initiatives in the Sensors segment. Selling and marketing expense as a percentage of revenue was 15.7% on higher volume, compared to 18.0% for the First Quarter of Fiscal 2010.

General and administrative expense was \$8.5 million, a decrease of \$0.9 million, or 9.6%, compared to \$9.4 million for the First Quarter of Fiscal 2010, primarily due to decreased legal and other professional fees. General and administrative expense as a percentage of revenue was 8.0% on higher volume, compared to 10.6% for the First Quarter of Fiscal 2010.

Research and development expense was \$3.1 million, a decrease of \$0.3 million, or 8.8%, compared to \$3.4 million for the First Quarter of Fiscal 2010, due to a planned reduction in expenditures in the Test segment. Research and development expense as a percentage of revenue was 2.9% on higher volume, compared to 3.8% for the First Quarter of Fiscal 2010.

Income from operations was \$18.5 million, an increase of \$12.1 million compared to income from operations of \$6.4 million for the First Quarter of Fiscal 2010. This increase was primarily driven by higher gross profit. Operating income as a percentage of revenue was 17.5% on higher volume, compared to 7.2% for the First Quarter of Fiscal 2010.

Interest expense was \$0.5 million, flat compared to the First Quarter of Fiscal 2010.

Interest income was less than \$0.1 million, flat compared to the First Quarter of Fiscal 2010.

Other income (expense), net was \$0.1 million of net other income, an increase of \$0.4 million, compared to \$0.3 million of net other expense in the First Quarter of Fiscal 2010.

Provision for income taxes totaled \$4.8 million for the First Quarter of Fiscal 2011, an increase of \$2.9 million compared to \$1.9 million for the First Quarter of Fiscal 2010. The effective tax rate for the First Quarter of Fiscal 2011 was 26.6%, a decrease of 6.1 percentage points compared to a tax rate of 32.7% for the First Quarter of Fiscal 2010, this decrease was primarily due to the enactment of tax legislation in the First Quarter of Fiscal 2011 that extended the United States research and development tax credits, with an effective date that was retroactive to January 1, 2010.

Net income was \$13.3 million, an increase of \$9.5 million compared to \$3.8 million for the First Quarter of Fiscal 2010. Earnings per diluted share increased \$0.63 to \$0.86, compared to \$0.23 for the First Quarter of Fiscal 2010. The increase was primarily driven by increased volume and gross profit, as well as a lower tax rate. In addition, the

reduction in the number of shares outstanding, resulting from the Company's share purchases, positively impacted earnings per share by \$0.06 for the First Quarter of Fiscal 2011.

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Segment Results

Test Segment

Orders and Backlog

First Quarter of Fiscal 2011 Compared to First Quarter of Fiscal 2010

The following is a comparison of First Quarter of Fiscal 2011 and First Quarter of Fiscal 2010 orders for the Test segment, separately identifying the estimated impact of currency translation (in millions):

| | Three Months Ended January 1, 2011 | Business Change | Estimated Currency Translation | Three Months Ended January 2, 2010 |
|--------|---|--------------------|--------------------------------------|---|
| Orders | \$ 115.8 | \$ 27.4 | \$ (1.7) | \$ 90.1 |

Orders totaled \$115.8 million, an increase of \$25.7 million, or 28.5%, compared to orders of \$90.1 million for the First Quarter of Fiscal 2010, primarily due to higher volume across all geographies, partially offset by an estimated \$1.7 million unfavorable impact of currency translation. First Quarter of Fiscal 2011 orders included two large ground vehicles orders totaling approximately \$29 million while First Quarter of Fiscal 2010 included two large materials and structures orders totaling approximately \$20 million. The Test segment accounted for 82.9% of total Company orders, compared to 83.7% for the First Quarter of Fiscal 2010.

Backlog of undelivered orders at the end of the quarter was \$230.2 million, an increase of 33.4% from backlog of \$172.6 million at the end of the First Quarter of Fiscal 2010.

Results of Operations

First Quarter of Fiscal 2011 Compared to First Quarter of Fiscal 2010

The following is a comparison of First Quarter of Fiscal 2011 and First Quarter of Fiscal 2010 results of operations for the Test segment, separately identifying the estimated impact of currency translation (in millions):

| | Three Months Ended January 1, 2011 | Business Change | Estimated Currency Translation | Three Months Ended January 2, 2010 |
|--------------------------|---|--------------------|--------------------------------------|---|
| Revenue | \$ 82.6 | \$ 11.2 | \$ (0.5) | \$ 71.9 |
| Cost of sales | 49.0 | 3.2 | (0.3) | 46.1 |
| Gross profit | 33.6 | 8.0 | (0.2) | 25.8 |
| Gross margin | 40.7 % | | | 35.9 % |
| Operating expenses: | | | | |
| Selling and marketing | 12.6 | (0.1) | (0.1) | 12.8 |
| General administrative | 6.2 | (1.1) | - | 7.3 |
| Research and development | 2.0 | (0.5) | - | 2.5 |

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| | | | | |
|--------------------------|---------|--------|-----------|--------|
| Total operating expenses | 20.8 | (1.7) | (0.1) | 22.6 |
| Income from operations | \$ 12.8 | \$ 9.7 | \$ (0.1) | \$ 3.2 |

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Revenue was \$82.6 million, an increase of \$10.7 million, or 14.9%, compared to revenue of \$71.9 million for the First Quarter of Fiscal 2010. The increase was primarily due to 26.7% higher beginning backlog and strong execution of short-cycle projects, partially offset by an estimated \$0.5 million unfavorable impact of currency translation.

Gross profit was \$33.6 million, an increase of \$7.8 million, or 30.2%, compared to gross profit of \$25.8 million for the First Quarter of Fiscal 2010. Gross profit as a percentage of revenue was 40.7%, an increase of 4.8 percentage points from 35.9% for the First Quarter of Fiscal 2010. This increase was primarily due to increased volume, favorable product mix, and lower warranty expense in the First Quarter of Fiscal 2011.

Selling and marketing expense was \$12.6 million, a decrease of \$0.2 million, or 1.6%, compared to \$12.8 million for the First Quarter of Fiscal 2010. This decrease was primarily due to reduced discretionary spending. Selling and marketing expense as a percentage of revenue was 15.3% on higher volume, compared to 17.8% for the First Quarter of Fiscal 2010.

General and administrative expense was \$6.2 million, a decrease of \$1.1 million, or 15.1%, compared to \$7.3 million for the First Quarter of Fiscal 2010. This decrease was primarily due to lower legal and other professional fees. General and administrative expense as a percentage of revenue was 7.5% on higher volume, compared to 10.2% for the First Quarter of Fiscal 2010.

Research and development expense was \$2.0 million, a decrease of \$0.5 million, or 20.0%, compared to \$2.5 million for the First Quarter of Fiscal 2010, due to lower level of planned expenditures. Research and development expense as a percentage of revenue was 2.4% on higher volume, compared to 3.5% for the First Quarter of Fiscal 2010.

Income from operations was \$12.8 million, an increase of \$9.6 million compared to income from operations of \$3.2 million for the First Quarter of Fiscal 2010. The increase reflects higher revenue and gross profit and reduced operating expenses. Operating income as a percentage of revenue was 15.5% on higher volume, compared to 4.5% for the First Quarter of Fiscal 2010.

Sensors Segment

Orders and Backlog

First Quarter of Fiscal 2011 Compared to First Quarter of Fiscal 2010

The following is a comparison of First Quarter of Fiscal 2011 and First Quarter of Fiscal 2010 orders for the Sensors segment, separately identifying the estimated impact of currency translation (in millions):

| | Three Months Ended January 1, 2011 | Estimated Business Change | Estimated Currency Translation | Three Months Ended January 2, 2010 |
|--------|---|---------------------------------|--------------------------------------|---|
| Orders | \$ 23.8 | \$ 6.8 | \$ (0.6) | \$ 17.6 |

Orders totaled \$23.8 million, an increase of \$6.2 million, or 35.2%, compared to orders of \$17.6 million for the First Quarter of Fiscal 2010, primarily due to higher volume in Europe, partially offset by an estimated \$0.6 million unfavorable impact of currency translation. The Sensors segment accounted for 17.1% of total Company orders, compared to 16.3% for the First Quarter of Fiscal 2010.

Backlog of undelivered orders at the end of the quarter was \$16.4 million, a increase of 40.2% from backlog of \$11.7 million at the end of the First Quarter of Fiscal 2010.

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Results of Operations

First Quarter of Fiscal 2011 Compared to First Quarter of Fiscal 2010

The following is a comparison of First Quarter of Fiscal 2011 and First Quarter of Fiscal 2010 results of operations for the Sensors segment, separately identifying the estimated impact of currency translation (in millions):

| | Three Months Ended January 1, 2011 | Business Change | Estimated Currency Translation | Three Months Ended January 2, 2010 |
|--------------------------|---|--------------------|--------------------------------------|---|
| Revenue | \$ 23.3 | \$ 6.6 | \$ (0.4) | \$ 17.1 |
| Cost of sales | 10.2 | 2.7 | (0.2) | 7.7 |
| Gross profit | 13.1 | 3.9 | (0.2) | 9.4 |
| Gross margin | 56.2 % | | | 54.8 % |
| Operating expenses: | | | | |
| Selling and marketing | 4.0 | 0.9 | (0.1) | 3.2 |
| General administrative | 2.3 | 0.3 | (0.1) | 2.1 |
| Research and development | 1.1 | 0.2 | - | 0.9 |
| Total operating expenses | 7.4 | 1.4 | (0.2) | 6.2 |
| Income from operations | \$ 5.7 | \$ 2.5 | \$ - | \$ 3.2 |

Revenue was \$23.3 million, an increase of \$6.2 million, or 36.3%, compared to revenue of \$17.1 million for the First Quarter of Fiscal 2010. This increase was primarily driven by increased worldwide volume, partially offset by an estimated \$0.4 million unfavorable impact of currency translation.

Gross profit was \$13.1 million, an increase of \$3.7 million, or 39.4%, compared to gross profit of \$9.4 million for the First Quarter of Fiscal 2010. Gross profit as a percentage of revenue was 56.2%, an increase of 1.4 percentage points from 54.8% for the First Quarter of Fiscal 2010, primarily due to improved leverage on higher volume.

Selling and marketing expense was \$4.0 million, an increase of \$0.8 million, or 25.0%, compared to \$3.2 million for the First Quarter of Fiscal 2010. The increase is primarily due to increased expenditures on selling and marketing initiatives. Selling and marketing expense as a percentage of revenue was 17.2% on higher volume, compared to 18.7% for the First Quarter of Fiscal 2010.

General and administrative expense was \$2.3 million, an increase of \$0.2 million, or 9.5%, compared to \$2.1 million for the First Quarter of Fiscal 2010. General and administrative expense as a percentage of revenue was 9.9% on higher volume, compared to 12.3% for the First Quarter of Fiscal 2010.

Research and development expense was \$1.1 million, an increase of \$0.2 million, or 22.2%, compared to \$0.9 million for the First Quarter of Fiscal 2010. The increase was primarily due to a higher level of planned expenditures. Research and development expense as a percentage of revenue was 4.7% on higher volume, compared to 5.3% for the First Quarter of Fiscal 2010.

Income from operations was \$5.7 million, an increase of \$2.5 million, or 78.1%, compared to income from operations of \$3.2 million for the First Quarter of Fiscal 2010. This increase was primarily due to higher gross profit, partially offset by increased operating expenses. Operating income as a percentage of revenue was 24.5% on higher volume,

compared to 18.7% for the First Quarter of Fiscal 2010.

Capital Resources and Liquidity

The Company had cash and cash equivalents of \$80.3 million at the end of the First Quarter of Fiscal 2011. Of this amount, \$20.2 million was located in North America, \$36.8 million in Europe, and \$23.3 million in Asia. The North American balance was primarily invested in money market funds and bank deposits. In Europe, the balances were primarily invested in Euro money market funds and bank deposits. In Asia, the balances were primarily invested in bank deposits. In accordance with its investment policy, the Company places cash equivalent investments with issuers who have high-quality investment credit ratings. In addition, the Company limits the amount of investment exposure it has with any particular issuer. The Company's investment objectives are to preserve principal, maintain liquidity, and achieve the best available return consistent with its primary objectives of safety and liquidity. At the end of the First Quarter of Fiscal 2011, the Company held no short-term investments.

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Total cash and cash equivalents increased \$3.7 million in the First Three Months of Fiscal 2011, primarily due to earnings, partially offset by employee incentives and related benefit payments, increased working capital requirements, and investment in property and equipment. Total cash and cash equivalents decreased \$5.2 million in the First Three Months of Fiscal 2010, primarily due to increased working capital requirements. The Company believes that its liquidity, represented by funds available from cash, cash equivalents, the credit facility, and anticipated cash from operations are adequate to fund ongoing operations, internal growth opportunities, capital expenditures, Company dividends and share purchases, as well as to fund strategic acquisitions.

Cash flows from operating activities provided cash totaling \$5.8 million for the First Three Months of Fiscal 2011, compared to cash provided of \$1.7 million for the First Three Months of Fiscal 2010. Cash provided for the First Three Months of Fiscal 2011 was primarily due to earnings and \$2.3 million decreased accounts and unbilled receivables resulting from general timing of billing and collections, partially offset by \$7.5 million net employee incentives and related benefit payments, primarily consisting of variable compensation relating to Fiscal 2010, \$3.6 million increased inventories to support future revenue, and \$1.6 million decreased accounts payable resulting from the general timing of purchases and payments. Cash provided for the First Three Months of Fiscal 2010 was primarily due to earnings and \$4.2 million increased advance payments received from customers driven by higher custom orders, partially offset by \$8.7 million increased accounts and unbilled receivables resulting from the general timing of billing and collections.

Cash flows from investing activities required the use of cash totaling \$2.3 million for the First Three Months of Fiscal 2011, compared to the use of cash totaling \$1.8 million for the First Three Months of Fiscal 2010. The cash usage for both periods reflects an investment in property and equipment.

Cash flows from financing activities provided cash totaling \$1.1 million for the First Three Months of Fiscal 2011, compared to the use of cash totaling \$3.6 million for the First Three Months of Fiscal 2010. The cash provided for the First Three Months of Fiscal 2011 was primarily due to the \$1.1 million received in connection with stock option exercises. The cash usage for the First Three Months of Fiscal 2010 was primarily due to payment of cash dividends of \$2.5 million, as well as the use of \$1.4 million to purchase approximately 52,700 shares of the Company's common stock.

Under the terms of its borrowing agreements, the Company has agreed to certain financial covenants. At the end of the First Quarter of Fiscal 2011, the Company was in compliance with the financial terms and conditions of those agreements.

Off-Balance Sheet Arrangements

As of January 1, 2011, the Company had no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

Critical Accounting Policies

The Consolidated Financial Statements are prepared in accordance with U.S. generally accepted accounting principles, which require the Company to make estimates and assumptions in certain circumstances that affect amounts reported. In preparing these financial statements, management has made its best estimates and judgments of certain amounts, giving due consideration to materiality. The Company believes that of its significant accounting policies, the following are particularly important to the portrayal of the Company's results of operations and financial position, may require the application of a higher level of judgment by the Company's management, and as a result, are subject to an inherent degree of uncertainty. Further information is provided in Note 1 in the Condensed Notes to Consolidated

Financial Statements in this Quarterly Report on Form 10-Q.

Revenue Recognition. The Company is required to comply with a variety of technical accounting requirements in order to achieve consistent and accurate revenue recognition. The most significant area of judgment and estimation is percentage of completion contract accounting. The Company develops cost estimates that include materials, component parts, labor and overhead costs. Detailed costs plans are developed for all aspects of the contracts during the bidding phase of the contract. Cost estimates are largely based on actual historical performance of similar projects combined with current knowledge of the projects in progress. Significant factors that impact the cost estimates include technical risk, inflationary cost of materials and labor, changes in scope and schedule, and internal and subcontractor performance. Actual costs incurred during the project phase are monitored and compared to the estimates on a monthly basis. Cost estimates are revised based on changes in circumstances. Anticipated losses on long-term contracts are recognized when such losses become evident.

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Inventories. The Company maintains a material amount of inventory to support its engineering and manufacturing operations. The Company establishes valuation reserves for excess, slow moving, and obsolete inventory based on inventory levels, expected product life, and forecasted sales demand. It is possible that an increase in the Company's inventory reserves may be required in the future if there is a significant decline in demand for the Company's products and the Company does not adjust its manufacturing production accordingly.

Impairment of Long-Lived Assets. The Company reviews the carrying value of long-lived assets or asset groups, such as property and equipment and intangibles subject to amortization, when events or changes in circumstances such as market value, asset utilization, physical change, legal factors, or other matters indicate that the carrying value may not be recoverable. When this review indicates the carrying value of an asset or asset group exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or asset group, the Company recognizes an asset impairment charge against operations. The amount of the impairment loss recorded is the amount by which the carrying value of the impaired asset or asset group exceeds its fair value.

Goodwill. The Company tests goodwill at least annually for impairment. Goodwill is also tested for impairment as changes in circumstances occur indicating that the carrying value may not be recoverable. Goodwill impairment testing first requires a comparison of the fair value of each reporting unit to the carrying value. If the carrying value of the reporting unit exceeds fair value, goodwill is considered impaired.

The Company has three discrete reporting units, two of which are assigned goodwill. At January 1, 2011, one reporting unit was assigned \$14.0 million of goodwill while another was assigned \$1.6 million. The fair value of a reporting unit is estimated using a discounted cash flow model that requires input of certain estimates and assumptions requiring management judgment, including projections of economic conditions and customer demand, revenue and margins, changes in competition, operating costs, and new product introductions. At the end of the prior fiscal year, the estimated fair value of the reporting unit assigned \$1.6 million of goodwill was substantially in excess of its carrying value, while the estimated fair value of the reporting unit assigned \$14.0 million of goodwill exceeded its carrying value by approximately 8 percent. While the Company believes the estimates and assumptions used in determining the fair value of its reporting units are reasonable, significant changes in estimates of future cash flows, such as those caused by unforeseen events or changes in market conditions could materially impact the fair value of a reporting unit which could result in the recognition of a goodwill impairment charge.

Software Development Costs. The Company incurs costs associated with the development of software to be sold, leased, or otherwise marketed. Software development costs are expensed as incurred until technological feasibility has been established, at which time future costs incurred are capitalized until the product is available for general release to the public. A certain amount of judgment and estimation is required to assess when technological feasibility is established, as well as the ongoing assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized software costs, the Company compares expected product performance, utilizing forecasted revenue amounts, to the total costs incurred to date and estimates of additional costs to be incurred. If revised forecasted product revenue is less than, and/or revised forecasted costs are greater than, the previously forecasted amounts, the net realizable value may be lower than previously estimated, which could result in the recognition of an impairment charge in the period in which such a determination is made.

Warranty Obligations. The Company is subject to warranty guarantees on sales of its products. A certain amount of judgment is required in determining appropriate reserve levels for anticipated warranty claims. While these reserve levels are based on historical warranty experience, they may not reflect the actual claims that will occur over the upcoming warranty period, and additional warranty reserves may be required.

Income Taxes. The Company records a tax provision for the anticipated tax consequences of the reported results of operations. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable

income in effect for the years in which those deferred tax assets and liabilities are expected to be realized or settled. The Company records a valuation allowance to reduce deferred tax assets to the amount that is believed more likely than not to be realized. The Company believes it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with the tax effects of the deferred tax liabilities, will be sufficient to fully recover the remaining net realizable value of its deferred tax assets. In the event that all or part of the net deferred tax assets are determined not to be realizable in the future, an adjustment to the valuation allowance would be charged to earnings in the period such determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with management's expectations could have a material impact on the Company's financial condition and operating results.

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Other Matters

The Company's dividend policy is to maintain a payout ratio that allows dividends to increase with the long-term growth of earnings per share, while sustaining dividends through economic cycles. The Company's dividend practice is to target over time a payout ratio of approximately 40% of net earnings per share.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company's investment portfolio at January 1, 2011 included \$80.3 million of cash and cash equivalents. The cash equivalent portion of the Company's investment portfolio is invested in money market funds and bank deposits. A hypothetical 1.0 percentage point increase or decrease in market interest rates would have caused interest income to increase or decrease by \$0.2 million for the three-month period ended January 1, 2011.

The Company is exposed to market risk from changes in foreign currency exchange rates and interest rates. The Company manages exposure to changes in foreign currency exchange rates through its regular operating and financing activities and through the use of foreign currency exchange contracts. These contracts are used to manage the Company's overall exposure to exchange rate fluctuations, as the gains and losses on these contracts are intended to offset gains and losses on the Company's assets, liabilities, and cash flows.

A hypothetical 10% appreciation or depreciation in foreign currencies against the U.S. dollar, assuming all other variables were held constant, would have resulted in an estimated increase or decrease of \$4.7 million in revenue for the three-month period ended January 1, 2011.

At January 1, 2011, the Company's short-term borrowings outstanding consisted of \$40.0 million utilization of the revolving credit facility and \$0.2 million in non-interest bearing notes payable to vendors. This utilization of the credit facility involves interest payments calculated at a floating rate. In order to mitigate the Company's exposure to interest rate increases, the Company has entered into floating to fixed interest rate swap agreements. The notes payable to vendors are non-interest bearing and, therefore, are not impacted by the effect of increases or decreases in market interest rates.

Item 4. Controls and Procedures

The Company's management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the "1934 Act")) as of January 1, 2011. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in the reports it files or submits under the 1934 Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information required to be disclosed by the Company in the reports that it files or submits under the 1934 Act is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There have been no changes in internal control over financial reporting during the fiscal quarter ended January 1, 2011 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II ----- OTHER INFORMATION

Item 1. Legal Proceedings

In January 2011, the Company was informed that the United States Department of Commerce and the United States Attorney's Office for the District of Minnesota were investigating whether the Company had accurately certified to a certain Federal Acquisition Regulation (FAR) since March 2008. The Company received an administrative subpoena from the United States Department of Commerce requesting, among other items, that all documents related to the certification made on the government's Online Representations and Certifications Application (ORCA) web site be preserved, retained and produced. We are cooperating with the government's investigation. At this point, the outcome or range of loss, if any, to resolve this matter cannot be determined.

Item 6. Exhibits

Exhibit
Number

Description

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).

32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350) (filed herewith).

32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350) (filed herewith).

SIGNATURES

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

MTS SYSTEMS CORPORATION

Dated: February 3, 2011

/s/ LAURA B. HAMILTON
Laura B. Hamilton
Chair and Chief Executive Officer

Dated: February 3, 2011

/s/ SUSAN E. KNIGHT
Susan E. Knight
Vice President and Chief Financial Officer

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EXHIBIT INDEX TO FORM 10-Q

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