

MTS SYSTEMS CORP
Form 10-Q
May 08, 2007

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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 March 31, 2007

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)

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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 May 4, 2007 was 17,735,135 shares.

MTS SYSTEMS CORPORATION

REPORT ON FORM 10-Q

FOR THE THREE AND SIX MONTHS ENDED MARCH 31, 2007

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MTS SYSTEMS CORPORATION

Consolidated Balance Sheets

(unaudited in thousands, except per share data)

	March 31, 2007	September 30, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 99,905	\$ 97,962
Short-term investments	17,490	23,575
Accounts receivable, net of allowances for doubtful accounts	65,471	72,997
Unbilled accounts receivable	36,125	27,132
Inventories	43,747	40,480
Prepaid expenses	4,284	3,180
Current deferred tax assets	5,430	5,134
Other current assets	499	1,065
Assets of discontinued operations	241	803
Total current assets	273,192	272,328
Property and Equipment:		
Land	1,668	1,668
Buildings and improvements	43,291	42,072
Machinery and equipment	85,086	78,651
Accumulated depreciation	(82,987)	(78,777)
Total property and equipment, net	47,058	43,614
Goodwill	4,513	4,466
Other assets	3,385	2,102
Non-current deferred tax assets	1,801	1,613
Total Assets	\$ 329,949	\$ 324,123
LIABILITIES AND SHAREHOLDERS INVESTMENT		
Current Liabilities:		
Notes payable	\$ 238	\$ 222
Current maturities of long-term debt	6,683	6,683
Accounts payable	18,933	17,090
Accrued payroll and related costs	24,769	29,273
Advance payments from customers	58,665	51,356
Accrued warranty costs	5,582	5,894
Accrued income taxes	5,013	512

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Current deferred income taxes	5,093	4,643
Other accrued liabilities	11,894	15,125
Total current liabilities	136,870	130,798
Deferred income taxes	2,544	2,487
Long-term debt, less current maturities	7,837	8,990
Other long-term liabilities	13,728	12,527
Total Liabilities	160,979	154,802
Shareholders' Investment:		
Common stock, \$.25 par; 64,000 shares authorized: 17,680 and 18,216 shares issued and outstanding		
	4,420	4,554
Retained earnings	149,199	152,657
Accumulated other comprehensive income	15,351	12,110
Total shareholders' investment	168,970	169,321
Total Liabilities and Shareholders' Investment	\$ 329,949	\$ 324,123

The accompanying 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 Months Ended		Six Months Ended	
	March 31, 2007	April 1, 2006	March 31, 2007	April 1, 2006
Revenue:				
Product	\$87,365	\$89,035	\$172,521	\$168,524
Service	14,465	13,833	28,365	26,187
Total revenue	101,830	102,868	200,886	194,711
Cost of sales:				
Product	48,755	50,882	98,606	95,897
Service	7,206	6,205	14,303	12,464
Total cost of sales	55,961	57,087	112,909	108,361
Gross profit	45,869	45,781	87,977	86,350
Operating expenses:				
Selling and marketing	17,293	15,933	34,232	31,937
General and administrative	7,810	8,896	15,823	17,000
Research and development	4,847	4,694	9,381	8,841
Total operating expenses	29,950	29,523	59,436	57,778

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Gain on sale of assets	763	860	763	860
Income from operations	16,682	17,118	29,304	29,432
Interest expense	(331)	(415)	(669)	(869)
Interest income	958	782	1,883	1,464
Other (expense) income, net	(885)	302	(810)	327
Income before income taxes	16,424	17,787	29,708	30,354
Provision for income taxes	6,093	6,488	9,260	11,099
Net income	\$ 10,331	\$ 11,299	\$ 20,448	\$ 19,255
Earnings per share:				
Basic				
Earnings per share	\$ 0.57	\$ 0.59	\$ 1.12	\$ 1.00
Weighted average number of common shares outstanding	18,159	19,072	18,200	19,263
Diluted				
Earnings per share	\$ 0.56	\$ 0.58	\$ 1.10	\$ 0.97
Weighted average number of common shares outstanding	18,536	19,580	18,568	19,792

The accompanying 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)

	Six Months Ended	
	March 31, 2007	April 1, 2006
Cash flows from operating activities:		
Net income	\$ 20,448	\$ 19,255
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,949	3,869
Gain on sale of assets	(763)	(860)
Deferred income taxes	(192)	
Bad debt provision	70	113
Stock-based compensation	2,624	2,142
Equity compensation income tax benefits	(539)	(971)
Changes in operating assets and liabilities:		
Accounts and unbilled contracts receivable	428	(14,759)

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Inventories	(2,597)	(2,261)
Prepaid expenses	(1,525)	(3,522)
Other assets	(2,188)	406
Accounts payable	1,634	1,447
Accrued payroll and related costs	(3,548)	(5,864)
Advance payments from customers	6,561	9,171
Accrued warranty costs	(412)	(825)
Other current liabilities	2,975	5,374
Operating activities of discontinued operations	546	(463)
Net cash provided by operating activities	27,471	12,252
Cash flows from investing activities:		
Additions to property and equipment	(5,840)	(3,939)
Proceeds from maturity of short-term investments	29,385	90,632
Purchases of short-term investments	(23,300)	(37,007)
Net proceeds from sale of assets	1,000	(90)
Net cash provided by investing activities	1,245	49,596
Cash flows from financing activities:		
Net proceeds under short-term borrowings	15	53
Payments of long-term debt	(1,154)	(1,178)
Equity compensation income tax benefits	539	971
Cash dividends	(6,062)	(3,856)
Proceeds from exercise of stock options and employee stock purchase plan	2,358	2,600
Payments to purchase and retire common stock	(25,869)	(59,508)
Net cash used in financing activities	(30,173)	(60,918)
Effect of exchange rate on changes in cash	3,400	86
Net increase in cash and cash equivalents	1,943	1,016
Cash and cash equivalents, at beginning of period	97,962	83,143
Cash and cash equivalents, at end of period	\$ 99,905	\$ 84,159
Supplemental disclosure of cash flow information:		
Cash paid during the period for -		
Interest expense	\$ 546	\$ 785
Income taxes	\$ 4,963	\$ 7,207

The accompanying 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

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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 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. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The accompanying financial statements of the Company should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's 2006 Form 10-K filed with the SEC. Interim results of operations for the three- and six-month periods ended March 31, 2007 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. Orders that are manufactured and delivered in less than six months with routine installations and no special acceptance protocol are considered to involve separable elements for revenue recognition purposes. Sufficient evidence of fair value of these elements exists to allow revenue recognition for these systems upon shipment, less the greater of the fair value associated with installation and training (if applicable) or the amount of revenue for which payment is deemed contingent upon delivery of these elements, which amount is deferred until customer acceptance. Fair value is determined based upon the sale price of similar products sold individually. In cases where special acceptance protocols exist, installation and training are not considered to be separable from the other elements of the arrangement. Accordingly, revenue for these systems is recognized upon the completion of installation and fulfillment of obligations specific to the terms of the arrangement.

Revenue on contracts requiring longer delivery periods, generally longer than six months (long-term contracts), is recognized using the percentage-of-completion method based on the cost incurred to date relative to estimated total cost of the contract. In most cases, orders with complex installations and/or unusual acceptance protocols involve long-term contracts for custom systems that follow the percentage-of-completion method of revenue recognition through customer acceptance. However, when elements that would not separately fall within the scope of accounting literature prescribing percentage-of-completion accounting are included in an arrangement, the fair value of these elements is separated from the arrangement and accounted for as such services are provided.

The Company enters into long-term contracts for customized equipment sold to its customers. Under the terms of such 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 for services is recognized as the service is performed or ratably over a defined contractual period for service maintenance contracts.

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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 March 31, 2007 and September 30, 2006 were as follows:

	March 31, 2007 (expressed in thousands)	September 30, 2006
Customer projects in various stages of completion	\$ 15,517	\$ 14,046
Components, assemblies and parts	28,230	26,434
Total	\$ 43,747	\$ 40,480

Warranty Obligations. Sales of the Company's products and systems are subject to limited warranty guarantees that are included in customer contracts. For sales that include installation services, warranty guarantees typically extend for a period of twelve months from the date of either shipment or acceptance. Product guarantees 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 warranty provisions monthly 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. Warranty provisions and claims for the periods ended March 31, 2007 and April 1, 2006 were as follows:

	Three Months Ended		Six Months Ended	
	March 31, 2007 (expressed in thousands)	April 1, 2006	March 31, 2007	April 1, 2006
Beginning balance	\$5,741	\$5,045	\$5,894	\$5,333
Warranty provisions	1,340	868	2,807	2,071
Warranty claims	(1,535)	(1,444)	(3,237)	(2,909)
Currency translation	36	42	118	16
Ending balance	\$5,582	\$4,511	\$5,582	\$4,511

2. Stock-Based Compensation

The Company compensates employees, officers, and directors with stock-based compensation under four plans approved by the Company's shareholders and administered under the supervision of the Company's Board of Directors. Stock-based compensation awards are generally granted annually at pre-determined dates, with a minor amount granted upon hire date for new employees. The Company has awarded stock options, employee stock purchase plan shares, and restricted stock under these plans. At March 31, 2007, a total of 2,573,066 shares were available for future grant under these plans. Stock-based compensation expense is determined based on the grant-date fair value and is recognized proportionally over the vesting period of each grant, which is generally three years. Stock-based compensation expense for the

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three-month periods ended March 31, 2007 and April 1, 2006 was \$1.3 million and \$1.2 million, respectively. Stock-based compensation expense for the six-month periods ended March 31, 2007 and April 1, 2006 was \$2.6 million and \$2.1 million, respectively.

3. Discontinued Operations

On August 5, 2005, the Company sold substantially all of the net assets of its engine test business, which was based in Ann Arbor, Michigan and also maintained operations in Byfleet, United Kingdom, to A&D Co., Ltd. of Tokyo, Japan. This sale represented the Company's exit from the engine test business. The engine test business was historically included in the Company's Test segment for financial reporting. The gain on the sale of the engine test business and its results of operations are excluded from the results of operations of the Test segment and are reported as discontinued operations.

Effective October 1, 2005, the Company closed its AeroMet subsidiary, a laser deposition technology business located in Eden Prairie, Minnesota. The AeroMet subsidiary was historically included in the Company's Industrial segment (now the Sensors segment) for financial reporting. The loss on disposition of the AeroMet business and its results of operations have been excluded from results of operations of the Sensors segment and are reported as discontinued operations.

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The assets of discontinued operations at March 31, 2007 and September 30, 2006 were as follows:

	March 31, 2007 (expressed in thousands)	September 30, 2006
Accounts receivable, net of allowances for doubtful accounts	\$ 58	\$ 635
Other current assets	183	168
Total assets of discontinued operations	\$ 241	\$ 803

4. Recently Issued Accounting Standards

In July 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes. FIN 48 defines the threshold for recognizing the benefits of tax positions in the financial statements as more-likely-than-not to be sustained upon examination. The interpretation also provides guidance on the de-recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of required disclosures associated with any recorded income tax uncertainties. The differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption are to be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. FIN 48 is effective for fiscal years beginning after December 15, 2006 and thus will be effective for the Company in fiscal year 2008. The Company is evaluating the impact of the adoption of FIN 48 to its consolidated financial statements.

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In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under this statement, fair value measurements are required to be separately disclosed, by level, within the fair value hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 157 is not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Post Retirement Plans, an Amendment of SFAS No. 87, Employers' Accounting for Pensions, SFAS No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, and SFAS No. 132(R), Employers' Disclosures about Pensions and Other Postretirement Benefits. SFAS No. 158 requires the recognition of the funded status of defined benefit pension and other post-retirement plans in the balance sheet, as well as the recognition as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that have yet to be recognized as components of net periodic retirement cost pursuant to SFAS No. 87 and SFAS No. 106. The provisions of SFAS No. 158 are effective as of the end of fiscal years ending after December 15, 2006. The adoption of SFAS No. 158 is not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB No. 108 is effective as of the end of fiscal years ending after November 15, 2006. The adoption of SAB No. 108 is not expected to have a material impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS No. 159 allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value in situations in which they are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current period earnings. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 159 is not expected to have a material impact on the Company's consolidated financial statements.

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5. Earnings Per Common Share

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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 includes the potentially dilutive effect of common shares granted in connection with stock-based compensation using the treasury stock method. Stock options to acquire 0.5 million weighted common shares have been excluded from the diluted weighted average shares outstanding calculation for the three and six-month periods ended March 31, 2007 and April 1, 2006, as the exercise of these options would lead to a net reduction in common shares outstanding under the treasury stock method. A reconciliation of these amounts is as follows:

	Three Months Ended		Six Months Ended	
	March 31, 2007	April 1, 2006	March 31, 2007	April 1, 2006
	(in thousands, except per share data)			
Net income	\$ 10,331	\$ 11,299	\$ 20,448	\$ 19,255
Weighted average common shares outstanding	18,159	19,072	18,200	19,263
Dilutive potential common shares	377	508	368	529
Total dilutive weighted average shares outstanding	18,536	19,580	18,568	19,792
Earnings per share:				
Basic	\$0.57	\$0.59	\$ 1.12	\$ 1.00
Diluted	\$0.56	\$0.58	\$ 1.10	\$0.97

6. Short-Term Investments

At March 31, 2007 and September 30, 2006, the Company's short-term investments consisted of U.S. municipal bonds with maturity dates ranging from 2010 through 2046. These bonds carry double-A or higher credit ratings from at least one of the three globally recognized credit rating services. The interest rates on these bonds are re-set every 7, 28, or 35 days in a market auction process such that yields typically reflect current market interest rates. The Company classifies these investments as available-for-sale, as it intends to liquidate them to fund current operations, acquisitions, or the return of capital to shareholders. All investments in available-for-sale securities are carried at fair value, and unrealized gains and losses are reported as a component of Accumulated Other Comprehensive Income within Shareholders' Investment on the Consolidated Balance Sheet. At March 31, 2007 and September 30, 2006, there were no material unrealized gains or losses associated with the Company's short-term investments.

7. Business Segment Information

The Company's Chief Executive Officer and its management regularly review financial information for the Company's discrete business units. 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 units have been aggregated for financial statement purposes into two reportable segments: Test and Sensors. During the three-month period ended December 30, 2006, the former Industrial segment was re-named the Sensors segment. This change was a change in name only; there was no underlying change in the components of the segment. 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 2006 Form 10-K. 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.

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Financial information by reportable segment for the periods ended March 31, 2007 and April 1, 2006 was as follows:

	Three Months Ended		Six Months Ended	
	March 31, 2007	April 1, 2006	March 31, 2007	April 1, 2006
Revenue by Segment:				
Test	\$ 82,943	\$ 86,975	\$ 164,260	\$ 163,814
Sensors	18,887	15,893	36,626	30,897
Total revenue	\$ 101,830	\$ 102,868	\$ 200,886	\$ 194,711
Income from Operations by Segment:				
Test	\$ 12,787	\$ 14,602	\$ 22,206	\$ 24,536
Sensors	3,895	2,516	7,098	4,896
Total income from operations	\$ 16,682	\$ 17,118	\$ 29,304	\$ 29,432

8. Derivative Instruments and Hedging Activities

The Company periodically enters into contracts with banks to exchange currencies at a set future date and rate to maintain the reporting currency value of specifically identified foreign currency exposures. Because the market value of these currency contracts is derived from current exchange rates, they are classified as derivative financial instruments. The Company does not use currency contracts for speculative or trading purposes.

Currency exchange contracts utilized to maintain the U.S. dollar value of expected financial transactions denominated in foreign currencies are designated as foreign currency cash flow hedges. Gains and losses related to changes in the market value of the contracts are recorded in Accumulated Other Comprehensive Income within Shareholders' Investment on the Consolidated Balance Sheet until they are recognized in earnings at the time income or loss is recognized on the underlying expected transaction. The Company periodically assesses whether the contracts are effective in offsetting the changes in the U.S. dollar value of the expected transactions. When a contract is no longer effective as a hedge, the Company discontinues hedge accounting prospectively.

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

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At March 31, 2007 and April 1, 2006, the Company had outstanding currency exchange contracts with gross notional U.S. dollar equivalent amounts of \$115.4 million and \$93.5 million, respectively. Netting offsetting contracts, net notional contracts outstanding in U.S. dollar equivalent amounts were \$42.6 million and \$16.8 million, respectively. At March 31, 2007 and April 1, 2006, the market value of the foreign currency exchange contracts was (\$0.1) million and \$1.0 million, respectively. The amount recognized in earnings as a result of the ineffectiveness of cash flow hedges was not material for the three- and six-month periods ended March 31, 2007 and April 1, 2006. At March 31, 2007 and April 1, 2006, the amount projected to be reclassified from Accumulated Other Comprehensive (Loss) Income into earnings in the next 12 months was (\$0.1) million and \$0.5 million, respectively. At March 31, 2007 and April 1, 2006, the maximum remaining maturity of any currency exchange contract was 1.1 years and 2.0 years, respectively.

9. Comprehensive Income

Comprehensive Income, a component of Shareholders' Investment, consists of net income, minimum pension liability adjustment, unrealized gains or losses on investments classified as available-for-sale, derivative instrument gains or losses, and foreign currency translation adjustments. There were no material unrealized gains or losses from available-for-sale securities at March 31, 2007 or April 1, 2006.

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Comprehensive income for the periods ended March 31, 2007 and April 1, 2006 was as follows:

	Three Months Ended		Six Months Ended	
	March 31, 2007	April 1, 2006	March 31, 2007	April 1, 2006
	(expressed in thousands)			
Net income	\$ 10,331	\$ 11,299	\$ 20,448	\$ 19,255
Change in cumulative translation adjustment	1,239	1,671	3,766	149
Decrease in unrealized loss on derivative instruments	(226)	(950)	(525)	(1,357)
Comprehensive income	\$ 11,344	\$ 12,020	\$ 23,689	\$ 18,047

10. Retirement Benefit Plan

One of the Company's German subsidiaries has a non-contributory, unfunded 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 Company uses a September 30 measurement date for this defined benefit retirement plan.

The cost for the plan for the periods ended March 31, 2007 and April 1, 2006 included the following components:

	Three Months Ended		Six Months Ended	
	March 31, 2007	April 1, 2006	March 31, 2007	April 1, 2006
	(expressed in thousands)			
Service cost-benefit earned during the period	\$ 127	\$ 115	\$ 251	\$ 229
Interest cost on projected benefit obligation	138	113	275	225
Net amortization and deferral	33	34	65	67
Net periodic retirement cost	\$ 298	\$ 262	\$ 591	\$ 521

11. Restructuring and Other Charges:

In the fourth quarter of fiscal year 2005, the Company decided to exit its noise and vibration business. The Company assessed the recoverability of the assets associated with this business using an undiscounted cash flow methodology. Based on this assessment, the Company reduced the assets to their fair market value. In addition, the Company recorded employee severance costs and software development expense that will not repeat in future years.

For the six-month period ended March 31, 2007 and the fiscal year ended September 30, 2006, the Company's provisions and write-offs associated with this restructuring activity were as follows:

	Severance	Contract	Total
	Charges	Termination	
	(expressed in thousands)		
Balances at October 1, 2005	\$ 1,267	\$ 52	\$ 1,319
Provision	30		30
Write-off/payments	(1,257) (52) (1,309
Balances at September 30, 2006	\$ 40	\$	\$ 40
Provision			
Write-off/payments	(40)	(40
Balances at March 31, 2007	\$	\$	\$

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12. Contingencies

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The Company is subject to the export control regulations of the U.S. Department of Commerce. As described in a newspaper article published in August 2003, the Department of Commerce and the U.S. Attorney for the District of Minnesota have each been conducting an inquiry into the Company's compliance with certain export regulations. The initial inquiry described in the newspaper article resulted in a \$36,000 civil settlement with the Department of Commerce without the Company admitting to violating any law or regulation. The separate criminal inquiry by the U.S. Attorney's office has been ongoing and, recently, the U.S. Attorney's office proposed terms to terminate the criminal inquiry, if the Company were to plead guilty to violating federal export control regulations and a related federal criminal statute and pay the maximum criminal fine, which the Company understands could be up to \$1,000,000, under applicable law.

The Company, together with its outside counsel, has thoroughly investigated all actions in question and firmly believes any allegation of wrongdoing is without merit. Furthermore, while the Company does not know whether any formal charges will be brought against it, it has evaluated its legal defenses, and the range of possible and probable outcomes, and does not believe the ultimate outcome of any proceeding would have a material adverse effect on the Company's business or financial condition.

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

MTS Systems Corporation is a leading global supplier of test systems and industrial position sensors. The Company's testing hardware, software, and service 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 enhance control to improve the productivity and safety of fixed and mobile industrial equipment. MTS had 1,510 employees and revenue of \$397 million for the fiscal year ended September 30, 2006.

Summary of Results

Three Months Ended March 31, 2007 (Second Quarter of Fiscal 2007) Compared to Three Months Ended April 1, 2006 (Second Quarter of Fiscal 2006)

Orders for the Second Quarter of Fiscal 2007 increased 19.0%, to \$97.0 million, compared to \$81.5 million for the Second Quarter of Fiscal 2006, primarily driven by increased Test segment orders in North America and Asia and worldwide growth in the Sensors segment, as well as an estimated \$2.4 million favorable impact of currency translation. Test segment orders included one large custom order in excess of \$5 million. Backlog of undelivered orders at March 31, 2007 was approximately \$204 million, a decrease of 1.9% from backlog of approximately \$208 million at December 30, 2006. Backlog at the end of the Second Quarter of Fiscal 2006 was approximately \$195 million.

Revenue of \$101.8 million for the Second Quarter of Fiscal 2007 decreased 1.1%, compared to revenue of \$102.9 million for the Second Quarter of Fiscal 2006, primarily due to decreased custom business in the Test segment, partially offset by continued growth in the Sensors segment, and an estimated \$3.4 million favorable impact of currency translation. Gross profit for the Second Quarter of Fiscal 2007 was \$45.9 million, flat compared to gross profit of \$45.8 million for the Second Quarter of Fiscal 2006, as increased volume in the Sensors segment and an estimated \$1.0 million favorable impact of currency translation were offset by unfavorable product mix in the Test segment. Income from operations for the Second Quarter of Fiscal 2007 was \$16.7 million, a decrease of 2.3% compared to income from operations of \$17.1 million for the Second Quarter of Fiscal 2006, primarily due to planned increases in selling, marketing and R&D expense, partially offset by an estimated \$0.3 million favorable impact of currency translation. Net income for the Second Quarter of Fiscal 2007 was \$10.3 million, or \$0.56 per diluted share, a decrease of 8.8% compared to \$11.3 million, or \$0.58 per diluted share, for the Second Quarter of Fiscal 2006, driven by lower income from operations and a \$1.1 million increase in net losses on foreign currency transactions, partially offset by an estimated \$0.2 million favorable impact of currency translation.

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Six Months Ended March 31, 2007 (First Half of Fiscal 2007) Compared to Six Months Ended April 1, 2006 (First Half of Fiscal 2006)

Orders for the First Half of Fiscal 2007 increased 16.9%, to \$208.5 million, compared to \$178.3 million for the First Half of Fiscal 2006, primarily driven by increased custom orders in the Test segment in Asia and worldwide growth in the Sensors segment, as well as an estimated \$5.2 million favorable impact of currency translation. Backlog of undelivered orders at March 31, 2007 was approximately \$204 million, an increase of 6.3% from backlog of approximately \$192 million at September 30, 2006, due to higher order volume and an estimated \$4.0 million favorable impact of currency translation.

Revenue of \$200.9 million for the First Half of Fiscal 2007 increased 3.2%, compared to revenue of \$194.7 million for the First Half of Fiscal 2006, driven by continued growth in the Sensors segment, and an estimated \$6.9 million favorable impact of currency translation, partially offset by decreased volume in the Test segment. Gross profit for the First Half of Fiscal 2007 was \$88.0 million, an increase of 1.9% compared to gross profit of \$86.4 million for the First Half of Fiscal 2006, primarily due to increased volume in the Sensors segment and an estimated \$2.2 million favorable impact of currency translation, partially offset by unfavorable product mix and increased manufacturing and support costs in the Test segment. Income from operations for the First Half of Fiscal 2007 was \$29.3 million, flat compared to income from operations of \$29.4 million for the First Half of Fiscal 2006. Increased gross profit in the Sensors segment and an estimated \$0.8 million favorable impact of currency translation were offset by decreased gross profit in the Test segment and planned increases in operating expenses in both segments. Net income for the First Half of Fiscal 2007 was \$20.4 million, or \$1.10 per diluted share, an increase of 5.7% compared to \$19.3 million, or \$0.97 per diluted share, for the First Half of Fiscal 2006, primarily due to decreased income tax expense and an estimated \$0.6 million favorable impact of currency translation, partially offset by a \$1.1 million increase in net losses on foreign currency transactions.

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Detailed Financial Results

Orders and Backlog

Second Quarter of Fiscal 2007 Compared to Second Quarter of Fiscal 2006

Orders for the Second Quarter of Fiscal 2007 aggregated \$97.0 million, an increase of 19.0% compared to orders of \$81.5 million for the Second Quarter of Fiscal 2006, due to increased custom order volume in the Test segment in North America and Asia and worldwide growth in the Sensors segment, as well as an estimated \$2.4 million favorable impact of currency translation.

Orders for the Test segment in the Second Quarter of Fiscal 2007 increased 18.7%, to \$77.3 million, compared to orders of \$65.1 million for the Second Quarter of Fiscal 2006. This increase was primarily due to custom order bookings in North America and Asia and an estimated \$1.5

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million favorable impact of currency translation, partially offset by decreased volume in Europe. Orders for the Second Quarter of Fiscal 2007 included one large custom order in excess of \$5 million. The Test segment accounted for 79.7% of total Company orders for the Second Quarter of Fiscal 2007, compared to 79.9% for the Second Quarter of Fiscal 2006.

Orders for the Sensors segment in the Second Quarter of Fiscal 2007 increased 20.1%, to \$19.7 million, compared to orders of \$16.4 million for the Second Quarter of Fiscal 2006, reflecting business growth in all geographies and an estimated \$0.9 million favorable impact of currency translation. The Sensors segment accounted for 20.3% of total Company orders for the Second Quarter of Fiscal 2007, compared to 20.1% for the Second Quarter of Fiscal 2006.

Backlog of undelivered orders at March 31, 2007 was approximately \$204 million, a decrease of 1.9% from backlog of \$208 million at December 30, 2006. Backlog at April 1, 2006 was approximately \$195 million. While the Company's backlog is subject to order cancellations, the Company seldom experiences an order cancellation larger than \$1.0 million.

First Half of Fiscal 2007 Compared to First Half of Fiscal 2006

Orders for the First Half of Fiscal 2007 aggregated \$208.5 million, an increase of 16.9% compared to orders of \$178.3 million for the First Half of Fiscal 2006, due to increased custom order volume in the Test segment in Asia and worldwide growth in the Sensors segment, as well as an estimated \$5.2 million favorable impact of currency translation.

Orders for the Test segment in the First Half of Fiscal 2007 increased 16.6%, to \$171.0 million, compared to orders of \$146.7 million for the First Half of Fiscal 2006. This increase was primarily due to increased custom order bookings in Asia and an estimated \$3.6 million favorable impact of currency translation. The Test segment accounted for 82.0% of total Company orders for the First Half of Fiscal 2007, compared to 82.3% for the First Half of Fiscal 2006.

Orders for the Sensors segment in the First Half of Fiscal 2007 increased 18.7%, to \$37.5 million, compared to orders of \$31.6 million for the First Half of Fiscal 2006, reflecting worldwide business growth and an estimated \$1.6 million favorable impact of currency translation. The Sensors segment accounted for 18.0% of total Company orders for the First Half of Fiscal 2007, compared to 17.7% for the First Half of Fiscal 2006.

Backlog of undelivered orders at March 31, 2007 was approximately \$204 million, an increase of 6.3% from backlog of \$192 million at September 30, 2006, primarily due to higher order volume and an estimated \$4.0 million favorable impact of currency translation.

Results of Operations

Second Quarter of Fiscal 2007 Compared to Second Quarter of Fiscal 2006

Revenue for the Second Quarter of Fiscal 2007 was \$101.8 million, a decrease of \$1.1 million, or 1.1%, compared to revenue of \$102.9 million for the Second Quarter of Fiscal 2006. Revenue from international customers for the Second Quarter of Fiscal 2007 represented 64.4% of total

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revenue, compared to 65.0% for the Second Quarter of Fiscal 2006. Test segment revenue for the Second Quarter of Fiscal 2007 was \$82.9 million, a decrease of \$4.1 million, or 4.7% compared to revenue of \$87.0 million for the Second Quarter of Fiscal 2006, reflecting decreased custom business, partially offset by and an estimated \$2.6 million favorable impact of currency translation. Sensors segment revenue for the Second Quarter of Fiscal 2007 was \$18.9 million, an increase of \$3.0 million, or 18.9%, compared to revenue of \$15.9 million for the Second Quarter of Fiscal 2006, driven by increased worldwide volume and an estimated \$0.8 million favorable impact of currency translation.

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Gross profit for the Second Quarter of Fiscal 2007 was \$45.9 million, flat compared to gross profit of \$45.8 million for the Second Quarter of Fiscal 2006. Gross profit as a percent of revenue was 45.1% for the Second Quarter of Fiscal 2007, an increase of 0.6 percentage points from 44.5% for the Second Quarter of Fiscal 2006. Test segment gross profit for the Second Quarter of Fiscal 2007 was \$35.5 million, a decrease of \$1.9 million, or 5.1%, compared to gross profit of \$37.4 million for the Second Quarter of Fiscal 2006. Gross profit as a percent of revenue for the Test segment decreased 0.2 percentage points, to 42.8%, for the Second Quarter of Fiscal 2007, compared to 43.0% for the Second Quarter of Fiscal 2006. This decrease was primarily due to decreased volume and unfavorable product mix, partially offset by an estimated \$0.6 million favorable impact of currency translation. Sensors segment gross profit for the Second Quarter of Fiscal 2007 was \$10.4 million, an increase of \$2.0 million, or 23.8%, compared to gross profit of \$8.4 million for the Second Quarter of Fiscal 2006. Gross profit as a percent of revenue for the Sensors segment increased 2.2 percentage points, to 55.0%, for the Second Quarter of Fiscal 2007, compared to 52.8% for the Second Quarter of Fiscal 2006, primarily due to increased volume, improved capacity utilization, and an estimated \$0.4 million favorable impact of currency translation.

Selling and marketing expense for the Second Quarter of Fiscal 2007 was \$17.3 million, an increase of \$1.4 million, or 8.8%, compared to \$15.9 million for the Second Quarter of Fiscal 2006, primarily due to \$1.0 million increased expense associated with increased compensation, benefits and commission expenses in the Test segment, \$0.3 million increased staffing and commission expense in the Sensors segment, and an estimated \$0.5 million unfavorable impact of currency translation, partially offset by a \$0.4 million decrease in expense associated with the exited noise and vibration business. Selling expense as a percent of revenue for the Second Quarter of Fiscal 2007 was 17.0%, compared to 15.5% for the Second Quarter of Fiscal 2006.

General and administrative expense totaled \$7.8 million for the Second Quarter of Fiscal 2007, a decrease of \$1.1 million, or 12.4%, compared to \$8.9 million for the Second Quarter of Fiscal 2006. This decrease was primarily due to a \$1.0 million decrease in consulting expenses and \$0.3 million decreased legal and audit fees, partially offset by an estimated \$0.2 million unfavorable impact of currency translation. General and administrative expense as a percent of revenue decreased to 7.7% for the Second Quarter of Fiscal 2007, compared to 8.6% for the Second Quarter of Fiscal 2006.

Research and development expense totaled \$4.8 million for the Second Quarter of Fiscal 2007, an increase of \$0.1 million, or 2.1%, compared to \$4.7 million for the Second Quarter of Fiscal 2006. This increase was primarily due to a planned increase in expenditures for new product development in both segments. Research and development expense as a percent of revenue increased to 4.7% for the Second Quarter of Fiscal 2007, compared to 4.6% for the Second Quarter of Fiscal 2006. There was no significant impact on research and development expense from currency translation.

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Gain on sale of assets of \$0.8 million for the Second Quarter of Fiscal 2007 resulted from the sale of assets associated with the Company's linear friction welding technology. The \$0.9 million gain on the sale of assets for the Second Quarter of Fiscal 2006 resulted from the sale of assets of the Company's noise and vibration business. There was no significant impact on gain on sale of assets from currency translation.

Income from operations for the Second Quarter of Fiscal 2007 decreased \$0.4 million, or 2.3%, to \$16.7 million, compared to income from operations of \$17.1 million for the Second Quarter of Fiscal 2006. Income from operations in the Test segment decreased \$1.8 million, or 12.3%, to \$12.8 million for the Second Quarter of Fiscal 2007, compared to \$14.6 million for the Second Quarter of Fiscal 2006. This decrease was primarily attributable to decreased gross profit. Income from operations in the Sensors segment for the Second Quarter of Fiscal 2007 increased \$1.4 million, or 56.0%, to \$3.9 million, compared to \$2.5 million for the Second Quarter of Fiscal 2006, primarily due to increased gross profit and an estimated \$0.3 million favorable impact of currency translation, partially offset by planned increases in operating expenses.

Interest expense was \$0.3 million for the Second Quarter of Fiscal 2007, a decrease of \$0.1 million compared to interest expense of \$0.4 million for the Second Quarter of Fiscal 2006, due to reduction in the Company's long-term debt obligations. There was no significant impact on interest expense from currency translation.

Interest income was \$1.0 million for the Second Quarter of Fiscal 2007, an increase of \$0.2 million compared to interest income of \$0.8 million for the Second Quarter of Fiscal 2006, reflecting higher average interest rates, partially offset by a lower average balance of cash, cash equivalents and short-term investments during the Second Quarter of Fiscal 2007 compared to the Second Quarter of Fiscal 2006. There was no significant impact on interest income from currency translation.

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Other (expense) income, net was \$0.9 million of net expense for the Second Quarter of Fiscal 2007, a decrease of \$1.2 million compared to \$0.3 million of net income in the Second Quarter of Fiscal 2006, primarily due to net losses on foreign currency transactions in the Second Quarter of Fiscal 2007 compared to net gains on foreign currency transactions in the Second Quarter of Fiscal 2006. There was no significant impact on Other (expense) income, net from currency translation.

Provision for income taxes totaled \$6.1 million for the Second Quarter of Fiscal 2007, a decrease of \$0.4 million, or 6.2%, compared to \$6.5 million for the Second Quarter of Fiscal 2006, primarily due to decreased income before taxes, partially offset by an estimated \$0.1 million unfavorable impact of currency translation. The effective tax rate for the Second Quarter of Fiscal 2007 was 37.1%, an increase of 0.6 percentage points compared to a tax rate of 36.5% for the Second Quarter of Fiscal 2006, primarily due to the Company's geographic mix of income among the various tax jurisdictions.

Net income was \$10.3 million for the Second Quarter of Fiscal 2007, a decrease of \$1.0 million, or 8.8%, compared to \$11.3 million for the Second Quarter of Fiscal 2006. The decrease was primarily due to a \$1.1 million increase in net losses on foreign currency transactions, partially offset by decreased income tax expense and an estimated \$0.2 million favorable impact of currency translation.

The reduction in number of shares outstanding, resulting from the Company's share purchases, positively impacted earnings per share by \$0.03 for the Second Quarter of Fiscal 2007.

First Half of Fiscal 2007 Compared to First Half of Fiscal 2006

Revenue for the First Half of Fiscal 2007 was \$200.9 million, an increase of \$6.2 million, or 3.2%, compared to revenue of \$194.7 million for the First Half of Fiscal 2006. Revenue from international customers for the First Half of Fiscal 2007 represented 63.2% of total revenue, compared to 66.5% for the First Half of Fiscal 2006. Test segment revenue for the First Half of Fiscal 2007 was \$164.3 million, an increase of \$0.5 million, or 0.3%, compared to revenue of \$163.8 million for the First Half of Fiscal 2006, reflecting an estimated \$5.2 million favorable impact of currency translation, partially offset by decreased volume. Sensors segment revenue for the First Half of Fiscal 2007 was \$36.6 million, an increase of \$5.7 million, or 18.4%, compared to revenue of \$30.9 million for the First Half of Fiscal 2006, driven by continued worldwide business growth and an estimated \$1.7 million favorable impact of currency translation.

Gross profit for the First Half of Fiscal 2007 increased \$1.6 million, or 1.9%, to \$88.0 million, compared to gross profit of \$86.4 million for the First Half of Fiscal 2006. Gross profit as a percent of revenue was 43.8% for the First Half of Fiscal 2007, a decrease of 0.6 percentage points from 44.4% for the First Half of Fiscal 2006. Test segment gross profit for the First Half of Fiscal 2007 was \$67.8 million, a decrease of \$2.2 million, or 3.1%, compared to gross profit of \$70.0 million for the First Half of Fiscal 2006. Gross profit as a percent of revenue for the Test segment decreased 1.4 percentage points, to 41.3%, for the First Half of Fiscal 2007, compared to 42.7% for the First Half of Fiscal 2006. This decrease was primarily due to unfavorable product mix and increased manufacturing and support costs, partially offset by an estimated \$1.3 million favorable impact of currency translation. Sensors segment gross profit for the First Half of Fiscal 2007 was \$20.2 million, an increase of \$3.8 million, or 23.2%, compared to gross profit of \$16.4 million for the First Half of Fiscal 2006. Gross profit as a percent of revenue for the Sensors segment increased 2.1 percentage points, to 55.2%, for the First Half of Fiscal 2007, compared to 53.1% for the First Half of Fiscal 2006, primarily due to increased volume, improved capacity utilization, and an estimated \$0.9 million favorable impact of currency translation.

Selling and marketing expense for the First Half of Fiscal 2007 was \$34.2 million, an increase of \$2.3 million, or 7.2%, compared to \$31.9 million for the First Half of Fiscal 2006, primarily due to \$1.7 million increased expense associated with increased compensation, benefits and commission expense in the Test segment, \$0.7 million increased staffing and commission expense in the Sensors segment, and an estimated \$1.0 million unfavorable impact of currency translation, partially offset by a \$1.1 million decrease in expense associated with the exited noise and vibration business. Selling expense as a percent of revenue for the First Half of Fiscal 2007 was 17.0%, compared to 16.4% for the First Half of Fiscal 2006.

General and administrative expense totaled \$15.8 million for the First Half of Fiscal 2007, a decrease of \$1.2 million, or 7.1%, compared to \$17.0 million for the First Half of Fiscal 2006. This decrease was primarily due to \$2.2 million decreased consulting expenses and \$0.4 million decreased legal and audit fees, partially offset by \$0.7 million increased staffing and benefits expense, \$0.4 million increased other expenses, and an estimated \$0.3 million unfavorable impact of currency translation. General and administrative expense as a percent of revenue decreased to 7.9% for the First Half of Fiscal 2007, compared to 8.7% for the First Half of Fiscal 2006.

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Research and development expense totaled \$9.4 million for the First Half of Fiscal 2007, an increase of \$0.6 million, or 6.8%, compared to \$8.8 million for the First Half of Fiscal 2006. This increase was primarily due to a planned increase in expenditures for new product development in both segments. Research and development expense as a percent of revenue for the First Half of Fiscal 2007 was 4.7%, compared to 4.5% for the First Half of Fiscal 2006. There was no significant impact on research and development expense from currency translation.

Gain on sale of assets of \$0.8 million for the First Half of Fiscal 2007 resulted from the sale of assets associated with the Company's linear friction welding technology. The \$0.9 million gain on sale of assets for the First Half of Fiscal 2006 resulted from the sale of assets of the Company's noise and vibration business. There was no significant impact on gain on sales of assets from currency translation.

Income from operations for the First Half of Fiscal 2007 was \$29.3 million, flat compared to income from operations of \$29.4 million for the First Half of Fiscal 2006. Income from operations in the Test segment decreased \$2.3 million, or 9.4%, to \$22.2 million for the First Half of Fiscal 2007, compared to \$24.5 million for the First Half of Fiscal 2006. This decrease was primarily attributable to decreased gross profit and planned increases in operating expenses, partially offset by an estimated \$0.3 million favorable impact of currency translation. Income from operations in the Sensors segment for the First Half of Fiscal 2007 increased \$2.2 million, or 44.9%, to \$7.1 million, compared to \$4.9 million for the First Half of Fiscal 2006, primarily due to increased gross profit and an estimated \$0.5 million favorable impact of currency translation, partially offset by planned increases in operating expenses.

Interest expense was \$0.7 million for the First Half of Fiscal 2007, a decrease of \$0.2 million compared to interest expense of \$0.9 million for the First Half of Fiscal 2006, due to reduction in the Company's long-term debt obligations. There was no significant impact on interest expense from currency translation.

Interest income was \$1.9 million for the First Half of Fiscal 2007, an increase of \$0.4 million compared to interest income of \$1.5 million for the First Half of Fiscal 2006, reflecting higher average interest rates, partially offset by a lower average balance of cash, cash equivalents and short-term investments during the First Half of Fiscal 2007 compared to the First Half of Fiscal 2006. There was no significant impact on interest income from currency translation.

Other (expense) income, net was \$0.8 million in net expense for the First Half of Fiscal 2007, a decrease of \$1.1 million compared to \$0.3 million in net income in the First Half of Fiscal 2006, primarily due to net losses on foreign currency transactions in the First Half of Fiscal 2007 compared to net gains on foreign currency transactions in the First Half of Fiscal 2006. There was no significant impact on Other (expense) income, net from currency translation.

Provision for income taxes totaled \$9.3 million for the First Half of Fiscal 2007, a decrease of \$1.8 million, or 16.2%, compared to \$11.1 million for the First Half of Fiscal 2006, primarily due to a lower effective tax rate and decreased income before taxes, partially offset by an estimated \$0.3 million unfavorable impact of currency translation. The effective tax rate for the First Half of Fiscal 2007 was 31.2%, a decrease of 5.4 percentage points compared to a tax rate of 36.6% for the First Half of Fiscal 2006, primarily due to the enactment of tax legislation in the First Half of Fiscal 2007 that retroactively extended the United States research and development tax credits as well as legislation that entitles the Company to a corporate income tax refund in Germany.

Net income was \$20.4 million for the First Half of Fiscal 2007, an increase of \$1.1 million, or 5.7%, compared to \$19.3 million for the First Half of Fiscal 2006. The increase was primarily due to decreased income tax expense and an estimated \$0.6 million favorable impact of currency translation, partially offset by a \$1.1 million increase in net losses on foreign currency transactions.

The reduction in number of shares outstanding, resulting from the Company's share purchases, positively impacted earnings per share by \$0.07 for the First Half of Fiscal 2007.

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Capital Resources and Liquidity

Total cash and cash equivalents increased \$1.9 million in the First Half of Fiscal 2007, primarily due to strong earnings, net proceeds generated from the conversion of short-term investments to cash and cash equivalents, increased advance payments received from customers, increased income taxes payable, and proceeds from the exercise of stock options, partially offset by employee incentives and related benefits payments, increased inventories, purchases of the Company's common stock, and dividend payments. Total cash and cash equivalents increased \$1.0 million in the First Half of Fiscal 2006, primarily due to strong earnings, advance payments received from customers, net proceeds generated from the conversion of short-term investments to cash and cash equivalents, and proceeds from the exercise of stock options, partially offset by employee incentive and related benefits payments, increased accounts and unbilled receivables, purchases of the Company's common stock, and dividend payments. The Company believes that its anticipated operating cash flows, in addition to funds available from cash, cash equivalents and short-term investments totaling \$117.4 million at March 31, 2007, are adequate to fund ongoing operations, capital expenditures, and share purchases, as well as to fund internal growth opportunities and strategic acquisitions.

Cash flows from operating activities provided cash totaling \$27.5 million for the First Half of Fiscal 2007, compared to cash provided of \$12.3 million for the First Half of Fiscal 2006. Operating cash flow for the First Half of Fiscal 2007 primarily resulted from strong earnings, \$6.6 million increased advance payments received from customers, and \$4.5 million increased income taxes payable, partially offset by net employee incentive and related benefit payments of \$3.5 million and \$2.6 million increased inventories. Operating cash flow for the First Half of Fiscal 2006 primarily resulted from strong earnings and \$9.2 million increased advance payments received from customers, partially offset by net employee incentive and related benefits payments of \$5.9 million and an increase in accounts and unbilled receivables of \$14.8 million.

Cash flows from investing activities provided cash totaling \$1.2 million for the First Half of Fiscal 2007, compared to cash provided of \$49.6 million for the First Half of Fiscal 2006. During the First Half of Fiscal 2007, the Company received net proceeds of \$6.1 million from the conversion of short-term investments to cash and cash equivalents, received \$1.0 million from the sale of assets associated with the Company's linear friction welding technology, and invested \$5.8 million in property and equipment additions. During the First Half of Fiscal 2006, the Company received net proceeds of \$53.6 million from the conversion of short-term investments to cash and cash equivalents and invested \$3.9 million in property and equipment additions.

Cash flows from financing activities required the use of cash totaling \$30.2 million for the First Half of Fiscal 2007, compared to a use of cash totaling \$60.9 million for the First Half of Fiscal 2006. The cash usage for the First Half of Fiscal 2007 was due to the use of \$25.9 million to purchase shares of the Company's common stock, payment of cash dividends of \$6.1 million, and repayment of interest-bearing debt of \$1.2 million, partially offset by \$2.4 million received in connection with stock option exercises and \$0.5 million equity compensation income tax benefits. The cash usage for the First Half of Fiscal 2006 was due to the use of \$59.5 million to purchase shares of the Company's common stock, payment of cash dividends of \$3.9 million, and repayment of interest-bearing debt of \$1.2 million, partially offset by \$2.6 million received in

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connection with stock option exercises and \$1.0 million equity compensation income tax benefits.

Under the terms of its long-term debt agreements, the Company has agreed to certain financial covenants. At March 31, 2007 the Company was in compliance with the financial terms and conditions of its debt and credit facility agreements.

During the three- and six-month periods ended March 31, 2007, the Company purchased 621,206 and 675,206 shares of its common stock for \$23.8 million and \$25.9 million, respectively. During the three- and six-month periods ended April 1, 2006, the Company purchased 998,500 and 1,621,435 shares of its common stock for \$37.3 million and \$59.5 million, respectively.

Restructuring and Other Charges

In the fourth quarter of fiscal year 2005, the Company decided to exit its noise and vibration business. The Company assessed the recoverability of the assets associated with this business using an undiscounted cash flow methodology. Based on this assessment, the Company reduced the assets to their fair market value. In addition, the Company recorded employee severance costs and software development expense that will not repeat in future years.

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For the six-month period ended March 31, 2007 and the fiscal year ended September 30, 2006, the Company's provisions and write-offs associated with this restructuring activity were as follows:

	Severance Charges	Contract Termination Charges	Total
Balances at October 1, 2005	\$ 1,267	\$ 52	\$ 1,319
Provision	30		30
Write-off/payments	(1,257) (52) (1,309
Balances at September 30, 2006	\$ 40	\$	\$ 40
Provision			
Write-off/payments	(40)	(40
Balances at March 31, 2007	\$	\$	\$

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 Form 10-Q.

Revenue Recognition. Due to the diversity of its products, the Company is required to comply with a variety of technical accounting requirements in order to achieve consistent and accurate revenue recognition. This requires a certain amount of judgment in the evaluation of completed contract versus percentage-of-completion accounting, the determination of estimated costs to complete contracts, and evaluation of customer acceptance terms.

Inventories. The Company maintains a material amount of inventory to support its engineering and manufacturing operations, and a certain amount of judgment is required in determining the appropriate level of inventory valuation reserves. While the Company expects its sales to grow, a reduction in its sales could reduce the demand for the Company's products, and additional inventory valuation adjustments may be required.

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.

Stock-Based Compensation. For purposes of determining estimated fair value of stock-based payment awards on the date of grant in accordance with Statement of Financial Accounting Standard (SFAS) No. 123R, Share-Based Payment, the Company utilizes a Black-Scholes option pricing model for estimating the fair value of stock option grants, which requires the input of certain assumptions requiring management judgment. Because the Company's employee stock option awards have characteristics significantly different from those of traded options, and because changes in the input assumptions can materially affect fair value estimates, existing models may not provide a reliable single measure of the fair value of employee stock options. Management will continue to assess the assumptions and methodologies used to calculate estimated fair value of stock-based compensation. Circumstances may change and additional data may become available over time that could result in changes to these assumptions and methodologies and thereby materially impact the fair value determination. If factors change and the Company employs different assumptions in the application of SFAS 123R in future periods, the compensation expense recorded under SFAS No. 123R may differ significantly from the stock-based compensation expense recorded in the current period. See Note 2 in the Condensed Notes to Consolidated Financial Statements in this Form 10-Q for more information regarding stock-based compensation.

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New Accounting Principles

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In July 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes. FIN 48 defines the threshold for recognizing the benefits of tax positions in the financial statements as more-likely-than-not to be sustained upon examination. The interpretation also provides guidance on the de-recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of required disclosures associated with any recorded income tax uncertainties. The differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption are to be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. FIN 48 is effective for fiscal years beginning after December 15, 2006 and thus will be effective for the Company in fiscal year 2008. The Company is evaluating the impact of the adoption of FIN 48 to its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under this statement, fair value measurements are required to be separately disclosed, by level, within the fair value hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 157 is not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Post Retirement Plans, an Amendment of SFAS No. 87, Employers' Accounting for Pensions, SFAS No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, and SFAS No. 132(R), Employers' Disclosures about Pensions and Other Postretirement Benefits. SFAS No. 158 requires the recognition of the funded status of defined benefit pension and other post-retirement plans in the balance sheet, as well as the recognition as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that have yet to be recognized as components of net periodic retirement cost pursuant to SFAS No. 87 and SFAS No. 106. The provisions of SFAS No. 158 are effective as of the end of fiscal years ending after December 15, 2006. The adoption of SFAS No. 158 is not expected to have a material impact on the Company's consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB No. 108 is effective as of the end of fiscal years ending after November 15, 2006. The adoption of SAB No. 108 is not expected to have a material impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS No. 159 allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value in situations in which they are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current earnings. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. SFAS no. 159 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS No. 159 is not expected to have a material impact on the Company's consolidated financial statements.

Other Matters

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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 hedge 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.

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 payout ratio target is approximately 25% of earnings per share over the long term.

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Forward-Looking Statements

Statements included or incorporated by reference in this Management's Discussion and Analysis of Financial Condition and Results of Operations, elsewhere in this Form 10-Q, and in the Company's press releases and oral statements made with the approval of an authorized executive officer, which are not historical or current facts are forward-looking statements, as defined in the Private Securities Litigation Reform Act of 1995, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results and those presently anticipated or projected. The following important factors, among others, could affect the Company's actual results in the future and could cause the Company's actual financial performance to differ materially from that expressed in any forward-looking statements:

- (i) Possible significant volatility in backlog and/or quarterly operating results may result from the timing of individual large, fixed-price orders in connection with sales of Test segment systems.
- (ii) Order volumes and other operating considerations may be directly or indirectly impacted by economic conditions generally and/or in various geographic areas in which the Company operates. The Company derives significant revenue from the global ground vehicles and aerospace industries and therefore is subject to economic cycles affecting these customers.
- (iii) Export controls based on U.S. initiatives and foreign policy, as well as import controls imposed by foreign governments, may cause delays in certain shipments or the rejection of orders by the Company. Such delays could create material fluctuations in quarterly operating results and could have a material adverse effect on results of operations. Local political conditions and/or currency restrictions may also affect foreign revenue. Violation of export control laws or regulations could result in civil or criminal penalties applicable to the Company which, under some circumstances, could have a material adverse impact on the Company.
- (iv) Delays in realization of orders in backlog may occur due to technical difficulties or delays in export licensing approval or the customer's preparation of the installation site, any of which can affect the quarterly or annual period when backlog is recognized as revenue and could materially affect the results of any such period.

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- (v) The Company experiences competition on a worldwide basis. Customers may choose to purchase equipment from the Company or from its competitors. For certain of the Company's products, customers may contract with testing laboratories or construct their own testing equipment from commercially available components. Factors that may influence a customer's decision include price, service, and required level of technology.
- (vi) The Company operates internationally and thus is subject to foreign currency exchange rate changes, which can affect its results of operations and financial condition.
- (vii) With regard to the Company's new product developments, there may be uncertainties concerning the expected results. In addition, the Company may not be aware of the introduction of new products or product enhancements by its competitors.
- (viii) The Company's short-term investments and borrowings carry floating interest rate risk. The Company has minimal earnings and cash flow exposure related to market risk on its long-term debt obligations as a result of the primarily fixed-rate nature of its debt.
- (ix) The Company relies on various raw material, component, and sub-assembly suppliers in its production processes and as such, business interruptions affecting these suppliers may cause delays in the Company's ability to convert its backlog of unfilled orders to revenue.

The foregoing list is not exhaustive, and the Company disclaims any obligation to revise any forward-looking statements to reflect new information, future events, or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company's investment portfolio at March 31, 2007 included \$99.9 million of cash and cash equivalents and \$17.5 million of short-term investments. The cash equivalent portion of the Company's investment portfolio is invested in money market funds and bank deposits. The short-term investment portfolio consisted of U.S. municipal bonds for which the interest rates are re-set every 7, 28, or 35 days in a market auction process such that yields typically reflect current market interest rates. Thus, changes in market interest rates will impact interest income on a current basis. A hypothetical 1.0 percentage point increase or decrease in market interest rates would have caused interest income to increase or decrease by \$0.6 million for the six months ending March 31, 2007.

The Company operates internationally and is subject to foreign currency exchange rate fluctuations. 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 \$8.8 million in revenue for the six months ended March 31, 2007.

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At March 31, 2007 the Company's long-term debt consisted of notes payable with fixed interest rates ranging from 6.6% to 7.5%. As such, interest rate fluctuations would not have an impact on the Company's interest expense or cash flows.

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 March 31, 2007. 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.

There have been no changes in internal control over financial reporting during the fiscal quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

The Company is subject to the export control regulations of the U.S. Department of Commerce. As described in a newspaper article published in August 2003, the Department of Commerce and the U.S. Attorney for the District of Minnesota have each been conducting an inquiry into the Company's compliance with certain export regulations. The initial inquiry described in the newspaper article resulted in a \$36,000 civil settlement with the Department of Commerce without the Company admitting to violating any law or regulation. The separate criminal inquiry by the U.S. Attorney's office has been ongoing and, recently, the U.S. Attorney's office proposed terms to terminate the criminal inquiry, if the Company were to plead guilty to violating federal export control regulations and a related federal criminal statute and pay the maximum criminal fine, which the Company understands could be up to \$1,000,000, under applicable law.

The Company, together with its outside counsel, has thoroughly investigated all actions in question and firmly believes any allegation of wrongdoing is without merit. Furthermore, while the Company does not know whether any formal charges will be brought against it, it has evaluated its legal defenses, and the range of possible and probable outcomes, and does not believe the ultimate outcome of any proceeding would have a material adverse effect on the Company's business or financial condition.

Item 1A. Risk Factors

No material changes.

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Purchases of Company Equity Securities:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs
December 31, 2006				
February 3, 2007	45,000	\$ 39.96	45,000	1,389,238
February 4, 2007				
March 3, 2007	86,000	\$ 39.50	86,000	1,303,238
March 4, 2007				
March 31, 2007	490,206	\$ 37.67	490,206	813,032
Total	621,206	\$ 38.09	621,206	

The Company purchases Company common stock to offset dilution from new shares created by equity compensation such as stock options, restricted stock awards, and the employee stock purchase plan, and as a means of returning excess cash to shareholders. The Company executes all purchases in accordance with Rule 10b-18 of the Securities Exchange Act of 1934.

The Company's share purchases were executed under a 3.0 million share purchase authorization approved by the Company's Board of Directors and announced on August 25, 2005. Authority over pricing and timing under the program has been delegated to management. The program has no expiration date.

Item 3. Defaults Upon Senior Securities

None

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

(a) The Company's Annual Meeting of Shareowners was held on January 30, 2007.

(b) The following persons were nominated and elected to continue as directors of the Company until the next Annual Meeting of Shareholders:

	Voted For	Voted Against
Ricardo Artigas	16,902,536	18,492
Jean-Lou Chameau	16,902,813	18,215
Merlin E. Dewing	16,903,368	17,660
Sidney W. Emery, Jr.	16,739,505	181,523
Brendan C. Hegarty	16,896,498	24,530
Lois M. Martin	16,902,854	18,174
Barb J. Samardzich	16,903,142	17,886

(c) The appointment of KPMG, LLP as the Company's independent registered public accounting firm for the current fiscal year was approved with 16,816,345 votes in favor, 83,467 votes against, and 21,216 votes abstained. There were no broker non-votes.

Item 5. Other Information

None

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Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description</u>
3.a	Restated and Amended Articles of Incorporation, incorporated by reference from Exhibit 3.a. of Form 10-K for the fiscal year ended September 30, 1996.
3.b	Amended and Restated Bylaws, incorporated herein by reference from Exhibit 3.1 of the Registrant's Form 8-K Current Report filed on December 4, 2006.

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- 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: May 8, 2007

/s/ SIDNEY W. EMERY, Jr.
Sidney W. Emery, Jr.
Chairman, President and Chief Executive Officer

Dated: May 8, 2007

/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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