DERMA SCIENCES, INC.
Form 10-Q
May 10, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2016

.. 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 1-31070

Derma Sciences, Inc.

(Exact name of registrant as specified in its charter)

Delaware	23-2328753
(State or other jurisdiction of Incorporation)	(IRS employer identification number)

214 Carnegie Center, Suite 300

Princeton, NJ 08540

(Address of principal executive offices)

(609) 514-4744

(Issuer's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

Large accelerated filer ¨		Accelerated filer	x
Non-accelerated filer ¨	(Do not check if a smaller reporting company)	Smaller reporting company	¨

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

Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Date: May 9, 2016 Class: Common Stock, par value $.01 per share Shares Outstanding: 25,887,369

PART I – FINANCIAL INFORMATION

DERMA SCIENCES, INC.

FORM 10-Q

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Part I – Financial Information

Item 1. Financial Statements.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets (Unaudited)

	March 31, 2016	December 31, 2015
ASSETS		
Current Assets		
Cash and cash equivalents	$11,778,942	$15,814,205
Short-term investments	25,000,000	25,003,990
Accounts receivable, net of allowances of $598,993 and $704,527, respectively	8,215,995	8,145,589
Inventories	21,354,855	20,690,706
Prepaid expenses and other current assets	1,444,842	1,449,407
Total current assets	67,794,634	71,103,897
Long-term equity investment	19,261,451	16,110,178
Equipment and improvements, net of accumulated depreciation and amortization of $8,114,297 and $7,634,541, respectively	4,162,660	4,129,208
Identifiable intangible assets, net of accumulated amortization of $14,361,696 and $13,615,631, respectively	9,085,180	9,831,245
Goodwill	13,457,693	13,457,693
Other assets	150,510	147,934
Total assets	$113,912,128	$114,780,155
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$2,548,115	$2,473,056
Accrued expenses and other current liabilities	4,827,309	6,691,340
Liabilities of discontinued operations	3,207,951	4,371,010
Total current liabilities	10,583,375	13,535,406
Long-term liabilities	998,981	1,014,378
Deferred tax liability	2,642,586	1,804,516
Total liabilities	14,224,942	16,354,300
Commitments and contingencies (Note 11)		

Stockholders’ Equity		
Convertible preferred stock, $.01 par value; shares authorized 1,468,750; issued and outstanding 73,332 at March 31, 2016 and December 31, 2015 (liquidation preference of $3,222,368 at March 31, 2016)	733	733
Common stock, $.01 par value; shares authorized 50,000,000; issued and outstanding 25,885,494 at March 31, 2016 and 25,876,870 at December 31, 2015	258,855	258,769
Additional paid-in capital	235,671,075	234,943,291
Accumulated other comprehensive income	7,564,122	5,272,908
Accumulated deficit	(143,807,599)	(142,049,846)
Total stockholders’ equity	99,687,186	98,425,855
Total liabilities and stockholders’ equity	$113,912,128	$114,780,155

See accompanying notes to consolidated financial statements.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Operations (Unaudited)

	Three Months Ended March 31, 2016	2015*
Net Sales	$ 20,242,557	$ 19,498,652
Cost of sales	12,535,034	11,963,526
Gross Profit	7,707,523	7,535,126
Operating Expenses		
Selling, general and administrative	9,953,114	13,258,405
Research and development	-	352,183
Total operating expenses	9,953,114	13,610,588
Operating loss	(2,245,591)	(6,075,462)
Other (income) expense, net	(268,040)	367,788
Loss from continuing operations before income taxes	(1,977,551)	(6,443,250)
Income tax (benefit) provision	(219,798)	8,051
Net Loss from Continuing Operations	(1,757,753)	(6,451,301)
Discontinued Operations		
Loss from discontinued operations, net of taxes	-	(4,158,276)
Net Loss	$ (1,757,753)	$ (10,609,577)
Net loss per common share – basic and diluted		
Continuing operations	$ (0.07)	$ (0.25)
Discontinued operations	-	(0.16)
Total net loss per common share – basic and diluted	$ (0.07)	$ (0.41)
Shares used in computing net loss per common share – basic and diluted	25,879,618	25,552,762

* Reclassified for discontinued operations. See Note 2.

See accompanying notes to consolidated financial statements.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

	Three Months Ended March 31,	
	2016	2015
Net Loss	$ (1,757,753)	$ (10,609,577)
Other Comprehensive Income (Loss)		
Foreign currency translation adjustment	320,565	(155,811)
Unrealized gain on equity securities, net of taxes of $1,180,624 and $5,501	1,970,649	8,805
Total other comprehensive income (loss)	2,291,214	(147,006)
Comprehensive Income (Loss)	$ 533,461	$ (10,756,583)

See accompanying notes to consolidated financial statements.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

	Three Months Ended March 31,	
	2016	2015
Operating Activities		
Net loss	$ (1,757,753)	$ (10,609,577)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization of equipment and improvements	243,121	267,003
Amortization of identifiable intangible assets	746,065	746,065
Provision for bad debts	827	37,585
Allowance for sales adjustments	(106,102)	27,406
Provision for inventory obsolescence	77,596	(74,219)
Loss on disposal of equipment	17,837	-
Deferred rent	(18,288)	(24,396)
Stock-based compensation	745,880	1,556,311
Deferred income taxes	(361,954)	3,306
Changes in operating assets and liabilities:		
Accounts receivable	13,620	448,814
Inventories	(209,341)	(2,971,412)
Prepaid expenses and other assets	10,003	137,711
Accounts payable	(468,871)	1,304,445
Accrued expenses and other liabilities	(2,674,059)	(1,576,478)
Net cash used in operating activities	(3,741,419)	(10,727,436)
Investing Activities		
Purchase of investments	(30,008,483)	(20,000,000)
Proceeds from sale of investments	30,012,473	25,996,000
Purchase of equipment and improvements	(107,750)	(433,135)
Net cash (used in) provided by investing activities	(103,760)	5,562,865
Financing Activities		
Proceeds from exercise of stock options and warrants, net of costs	-	1,885,630
Payment of withholding taxes related to employee stock-based compensation	(18,010)	(67,409)
Net cash (used in) provided by financing activities	(18,010)	1,818,221
Effect of exchange rate changes on cash and cash equivalents	(172,074)	447,230
Net decrease in cash and cash equivalents	(4,035,263)	(2,899,120)
Cash and cash equivalents		
Beginning of period	15,814,205	19,396,845
End of period	$ 11,778,942	$ 16,497,725
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
TaxesCash and cash equivalents and investments at March 31, 2016	$ 430,922	$ -

See accompanying notes to consolidated financial statements.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiaries (the “Company”) is a medical device company focused on two segments of the wound care marketplace: advanced wound care and traditional wound care products. The Company markets its products principally through direct sales representatives in the United States (“U.S.”), Canada and the United Kingdom (“U.K.”), and through independent distributors within other select international markets. The Company’s U.S. distribution facilities are located in St. Louis, Missouri and Houston, Texas. The Company utilizes third party distributors for distribution in Canada, Europe, Latin America, Asia and the Pacific. The Company has manufacturing facilities in Toronto, Canada and Nantong, China.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. Information included in the consolidated balance sheet as of December 31, 2015 has been derived from the consolidated financial statements and footnotes thereto for the year ended December 31, 2015, included in the Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. For further information refer to the Annual Report on Form 10-K for the year ended December 31, 2015.

Principles of Consolidation – The consolidated financial statements include the accounts of Derma Sciences, Inc. and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates – The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Although these estimates are based on knowledge of current events and actions which may be undertaken in the future, actual results may ultimately differ from these estimates. Estimates and assumptions are required in the determination of sales deductions for trade rebates, sales incentives, discounts and allowances. Significant estimates and assumptions are also required in determining the appropriateness of amortization periods for identifiable intangible assets, the potential impairment of goodwill and the valuation of inventory.

Revenue Recognition – Sales are recorded when product is shipped or title passes to customers and collectability is reasonably assured. Gross sales are adjusted for cash discounts, returns and allowances, trade rebates, distribution fees (in Canada) and other sales deductions in the same period that the related sales are recorded. Freight costs billed to and reimbursed by customers are recorded as a component of revenue. Freight costs to ship product to customers are recorded as a component of cost of sales.

Net Loss per Share – Net loss per common share – basic is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Net loss per common share – diluted reflects the potential dilution of earnings by including the effects of the assumed exercise, conversion or issuance of potentially issuable shares of common stock ("potentially dilutive securities"), including those attributable to stock options, warrants, convertible preferred stock and restricted stock units, in the weighted average number of common shares outstanding for a period, if dilutive. The effects of convertible preferred stock are determined using the if converted method. The effects of the assumed exercise of warrants and stock options, and restricted share units, are determined using the treasury stock method. Potentially dilutive securities have not been included in the computation of diluted loss per share for the three months ended March 31, 2016 and 2015 as the effect would be anti-dilutive.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

Potentially dilutive securities excluded as a result of the effects of being anti-dilutive are as follows:

	Three Months Ended March 31, 2016	2015
Excluded dilutive shares:		
Convertible preferred stock	73,332	73,332
Additional stock issuable related to conversion of preferred stock	49,782	49,782
Restricted share units	175,550	672,000
Warrants	1,755,330	1,755,330
Stock options	2,680,724	2,595,426
Total dilutive shares	4,734,718	5,145,870

Recently Issued Accounting Pronouncements – In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, *Revenue from Contracts with Customers*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. In August 2015, the FASB issued ASU No. 2015-14 which defers the effective date of ASU No. 2014-09 until fiscal years beginning after December 15, 2017 with early application permitted for fiscal years beginning after December 15, 2016. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting. In March 2016, the FASB issued ASU No. 2016-08, which clarifies the implementation guidance provided in ASU 2014-09 on principal versus agent considerations. In April 2016, the FASB issued ASU 2016-10, which clarifies the implementation guidance in ASU 2014-09 on licensing and identifying performance obligations. Both ASU 2016-08 and ASU 2016-10 must be adopted concurrently with ASU 2014-09. We are currently evaluating the transition methods and the impact the adoption of these standards will have on our consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, *Accounting for Equity Investments and Financial Liabilities*, which changes the income statement impact of equity investments held by an entity, as well as the recognition of changes in fair value of financial liabilities when the fair value option is elected. The standard is effective for annual and interim periods in fiscal years beginning after December 15, 2017 for public business entities. Early adoption is not permitted for the provision related to equity investments. After the Company adopts this ASU for the year beginning January 1, 2018, any change in the fair value of the Company's equity investments will be included in other expense (income), net in the Consolidated Statement of Operations.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, which revises the accounting related to lessee accounting. Under the new guidance, lessees will be required to recognize a lease liability and a right-of-use asset for all leases. Consistent with current guidance, the recognition, measurement, and presentation of expenses and cash flows arising from a lease primarily will depend on its classification as a finance or operating lease. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within that reporting period. Early adoption is permitted. The new standard is to be applied using a modified retrospective approach. The Company is currently evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU No. 2016-09, *Improvements to Employee Share-Based Payment Accounting*, which simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The standard is effective for annual periods beginning after December 15, 2016 for public business entities. Early adoption is permitted. The Company is currently evaluating the effect that ASU 2016-09 will have on its consolidated financial statements and related disclosures.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

2. Discontinued Operations

Effective November 12, 2015, the Company approved a plan to terminate its Phase 3 Aclerastide (DSC127) clinical program for diabetic foot ulcer healing. This action was based on futility determinations emanating out of the planned, pre-specified interim analyses of trial data conducted by the program’s independent Data Monitoring Committee (“DMC”). The decision to end the studies followed the recommendation by the DMC to stop the trials. Based on this recommendation, the Company initiated an orderly termination of all its existing pharmaceutical development activities, comprised of the diabetic foot ulcer healing program and two other programs utilizing the DSC127 compound for other therapeutic indications. As a result of these actions, the Company’s pharmaceutical development activities have been reported as discontinued operations in the Company’s Consolidated Financial Statements. Amounts previously reported in the Pharmaceutical Wound Care segment have been reclassified to conform to this presentation to allow for meaningful comparison of continuing operations. There were no noncash charges included in the loss from discontinued operations in the consolidated statement of operations for the three months ended March 31, 2015.

At March 31, 2016, the Company had $3,207,951 of unpaid severance, cancellation and closure costs included in liabilities of discontinued operations on the Consolidated Balance Sheet.

3. Restructuring and Other Charges

During the fourth quarter of 2015, the Company implemented a plan to reduce its cost structure in consideration of prospective market expectations for the business, coupled with the decision to move the business towards positive cash flow and profitability as soon as feasibly possible. The restructuring plan included the elimination of 39 positions and certain other non-employee discretionary costs. The Company incurred severance charges from continuing operations of $952,534 associated with the elimination of the positions.

Effective December 21, 2015, the Company’s Chairman of the Board, President and Chief Executive Officer (“CEO”) departed from the Company. On February 26, 2016, the former CEO resigned from the Company’s Board of Directors. While a national recruiting search for a permanent CEO is in process, the former lead director of the Company has assumed the role of Executive Chairman and Interim CEO.

The Company incurred compensation and other benefit severance charges of $1,506,021, including $114,573 of stock-based compensation, associated with the former CEO's departure. The payments are payable over a two year period.

A summary of the Company's restructuring activity for the three months ended March 31, 2016 is as follows:

	CEO	Other Employees	Total
Balance, January 1, 2016	$1,252,105	$826,932	$2,079,037
Charges during period	-	-	-
Payments during period	(199,356)	(641,536)	(840,892)
Balance, March 31, 2016	$1,052,749	$185,396	$1,238,145
Less current portion	(465,826)	(185,396)	(651,222)
Long term portion	$586,923	$-	$586,923

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

4. Cash and Cash Equivalents and Investments

Cash and Cash Equivalents

The Company considers cash and cash equivalents as amounts on hand, on deposit in financial institutions and highly liquid investments purchased with an original maturity of three months or less. The Company maintains cash and cash equivalents and money market mutual funds with various domestic and foreign financial institutions within the ordinary course of business, which at times may exceed jurisdictional insurance limits. Money market mutual funds consist of funds deposited into mutual funds investing in U.S. government and non-government obligations.

Investments in Debt Securities

Investments in debt securities include certificates of deposit purchased with an original maturity greater than three months which are deposited in various U.S. financial institutions and are fully insured by the Federal Deposit Insurance Corporation. The Company intends to hold the certificates of deposit to maturity and accordingly these investments are carried at amortized cost. Investments in debt securities with maturities greater than one year from the balance sheet date are classified as a long-term asset.

Investment in Equity Securities

In 2013 and 2014, the Company purchased an aggregate 2,802,277 shares of Comvita Limited ("Comvita") common stock for $8,483,693. At March 31, 2016, the 2,802,277 shares of Comvita common stock owned by the Company represented approximately 7.0% of Comvita's outstanding shares.

The investment in Comvita common stock is classified as an available-for-sale investment carried at fair value, with any unrealized gains and losses associated with the investment included in accumulated other comprehensive income and any dividends received recorded in other (income) expense, net in the Consolidated Statement of Operations. The investment is classified as a long term asset. As of March 31, 2016, the fair value of the Comvita common stock was $19,261,451 as determined by the quoted market price of the outstanding stock on the New Zealand stock exchange. The cumulative increase in fair value from cost of $10,777,758 has been recorded in accumulated other comprehensive income, net of taxes.

Cash and cash equivalents and investments at March 31, 2016 and December 31, 2015 consisted of the following:

	March 31, 2016	December 31, 2015
Cash	$ 11,778,942	$ 10,784,522
Cash equivalents	-	5,029,683
Cash and cash equivalents	11,778,942	15,814,205
Investments in debt securities	25,000,000	25,003,990
Investment in equity securities	19,261,451	16,110,178
Total investments	44,261,451	41,114,168
Total cash and cash equivalents and investments	$ 56,040,393	$ 56,928,373

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

The following table provides fair value information as of March 31, 2016:

		Fair Value Measurements, Using		
	Total carrying value as of March 31, 2016	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash and cash equivalents	$ 11,778,942	$ 11,778,942	$ -	$ -
Investments in debt securities	25,000,000	25,000,000	-	-
Investment in equity securities	19,261,451	19,261,451	-	-
Total investments	44,261,451	44,261,451	-	-
Total	$ 56,040,393	$ 56,040,393	$ -	$ -

The following table provides fair value information as of December 31, 2015:

		Fair Value Measurements, Using		
	Total carrying value as of December 31, 2015	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash and cash equivalents	$ 15,814,205	$ 15,814,205	$ -	$ -
Investments in debt securities	25,003,990	25,003,990	-	-
Investment in equity securities	16,110,178	16,110,178	-	-
Total investments	41,114,168	41,114,168	-	-

Total	$ 56,928,373	$56,928,373	$ -	$ -

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets. Level 2 inputs are quoted prices for similar assets in active markets or inputs that are observable for the asset, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on management's own assumptions used to measure assets at fair value. A financial asset's classification is determined based on the lowest level input that is significant to the fair value measurement.

5. Inventories

Inventories include the following:

	March 31, 2016	December 31, 2015
Finished goods	$ 15,185,747	$ 15,347,592
Work in process	65,743	346,233
Packaging materials	1,304,631	1,152,993
Raw materials	4,798,734	3,843,888
Total inventory	$ 21,354,855	$ 20,690,706

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

6. Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities include the following:

	March 31, 2016	December 31, 2015
Accrued compensation and related taxes	$ 1,029,055	$ 2,390,855
Liabilities related to restructuring (Note 3)	1,238,145	2,079,037
Accrued sales incentives and other fees	550,377	613,186
Accrued Canadian sales rebate, net	560,122	237,141
Other	2,448,591	2,385,499
Total accrued expenses and other liabilities	$ 5,826,290	$ 7,705,718
Less current portion	(4,827,309)	(6,691,340)
Long term liabilities	$ 998,981	$ 1,014,378

7. Stockholders' Equity

Preferred Stock

Subsequent to the issuances of its preferred stock, the Company has undertaken a number of common stock offerings that impact the preferred stock conversion ratios. As of March 31, 2016, current Series A and B preferred stockholders holding 73,332 preferred shares are entitled to receive an aggregate of 123,114 shares (49,782 additional shares) of common stock upon conversion of their holdings, as a result of the conversion ratio adjustments. The number of shares issuable upon conversion is subject to further adjustment should the Company in the future undertake one or more offerings of its common stock at less than the prevailing market price.

Upon conversion, the 49,782 incremental shares associated with the conversion ratio adjustments will be recorded to common stock at par with the offset to additional paid in capital as all of the convertible preferred stock was issued prior to the November 16, 2000 effective date of certain provisions of Accounting Standards Codification 470 (formerly Emerging Issues Task Force Issue No. 00-27 *Application of Issue No. 98-5 to Certain Convertible*

Instruments).

Common Stock

During the three months ended March 31, 2016, the Company issued 8,624 shares of common stock in connection with the vesting of 14,200 restricted share units.

Stock Purchase Warrants

At March 31, 2016, the Company had warrants outstanding to purchase shares of the Company's common stock consisting of the following:

Series	Number of Warrants	Exercise Price	Expiration Date
R	1,705,330	$ 9.90	June 22, 2016
S	50,000	$ 11.81	January 14, 2019
Total	1,755,330		

There were no warrants exercised or forfeited during the three months ended March 31, 2016.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

Equity Based Compensation

Under the Derma Sciences, Inc. 2012 Equity Incentive Plan (the "EIP Plan") the Company is authorized to issue 6,000,000 shares of common stock. The EIP Plan authorizes the Company to grant equity-based and cash-based incentive compensation in the form of stock options, stock appreciation rights, restricted shares, restricted share units, other share-based awards and cash-based awards, for the purpose of providing the Company's employees, non-employee directors and consultants with incentives and rewards for performance. At March 31, 2016, options to purchase 2,680,724 shares and 175,550 restricted share units were issued and outstanding under the EIP Plan and 2,004,284 shares were available for grant.

Stock Options

The EIP Plan permits the granting of both incentive and nonqualified stock options to employees and nonqualified stock options to non-employee directors and consultants of the Company. The option exercise price may not be less than the fair market value of the stock on the date of the grant of the option. The duration of each option may not exceed 10 years from the date of grant.

For the three months ended March 31, 2016 and 2015, the fair value of each option award was estimated at the date of grant using the Black-Scholes option-pricing model. The weighted-average assumptions used were as follows:

	Three Months Ended March 31,			
	2016		2015	
Risk-free interest rate	1.45	%	1.63	%
Volatility factor	44.2	%	46.0	%
Dividend yield	0	%	0	%
Expected option life (years)	5.68		5.77	

The risk-free rate utilized represents the U.S. treasury yield curve rate for the expected option life at the time of grant. The volatility factor was calculated based on the Company's historical stock price volatility equal to the expected life of the option at the grant date. The dividend yield is 0% since the Company does not anticipate paying dividends in the near future. The simplified expected option life method is used to determine the expected option life for Company employees and directors while the contractual option life period is utilized for consultants.

Based on the Company's historical experience of options that were forfeited before becoming fully vested, the Company has assumed an annualized forfeiture rate of 1.0% for all options. The Company will record additional expense if the actual forfeiture rate is lower than estimated, and will record a recovery of prior expense if the actual forfeiture rate is higher than estimated.

A summary of the Company's stock option activity and related information for the three months ended March 31, 2016 is as follows:

	Options	Weighted Average Exercise Price
Outstanding – January 1, 2016	2,301,760	$ 9.04
Granted	582,790	$ 3.31
Forfeited	(17,446)	$ 9.64
Exercised	-	$ -
Expired	(186,380)	$ 9.86
Outstanding – March 31, 2016	2,680,724	$ 7.73
Expected to vest – March 31, 2016	2,653,917	$ 7.73
Exercisable at March 31, 2016	1,963,573	$ 8.47

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

During the three months ended March 31, 2016, the Company granted 462,890 service based options and 119,900 performance based options to Company employees. The weighted average fair value per share of options granted during the three months ended March 31, 2016 was $1.41.

During the three months ended March 31, 2016 there were no stock options exercised.

During the three months ended March 31, 2016 and 2015, stock option compensation expense was recorded as follows:

	Three Months Ended March 31,	
	2016	2015
Cost of sales	$ 43,719	$ 72,703
Selling, general and administrative expenses	418,692	784,078
Discontinued operations	-	46,789
Total stock option compensation expense	$ 462,411	$ 903,570

As of March 31, 2016, there was $1,872,430 of unrecognized compensation cost related to nonvested service based awards and $148,404 related to nonvested performance based awards. These costs are expected to be recognized over the options' remaining weighted average vesting period of 2.31 years and 0.75 years for the service and performance based awards, respectively.

Restricted Share Units

The Company has issued service, performance and market-based restricted share units to employees, consultants and directors of the Company. Expense for restricted share awards is amortized on a straight-line basis over the awards' vesting period. The fair value of service and performance awards are determined using the quoted market price of the Company's common stock on the date of grant, while market based performance awards are valued using a binomial/lattice pricing mode.

The following table summarizes the restricted share unit activity for the period:

	Number of Units	Weighted Average Fair Value
Unvested – January 1, 2016	152,750	$ 8.59
Granted	39,300	$ 3.30
Vested	(14,200)	$ 8.83
Cancelled	(2,300)	$ 8.83
Unvested – March 31, 2016	175,550	$ 7.38

In connection with the vesting of restricted share unit awards during the three months ended March 31, 2016, 5,576 common stock shares with a fair value of $18,010 were withheld in satisfaction of employee tax withholding obligations.

During the three months ended March 31, 2016 and 2015, restricted share unit compensation expense was $283,469 and $652,741, respectively, and included in selling, general and administrative expense.

As of March 31, 2016, the intrinsic value of the non-vested awards was $544,205 and there was $658,072 of unrecognized compensation cost related to unvested restricted share unit awards. These costs are expected to be recognized over the restricted shares units' remaining weighted average vesting period of 0.47 years.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

Shares Reserved for Future Issuance

At March 31, 2016, the Company had reserved the following shares of common stock for future issuance:

Convertible preferred stock (series A – B)	73,332
Additional stock issuable related to conversion of preferred stock (series A – B)	49,782
Common stock options outstanding	2,680,724
Common stock warrants outstanding	1,755,330
Restricted share units outstanding	175,550
Common stock equivalents available for grant	2,004,284
Total common stock shares reserved	6,739,002

8. Accumulated Other Comprehensive Income

The Company’s accumulated other comprehensive income as of March 31, 2016 was as follows:

	Foreign Currency Translation Adjustments	Unrealized Gain on Equity Securities	Total
Balance at January 1, 2016	$ 555,938	$4,716,970	$5,272,908
Current period - other comprehensive income	320,565	1,970,649	2,291,214
Balance at March 31, 2016	$ 876,503	$6,687,619	$7,564,122

9. Operating Segments

The Company operates in two segments: advanced wound care and traditional wound care products. They are managed separately as each segment requires different technology, marketing and sales strategies. Advanced wound care products principally consist of both novel and otherwise differentiated dressings, devices and skin substitutes designed to promote wound healing and/or prevent infection. Traditional wound care products principally consist of commodity related dressings, ointments, gauze bandages, adhesive bandages, wound closure strips, catheter fasteners and skin care products.

Advanced and traditional wound care products are marketed globally to acute care, extended care, home health care, wound and burn care clinics and physician offices. The Company utilizes a broad network of well-established distributors to deploy the majority of its products to end users. A smaller portion of the Company's sales are sold directly to care providers and through retail. The advanced and traditional wound care products are both manufactured internally and sourced from third party suppliers. The majority of marketing expenses are deployed in support of advanced wound care products with traditional wound care products requiring limited support. The Company utilizes direct sales representatives, distributor relationships and contractual relationships with buying groups and wound care service providers to sell its products. Direct sales representatives are used solely in support of advanced wound care sales in the U.S. and the U.K. and for both advanced and traditional wound care products in Canada.

Each operating segment is managed at the segment contribution level consisting of gross profit minus direct expense consisting of distribution, marketing, sales, research and development and intangible amortization expenses. Expenses are allocated directly by segment to the extent possible. Expenses common to both operating segments are allocated consistently using activity based assumptions. The aggregation or allocation of indirect expenses by segment is not practical.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

Operating segment sales, gross profit, segment contribution and other related information for 2016 and 2015 from continuing operations were as follows:

	Three Months Ended March 31, 2016			
	Advanced Wound Care	Traditional Wound Care	Other	Total Company
Net sales	$10,600,171	$9,642,386	$-	$20,242,557
Gross profit	5,385,146	2,322,377	-	7,707,523
Direct expense	(5,985,243)	(1,016,864)	-	(7,002,107)
Segment contribution	$(600,097)	$1,305,513	-	705,416
Indirect expenses			$(2,463,169)	(2,463,169)
Net loss from continuing operations				$(1,757,753)

	Three Months Ended March 31, 2015			
Net sales	$9,771,024	$9,727,628	$-	$19,498,652
Gross profit	4,901,124	2,634,002	-	7,535,126
Direct expense	(8,435,080)	(1,313,451)	-	(9,748,531)
Segment contribution	$(3,533,956)	$1,320,551	-	(2,213,405)
Indirect expenses			$(4,237,896)	(4,237,896))
Net loss from continuing operations				$(6,451,301)

The following table presents net sales by location of entity:

	Three Months Ended March 31,			
	2016		2015	
United States	83	%	84	%
Canada	11	%	10	%
Rest of World	6	%	6	%

For the three months ended March 31, 2016 and 2015, the Company had a major Canadian customer comprising 11% and 10%, respectively, of consolidated net sales. At March 31, 2016 and December 31, 2015 the Company was in a net liability position to this customer due to the timing of receivables and related rebate obligations.

10. Income Taxes

The following table summarizes the income tax (benefit) provision and effective tax rate for continuing operations for the three months ended March 31, 2016 and 2015:

	Three Months Ended March 31,					
	2016			2015		
Current tax (benefit) expense	$	(45,146	)	$	4,745	
Deferred tax (benefit) expense		(174,652	)		3,306	
Income tax (benefit) expense	$	(219,798	)	$	8,051	
Effective tax rate		(11.1	%)		(0.1	%)

For the three months ended March 31, 2016, the Company recognized a $219,798 income tax benefit consisting of a U.S. income tax benefit of $268,892 and a foreign income tax expense of $49,094. The U.S. income tax benefit relates to a reduction in the Company's U.S. valuation allowance due to the tax impact of the unrealized gain on equity securities included in accumulated other comprehensive income. The foreign income tax expense relates to income taxes recognized as a result of income recognized by the Canadian operations.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

For the three months ended March 31, 2015, the Company recognized an $8,051 income tax expense consisting of a U.S. and foreign income tax expense of $6,999 and $1,052, respectively. The U.S. income tax expense consisted of a deferred tax expense due to differences in financial reporting and tax treatment of goodwill net of amortization for financial reporting but not for tax purposes of acquired MedEfficiency identified intangible assets.

11. Commitments and Contingencies

Comvita Licensing Agreement

In February 2010, the Company entered into a new agreement with Comvita (the "Comvita Agreement") under which the Company received perpetual and exclusive worldwide licensing rights for Manuka Honey based MEDIHONEY wound and skin care products for all markets outside of the consumer market. The Comvita Agreement also provides that Comvita will serve as the Company's supplier for Manuka Honey and will not provide Manuka Honey to any other entities for use in the professional medical-surgical marketplace. The Comvita Agreement calls for graduated royalty payments based on sales and milestone payments. The license rights may be terminated or rendered non-exclusive by Comvita if the Company fails to meet certain minimum royalty requirements.

Comvita is a stockholder of the Company. The Company purchased $790,956 and $946,770 of medical grade honey from Comvita in the three months ended March 31, 2016 and 2015, respectively. In addition, the Company incurred MEDIHONEY royalties of $334,585 and $349,061 in the three months ended March 31, 2016 and 2015, respectively. Amounts due to Comvita for raw material purchases and royalties totaled $629,623 and $506,795 at March 31, 2016 and December 31, 2015, respectively.

BioDLogics, LLC License Agreement

On January 14, 2014, the Company entered into a license, market development and commercialization agreement (the "Agreement") with BioDLogics, LLC ("BioD") relating to BioD's human placental based products (the "Licensed Products") and intellectual property related thereto.

Under the Agreement, BioD granted to the Company an exclusive, perpetual, royalty-bearing license to use, offer for sale and sell, the Licensed Products in North America (the “Territory”), including the rights to sublicense solely as provided in the Agreement, for a broad range of dermal applications (the “Field”). During the term of the Agreement, the Company will be responsible for the sale and marketing of the Licensed Products in the Field throughout the Territory. As part of its commercialization efforts, the Company is required to fund clinical studies up to $2,000,000 in support of the Field pursuant to the Agreement.

Royalties are payable to BioD under the agreement based upon a sliding scale of the Company’s net sales of Licensed Products within the Territory and declining as net sales increase. Royalty rates range from the low double digits and decline to the mid-single digits. The Company incurred BioD royalties of $76,663 and $49,306 in the three months ended March 31, 2016 and 2015, respectively. The Agreement also requires the Company to make milestone payments to BioD of up to $19,750,000 based upon the achievement of certain development events and annual net sales levels.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

The Agreement may be terminated as follows: (i) upon mutual agreement of the parties; (ii) by BioD if the Company challenges certain BioD patents or trade secrets; (iii) by BioD if the Company fails to meet the annual minimum net sales requirement under the Agreement, unless the Company pays the difference between the amount of royalties that would have been due had the minimum annual net sales for such year been achieved and royalty payments made by the Company with respect to net sales during such year plus any milestone payments payable; or (iv) by either party in the event of a material breach or certain events of bankruptcy. The annual minimum net sales requirement commenced in 2015. The Company achieved the minimum net sales requirement for the April 1, 2015 through March 31, 2016 contract year. The minimum net sales requirements for future years are subject to good faith negotiation. The parties have discussed but have not yet agreed on a minimum sales requirement for any subsequent contract year.

Canadian Distribution Agreement

In May 2005, the Company entered into a distribution agreement with a Canadian company to serve as the exclusive distributor of its products in Canada. The agreement also appoints the distributor as the Company's Canadian servicing agent to fulfill supply contracts held directly by the Company. The agreement was most recently amended in May 2016, extending it through August 31, 2016, while negotiations for a new agreement proceed.

Contingencies

On occasion, the Company is involved in claims and other legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations, or liquidity.

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

This Quarterly Report on Form 10-Q (this "Report") includes certain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, statements about the confidence, strategies, plans, expectations, intentions, objectives, technologies, opportunities, market demand or acceptance of new or existing products of Derma Sciences, Inc., a Delaware corporation, and its subsidiaries ("we" or "us" or the "Company"), and other statements contained in this Report that are not historical facts. Forward-looking statements in this Report or hereafter included in other publicly available documents filed with the Securities and Exchange Commission (the "Commission") reports to our stockholders and other publicly available statements issued or released by us involve known and unknown risks, uncertainties and other factors that could cause our actual results, performance (financial or operating) or achievements to differ from the future results, performance (financial or operating) or achievements expressed or implied by such forward-looking statements. Such future results are based upon management's best estimates, current conditions and the most recent results of operations. When used in this Report, the words "expect," "anticipate," "intend," "plan," "believe," "seek," "estimate" and similar expressions are generally intended to identify forward-looking statements, because these forward-looking statements involve risks and uncertainties. There are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements, including our plans, objectives, expectations and intentions, changes in political, economic, business, competitive, market and regulatory factors and other factors that are discussed under the section in this Report entitled "Risk Factors," as well as our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 filed on March 15, 2016 (the "2015 Form 10-K") and other filings with the Commission. Neither we nor any other person assume responsibility for the accuracy or completeness of these forward-looking statements. We are under no duty to update any of the forward-looking statements after the date of this Report to conform these statements to actual results.

Three Months Ended March 31, 2016 Compared to Three Months Ended March 31, 2015

Overview

Operating Results of Three Months Ended March 31, 2016 and 2015

The following table highlights the operating results for the three months ended March 31, 2016 and 2015:

	Three Months Ended March 31, 2016	2015	Variance	
Gross sales	$22,766,903	$ 21,897,074	$869,829	4.0%
Sales adjustments	(2,524,346)	(2,398,422)	(125,924)	5.3%
Net sales	20,242,557	19,498,652	743,905	3.8%
Cost of sales	12,535,034	11,963,526	571,508	4.8%
Gross profit	7,707,523	7,535,126	172,397	2.3%
Selling, general and administrative expense	9,953,114	$1.26		

Weighted average shares used in diluted per share calculation	**20,434**	21,048	20,502

See accompanying notes.

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COHU, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands, except par value and per share amounts)

	Years ended December 31, 2001, 2000 and 1999				
	Common stock $1 par value	Paid-in capital	Retained earnings	Accumulated other comprehensive income	Total
Balance at December 31, 1998	$ 9,779	$ 11,169	$ 116,515	$	$ 137,463
Two-for-one stock split	9,779	(9,779)			
Cash dividends $.18 per share			(3,562)		(3,562)
Repurchase and retirement of stock	(23)	(349)			(372)
Exercise of stock options	328	1,503			1,831
Shares issued under employee stock purchase plan	75	583			658
Tax benefit from stock options		412			412
Net income			25,926		25,926
Balance at December 31, 1999	19,938	3,539	138,879		162,356
Cash dividends $.20 per share			(4,048)		(4,048)
Repurchase and retirement of stock	(3)	(137)			(140)
Exercise of stock options	292	2,368			2,660
Shares issued under employee stock purchase plan	86	1,150			1,236
Tax benefit from stock options		2,037			2,037
Net income			33,739		33,739
Balance at December 31, 2000	20,313	8,957	168,570		197,840
Components of comprehensive income (loss):					
Net loss			**(6,467)**		**(6,467)**
Changes in unrealized gain on investments net of $130 of income taxes				**200**	**200**
Comprehensive income (loss)					**(6,267)**
Cash dividends $.20 per share			**(4,091)**		**(4,091)**
Exercise of stock options	**140**	**1,352**			**1,492**
Shares issued under employee stock purchase plan	**90**	**1,154**			**1,244**
Tax benefit from stock options		**313**			**313**
Balance at December 31, 2001	**$ 20,543**	**$ 11,776**	**$ 158,012**	**$ 200**	**$ 190,531**

See accompanying notes.

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COHU, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Years ended December 31,		
	2001	2000	1999
Cash flows from operating activities:			
Net income (loss)	**$ (6,467)**	$ 33,739	$ 25,926
Adjustments to reconcile net income (loss) to net cash provided from operating activities:			
Depreciation and amortization	**4,623**	3,585	3,294
Gain on sale of facilities	**(7,746)**		
Acquired in-process research and development	**2,050**		
Deferred income taxes	**2,525**	(2,760)	(600)
Increase (decrease) in accrued retiree medical benefits	**51**	74	(9)
Tax benefit from stock options	**313**	2,037	412
Changes in current assets and liabilities, net of effects from purchase of Automated Systems:			
Accounts receivable	**11,960**	15,098	(33,462)
Inventories	**18,135**	9,607	(29,769)
Other current assets	**(2,566)**	(1,115)	(489)
Accounts payable	**241**	(5,438)	10,026
Income taxes payable		(6,778)	3,708
Customer advances	**1,774**	(17,696)	14,552
Deferred profit	**(2,852)**	5,960	
Accrued compensation, warranty and other liabilities	**(6,127)**	(634)	5,178
Net cash provided from (used for) operating activities	**15,914**	35,679	(1,233)
Cash flows from investing activities:			
Purchases of short-term investments	**(19,889)**	(10,207)	(22,429)
Sales and maturities of short-term investments	**9,230**	22,385	9,040
Net proceeds from sale of facilities	**2,699**		
Purchases of property, plant, equipment	**(5,826)**	(24,397)	(2,409)
Purchase of Automated Systems assets	**(14,300)**		
Other assets	**(82)**	(3)	(16)
Net cash used for investing activities	**(28,168)**	(12,222)	(15,814)
Cash flows from financing activities:			
Issuance of stock, net	**2,736**	3,756	2,117
Cash dividends	**(4,091)**	(4,048)	(3,562)
Net cash used for financing activities	**(1,355)**	(292)	(1,445)
Net increase (decrease) in cash and cash equivalents	**(13,609)**	23,165	(18,492)
Cash and cash equivalents at beginning of year	**79,119**	55,954	74,446
Cash and cash equivalents at end of year	**$ 65,510**	$ 79,119	$ 55,954
Supplemental disclosure of cash flow information:			
Cash paid (received) during the year for:			
Income taxes, net of refunds	**$ (5,108)**	$ 25,321	$ 9,480

See accompanying notes.

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COHU, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Presentation - The consolidated financial statements include the accounts of Cohu, Inc. and its wholly-owned subsidiaries (the Company or Cohu). All significant intercompany transactions and balances have been eliminated in consolidation.

Investments - Highly liquid investments with insignificant interest rate risk and original maturities of three months or less are classified as cash and cash equivalents. Cash equivalents are comprised of money market funds, commercial paper and other corporate debt securities. The carrying amounts approximate fair value due to the short maturities of these instruments. Cash and cash equivalents included investments in debt securities of $58.7 million and $61.4 million at December 31, 2001 and 2000, respectively. Investments with maturities greater than three months are classified as short-term investments. All of the Company s short-term investments are classified as available-for-sale and are reported at fair value with any material unrealized gains and losses, net of tax, recorded as a separate component of accumulated other comprehensive income in stockholders equity. The Company manages its cash equivalents and short-term investments as a single portfolio of highly marketable securities, all of which are intended to be available for the Company s current operations.

Concentration of Credit Risk - Financial instruments that potentially subject the Company to significant credit risk consist principally of cash equivalents, short-term investments, note receivable and trade accounts receivable. The Company invests in a variety of financial instruments and by policy limits the amount of credit exposure with any one issuer. The Company s customers include semiconductor manufacturers and others located throughout the world. The Company performs ongoing credit evaluations of its customers and generally requires no collateral.

Inventories - Inventories are stated at the lower of cost, determined on a current average or first-in, first-out basis, or market.

Property, Plant and Equipment - Depreciation and amortization of property, plant and equipment is calculated principally on the straight-line method based on estimated useful lives of thirty to forty years for buildings, five to fifteen years for land and building improvements and three to ten years for machinery and equipment.

Goodwill and Other Intangible Assets Through December 31, 1998, goodwill was amortized on the straight-line method over twenty years. In January 1999, the Company reduced the amortizable useful life of goodwill to four years. In June 2001, Cohu wrote-off the remaining goodwill balance of $434,000 related to an acquisition completed in 1994. The writedown was deemed necessary as a result of a decline in the forecasts for certain of the Company s semiconductor equipment products and is included in selling, general and administrative expense. The Company used undiscounted cash flow estimates to determine the amount of the writedown.

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement No. 142*, Goodwill and Other Intangible Assets*. Under Statement No. 142, goodwill and other intangible assets with indefinite useful lives are not amortized, but are reviewed annually for impairment or more frequently if impairment indicators arise. Separable intangible assets that have finite lives are amortized over their useful lives. Under Statement No. 142, goodwill and other intangible assets with indefinite useful lives resulting from acquisitions completed after June 30, 2001 will not be amortized. Goodwill at December 31, 2001 will be evaluated for impairment in accordance with Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*. The Company will be required to fully adopt Statement No. 142 on January 1, 2002. The Company is required to complete a transitional goodwill impairment test as of January 1, 2002 by June 30, 2002. Any impairment loss resulting from the transitional goodwill impairment test will be recognized as the effect of a change in accounting principle. See Note 3, Purchase of Automated Systems Assets.

Earnings (Loss) Per Share - Basic earnings per share are computed using the weighted average number of common shares outstanding during each period. Diluted earnings per share include the dilutive effect of common shares potentially issuable upon the exercise of stock options. For purposes of computing diluted earnings per share, stock options with exercise prices that exceed the average fair market value of the Company s common stock for the period are excluded. In 2000 and 1999, options to purchase 114,000 and 100,000 shares, respectively, of common stock at average exercise prices of $27.28 and $18.71 respectively, were excluded from the diluted computation. The impact of stock options is excluded for loss periods as they would be antidilutive. The following table reconciles the denominators used in computing basic and diluted earnings per share:

	2001	2000	1999

(in thousands)			
Weighted average common shares outstanding	**20,434**	20,197	19,763
Effect of dilutive stock options		851	739
	20,434	21,048	20,502

COHU, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Revenue Recognition - Effective January 1, 2000, the Company changed its method of revenue recognition for certain semiconductor equipment sales to comply with SEC Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* (SAB 101). See Note 2, Change in Accounting for Revenue Recognition. SAB 101 sets forth guidelines on the timing of revenue recognition based upon factors such as passage of title, installation, payment and customer acceptance. Prior to SAB 101, the Company generally recognized revenue upon shipment once customer acceptance provisions had been met. Revenue for established products that have previously satisfied customer acceptance requirements and that provide for full payment tied to shipment is generally recognized upon shipment and passage of title. Revenue for products that have not previously satisfied customer acceptance requirements or from sales where customer payment dates are not determinable are recognized upon customer acceptance. In certain instances, customer payment terms may provide that a minority portion of the equipment purchase price be paid only upon customer acceptance. In those situations, the portion of the purchase price related to customer acceptance is generally recognized upon customer acceptance with the majority portion of revenue and the entire product cost recognized upon shipment and passage of title. Equipment installation is typically provided by the Company and is generally not billed separately to the customer. The estimated fair value of installation related revenue is recognized in the period the installation is performed. Service revenue is recognized ratably over the period of the related contract. The gross profit on sales that are not recognized is generally recorded as deferred profit in the consolidated balance sheet. In certain instances where revenue and the related receivable are not recognized, customer payments received are recorded as customer advances in the consolidated balance sheet. Spares and kit revenue and revenue from Cohu s non-semiconductor equipment businesses is generally recognized upon shipment. Product warranty costs are accrued in the period sales are recognized.

Stock Based Compensation As permitted by FASB Statement No. 123, *Accounting for Stock Based Compensation,* Cohu elected to continue to apply the provisions of Accounting Principles Board s Opinion No. 25, *Accounting for Stock Issued to Employees (* APB 25), and related interpretations in accounting for its employee stock option and stock purchase plans. Cohu is generally not required under APB 25 to recognize compensation expense in connection with its employee stock option and stock purchase plans. Cohu is required by Statement No. 123 to present, in the notes to the consolidated financial statements, the pro forma effects on reported net income and earnings per share as if compensation expense had been recognized based on the fair value method of accounting prescribed by Statement No. 123.

Foreign Currency Translation Cohu s foreign subsidiaries primarily use the U.S. dollar as their functional currency. Accordingly, assets and liabilities of these subsidiaries are translated using exchange rates in effect at the end of the period, except for nonmonetary assets, such as inventories and property, plant and equipment, that are translated using historical exchange rates. Revenues and costs are translated using average exchange rates for the period, except for costs related to those balance sheet items that are translated using historical exchange rates. The resulting transaction gains and losses are included in the Consolidated Statements of Operations as they are incurred.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions about the future that affect the amounts reported in the consolidated financial statements. These estimates include assessing the collectibility of accounts receivable, usage and recoverability of inventory and long-lived assets and incurrence of warranty costs. Actual results could differ from those estimates.

Derivative Instruments and Hedging Activities - Cohu adopted FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, on January 1, 2001. Statement No. 133 requires, among other things, that all derivatives be recognized in the balance sheet at fair value and special accounting for hedging activities that meet certain criteria. The Company generally does not hold derivative instruments or engage in hedging activities and as a result the adoption of Statement No. 133 had no material effect on the Company s financial condition or results of operations.

Fair Value of Financial Instruments - The carrying amounts of Cohu s financial instruments, including cash and cash equivalents, short-term investments, accounts receivable, note receivable, accounts payable and accrued expenses, approximate fair value due to the short maturities of these financial instruments.

Recent Accounting Pronouncements In October 2001, the FASB issued Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* which supersedes Statement No. 121. Statement No. 144 addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed of. However, Statement No. 144 retains the fundamental provisions of Statement No. 121 for recognition and measurement of the impairment of long-lived assets to be held and used and measurement of long-lived assets to be disposed of by sale. Statement No. 144 is effective for fiscal years beginning after December 15, 2001. Cohu is in the process of assessing the effect of adopting Statement No. 144 and has not determined the effect of such adoption on its financial statements.

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COHU, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

2. Change in Accounting for Revenue Recognition

In the fourth quarter of 2000, the Company changed its method of recognizing revenue from certain semiconductor equipment sales. The new method of accounting was adopted to comply with SAB 101. In accordance with SAB 101 the new method of accounting has been applied retroactively to transactions that occurred prior to 2000. The cumulative effect adjustment of the change in accounting on prior years through December 31, 1999 was a reduction to income of $3,299,000 (after credit for income taxes of $1,700,000) and is included in income for the year ended December 31, 2000. Revenue amounting to $9,002,000 that was previously recognized and included in the cumulative effect adjustment at December 31, 1999 was recognized during 2000. The effect of the change on the year ended December 31, 2000 was to decrease income before cumulative effect of change in accounting principle by $661,000 ($.03 per diluted share). Pro forma amounts showing the retroactive application of SAB 101 for periods prior to 2000 could not be reasonably estimated and have not been provided.

3. Purchase of Automated Systems Assets

On July 16, 2001, the Company purchased the assets of the Automated Systems business (AS) from Schlumberger Technologies, Inc. The results of AS s operations have been included in the consolidated financial statements since that date. AS designs, manufactures and sells semiconductor equipment including pick and place test handlers and burn-in board loaders and unloaders. AS has technology and intellectual property associated with precise temperature control and heat dissipation of high-speed, high-power semiconductors during test that is expected to extend the capabilities of the Company s semiconductor equipment products.

The aggregate cash purchase price of AS was $14.2 million. The Company engaged an independent firm to assist in the valuation of the intangible assets acquired and the allocation of the purchase price in accordance with FASB No. 141.

The $14.2 million cash purchase price, plus $100,000 of related acquisition costs, was allocated as follows (in thousands):

Current assets	$ 3,200
Fixed assets	200
Intangible assets	3,010
Goodwill	8,340
Total assets acquired	14,750
Current liabilities assumed	(450)
Net assets acquired	$ 14,300

Of the $3,010,000 of acquired intangible assets, $2,050,000 was assigned to research and development assets that were written off at the date of the acquisition in accordance with FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.* The amount of acquired in-process research and development expense was determined by identifying research projects for which technological feasibility had not been established and for which no alternative future uses existed. The value of the projects identified to be in-process was determined by estimating the future cash flows from the projects once commercially feasible, discounting the net cash flows back to their present value at a rate commensurate with the level of risk and maturity of the projects, and then applying a percentage of completion to the calculated value. The remaining intangible assets include, among other things, a license valued at $360,000 and core technology valued at $500,000, both with estimated useful lives of 5 years. All assets are expected to be fully deductible for tax purposes. The goodwill was assigned to the semiconductor equipment segment.

The Company evaluated the goodwill and other long-lived assets resulting from the AS acquisition for impairment at December 31, 2001 as required by FASB Statement No. 121. The Company compared the carrying value of such assets to estimated undiscounted cash flows expected to result from their use and concluded that there was no impairment loss at December 31, 2001. The Company will be required to fully adopt Statement No. 142 effective January 1, 2002. Statement No. 142 uses a different goodwill impairment assessment methodology than Statement No. 121. The Company has not yet fully determined the financial statement impact of the application of the impairment test required by Statement No. 142.

The unaudited pro forma results reflected below assume the purchase occurred at the beginning of each year presented.

(in thousands, except per share amounts)	**2001**	2000
Net sales	**$131,032**	$306,164
Income (loss) before cumulative effect	**(7,769)**	35,586
Net income (loss)	**(7,769)**	32,287
Diluted earnings (loss) per share:		
Before cumulative effect	**(.38)**	1.69
Net income (loss)	**(.38)**	1.53

4. Investments

Short-term investments by security type at December 31, were as follows:

(in thousands)	**2001**				2000
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**	Cost and Estimated Fair Value
Corporate debt securities	**$10,441**	**$ 180**	**$ 6**	**$10,615**	$11,442
U.S. government agencies	**13,686**	**168**	**12**	**13,842**	2,026
	$24,127	**$ 348**	**$ 18**	**$24,457**	$13,468

Contractual maturities of short-term investments at December 31, 2001 were as follows:

(in thousands)	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 9,220	$ 9,401
Due after one year through two years	14,907	15,056
	$24,127	$24,457

At December 31, 2000, the estimated fair value of the Company s short-term investments approximated amortized cost. Accordingly, temporary differences between the short-term investment portfolio s fair value and its cost have not been presented as a separate component of other comprehensive income in stockholders equity. Gross realized gains and losses on sales of short-term investments were not significant in 2001, 2000 or 1999.

5. Real Estate Transactions

On October 27, 2000, the Company entered into agreements with a third party under which it became obligated to acquire certain real property in Poway, California consisting of a 338,000 square-foot building and approximately twenty acres of land (the Poway Facility).

On April 16, 2001, the Company sold its land and buildings in San Diego, California to TC Kearny Villa, L.P., an unrelated party, for $12.5 million, excluding commissions and other related expenses. The $12.5 million purchase price included a cash payment of $3.1 million and a $9.4 million, 8% non-recourse note, secured by a deed of trust on the property, due in six months. The note provided for a 180-day extension option that was exercised in September 2001, extending the due date to April 2002. The Company entered into a three-month leaseback of the property with the buyer that expired in July 2001. The sale-leaseback transaction was accounted for as a financing pursuant to FASB Statement No. 98, *Accounting for Leases*. The Company recorded a gain on the sale transaction of approximately $7.7 million in the third quarter of 2001, upon the expiration of the leaseback.

On April 23, 2001, the Company completed the acquisition of the Poway Facility. The purchase price of the Poway Facility was approximately $21.3 million and was funded from the Company s cash reserves in October 2000. The Company remodeled the Poway Facility at a cost of approximately $4.2 million and moved its corporate headquarters and the San Diego operations of its Delta Design and BMS subsidiaries to the Poway Facility in June 2001.

6. Line of Credit

The Company maintains a $10,000,000 unsecured bank line-of-credit facility bearing interest at the bank s prime rate. The facility requires compliance with certain financial covenants and expires in May 2002. No borrowings were outstanding at December 31, 2001 or 2000.

7. Income Taxes

Significant components of the provision (credit) for income taxes are as follows:

(in thousands)	**2001**	2000	1999
Current:			
Federal	**$(7,600)**	$17,716	$11,734
State	**(25)**	2,344	1,866
Total current	**(7,625)**	20,060	13,600

COHU, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(in thousands)	**2001**	2000	1999
Deferred:			
Federal	**3,163**	(921)	(674)
State	**(638)**	(139)	74
Total deferred	**2,525**	(1,060)	(600)
	$ (5,100)	$ 19,000	$ 13,000

The cumulative effect of change in accounting principle included in the 2000 consolidated statement of operations is net of a $1,700,000 deferred tax benefit not reflected in the table above.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting and tax purposes. Significant components of the Company s deferred tax assets and liabilities are as follows:

December 31,	**2001**	2000
(in thousands)		
Deferred tax assets:		
Reserves and accrued warranty costs	**$ 11,152**	$ 10,268
Accrued state income taxes and carryforwards	**602**	593
Accrued employee benefits	**1,347**	1,258
Deferred profit under SAB 101	**1,197**	2,000
Acquisition basis differences	**1,248**	
Other	**395**	540
Total deferred tax assets	**15,941**	14,659
Deferred tax liabilities:		
Tax over book depreciation	**646**	1,342
Gain on facilities sale	**2,983**	
Acquisition basis differences	**1,520**	
Total deferred tax liabilities	**5,149**	1,342
Net deferred tax assets	**$ 10,792**	$ 13,317

No valuation allowance has been provided on deferred tax assets at December 31, 2001, as the Company believes it is more likely than not that all such assets will be realized. The Company reached this conclusion after considering the availability of taxable income in prior carryback years, tax planning strategies and the likelihood of future taxable income exclusive of reversing temporary differences and carryforwards. Differences between forecasted and actual future operating results could adversely impact the Company s ability to realize deferred tax assets. The Company intends to evaluate the realizability of deferred tax assets quarterly in 2002 by assessing the need for a valuation allowance.

The reconciliation of income tax computed at the U.S. federal statutory tax rate to the provision (credit) for income taxes is as follows:

	2001	2000	1999

(in thousands)			
Tax at U.S. statutory rate	**$(4,048)**	$19,613	$13,624
State income taxes, net of federal tax benefit	**(431)**	1,434	1,261
Foreign Sales Corporation benefit		(1,929)	(1,487)
Nondeductible goodwill and performance-based consideration expense	**202**	101	101
Tax credits	**(600)**	(500)	(350)
Other net	**(223)**	281	(149)
	$(5,100)	$19,000	$13,000

At December 31, 2001, the Company had state net operating loss carryforwards of approximately $8,200,000 and state tax credit carryforwards of approximately $500,000 that generally expire through 2006.

COHU, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

8. Stockholder Rights Plan

In November 1996, the Company adopted a Stockholder Rights Plan and declared a dividend distribution of one-half Right (Right) for each share of Common Stock, payable to holders of record on December 3, 1996. Under certain conditions, each Right may be exercised to purchase 1/200 of a share of Series A Preferred Stock at a purchase price of $45, subject to adjustment. The Rights are not presently exercisable and will only become exercisable following the occurrence of certain specified events. If these specified events occur, each Right will be adjusted to entitle its holder to receive upon exercise Common Stock having a value equal to two times the exercise price of the Right or each Right will be adjusted to entitle its holder to receive common stock of the acquiring company having a value equal to two times the exercise price of the Right, depending on the circumstances. The Rights expire on November 14, 2006 and may be redeemed by the Company for $0.001 per Right. The Rights do not have voting or dividend rights and, until they become exercisable, have no dilutive effect on the earnings per share of the Company.

9. Segment and Related Information

The Company has two reportable segments as defined by FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information.* The Company s reportable segments are business units that offer different products and are managed separately because each business requires different technology and marketing strategies. The semiconductor equipment segment designs, manufactures and sells semiconductor test handling equipment to semiconductor manufacturers throughout the world and accounted for 75% of net sales in 2001. The television camera segment designs, manufactures and sells closed circuit television cameras and systems to original equipment manufacturers, contractors and government agencies and accounted for 17% of net sales in 2001. The Company s other operating segments include a metal detection business and a microwave communications equipment company. Neither of these other segments met any of the quantitative thresholds for determining reportable segments. Information regarding industry segments for 2001, 2000 and 1999 contained in the Selected Financial Data on pages 9 and 10 is an integral part of these consolidated financial statements.

The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. The Company allocates resources and evaluates the performance of segments based on pretax profit or loss from operations, excluding unusual gains or losses. Intersegment sales were not significant for any period.

Customers from the semiconductor equipment segment comprising 10% or greater of the Company s net sales are summarized as follows:

	2001	2000	1999
Intel	**34%**	26%	7%
Texas Instruments	**10%**	12%	12%
Motorola	**1%**	10%	24%

Assets located in foreign countries were not significant. Net sales to customers, attributed to countries based on product shipment destination, were as follows:

	2001	2000	1999
(in thousands)			
United States	**$ 61,495**	$107,770	$ 76,715
Malaysia	**21,009**	45,204	18,822
Philippines	**11,271**	28,451	13,363
Taiwan	**5,307**	24,553	19,849
Singapore	**4,087**	17,690	25,616
China	**1,813**	12,444	21,351
Other foreign countries	**21,568**	53,452	33,064
Total	**$126,550**	$289,564	$208,780

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COHU, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

10. Employee Benefit Plans

Retirement Plans - The Company has voluntary defined contribution retirement 401(k) plans whereby it will match contributions up to 4% of employee compensation. Company contributions to the plans were $1,380,000 in 2001, $1,550,000 in 2000, $1,199,000 in 1999. Certain of the Company s foreign employees participate in a defined benefit pension plan. The related expense and benefit obligation of this plan were not significant.

Retiree Medical Benefits - The Company provides post-retirement health benefits under a noncontributory plan to certain executives and directors. The net periodic benefit cost was $80,000, $76,000 and $80,000, in 2001, 2000 and 1999, respectively. The Company funds benefits as costs are incurred. Benefits paid and other changes in the benefit obligation for each of the three years in the period ended December 31, 2001 were not significant. The weighted average discount rate used in determining the accumulated post-retirement benefit obligation was 7.0% in 2001, 2000 and 1999. Annual rates of increase of the cost of health benefits were assumed to be 8.50% for 2002. These rates were then assumed to decrease 0.25% per year to 6% in 2012 and remain level thereafter. A 1% increase (decrease) in health care cost trend rates would increase (decrease) the 2001 net periodic benefit cost by approximately $14,000 ($11,000) and the accumulated post-retirement benefit obligation as of December 31, 2001 by approximately $161,000 ($133,000).

Employee Stock Purchase Plan - The Cohu, Inc. 1997 Employee Stock Purchase Plan provides for the issuance of a maximum of 1,000,000 shares of the Company s Common Stock. Under the Plan, eligible employees may purchase shares of common stock through payroll deductions. The price paid for the common stock is equal to 85% of the fair market value of the Company s Common Stock on specified dates. In 2001, 2000 and 1999, 90,512, 85,994 and 74,995 shares, respectively, were issued under the Plan.

The estimated weighted average fair value of purchase rights granted in 2001, 2000 and 1999 was $5.89, $8.52 and $4.39, respectively. The fair value of the purchase rights was estimated using the Black-Scholes option-pricing model with the following assumptions for 2001, 2000 and 1999: risk-free interest rates ranging from 3.7% to 6.4%; dividend yield of 1%; expected life of 6 months and volatility ranging from 56% to 62%.

Stock Options - Under the Company s stock option plans, options may be granted to employees and outside directors to purchase a fixed number of shares of the Company s Common Stock at prices not less than 100% of the fair market value at the date of grant. All options become exercisable one-fourth annually beginning one year after the grant date and expire 10 years from the grant date. At December 31, 2001, 253,090 and 200,000 shares were available for future grants under the employee and outside director plans, respectively.

The estimated weighted average fair value of options granted during 2001, 2000 and 1999 was $7.08, $8.03 and $6.04, respectively. The fair value of each option grant was estimated on the grant date using the Black-Scholes option-pricing model with the following assumptions for 2001, 2000 and 1999: risk-free interest rates ranging from 3.8% to 6.7%; dividend yield of 1%; expected life of 4 to 5 years and volatility ranging from 56% to 62%.

Had compensation cost for the Company s stock option and purchase plan grants from 1995 through 2001 been determined based on the fair value at the date of grant accounting consistent with FASB Statement No. 123*,* the Company s pro forma net income (loss) and earnings per share would have been as follows:

	2001	2000	1999
(in thousands, except per share amounts)			
Pro forma net income (loss)	**$ (9,597)**	$ 30,078	$ 23,593
Pro forma earnings (loss) per share:			
Basic	**(.47)**	1.49	1.19
Diluted	**(.47)**	1.45	1.17

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. Because the Company s employee stock option and purchase plans have characteristics significantly different from those of traded options, in management s opinion, this model does not necessarily provide a reliable single measure of the fair value of its employee stock option and purchase plans.

COHU, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Stock option activity under all option plans was as follows:

	2001		2000		1999	
	Shares	**Wt. Avg. Ex. Price**	Shares	Wt. Avg. Ex. Price	Shares	Wt. Avg. Ex. Price
(in thousands, except per share data)						
Outstanding, beginning of year	**2,238**	**$13.04**	1,911	$11.42	1,598	$ 9.47
Granted	**545**	**$14.81**	698	$16.24	816	$12.98
Exercised	**(140)**	**$10.67**	(292)	$ 9.13	(328)	$ 5.58
Canceled	**(191)**	**$14.54**	(79)	$16.78	(175)	$11.78
Outstanding, end of year	**2,452**	**$13.41**	2,238	$13.04	1,911	$11.42
Options exercisable at year end	**1,036**	**$11.90**	725	$10.53	559	$ 8.87

Information about stock options outstanding at December 31, 2001 is as follows:

(options in thousands)	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/01	Approximate Wt. Avg. Remaining Life (Years)	Wt. Avg. Ex. Price	Number Exercisable at 12/31/01	Wt. Avg. Ex. Price
$ 4.03 $ 7.69	107	3.2	$ 4.55	102	$ 4.39
8.50 13.88	1,582	7.3	$12.11	812	$11.39
14.00 27.69	720	9.0	$16.12	112	$19.97
35.00 38.81	43	8.2	$37.93	10	$37.93
	2,452	7.6	$13.41	1,036	$11.90

11. Commitments and Contingencies

Rent expense for the years ended December 31, 2001, 2000 and 1999 was $1,259,000, $1,329,000 and $1,006,000, respectively. Future minimum lease payments at December 31, 2001 are: 2002 $1,270,000; 2003 $844,000; 2004 - $708,000; 2005 $652,000; totaling $3,474,000. Future minimum payments have not been reduced by minimum sublease rentals totaling $417,000 due in 2002.

Cohu is currently subject to various legal proceedings and claims that have arisen in the ordinary course of its businesses. Although the outcome of these legal proceedings and claims cannot be predicted with certainty, Cohu does not believe that any of these legal matters will have a material adverse effect on its financial condition or results of operations.

12. Quarterly Financial Data (unaudited)

Quarter	First*	Second*	Third*	Fourth	Year
(in thousands, except per share data)					

Net sales:	**2001**	**$43,718**	**$29,281**	**$25,430**	**$28,121**	**$126,550**
	2000	72,732	86,761	74,188	55,883	289,564
Gross profit:	**2001**	**11,485**	**7,595**	**4,043**	**9,833**	**32,956**
	2000	28,530	35,061	29,488	19,524	112,603
Income (loss) before cumulative effect of accounting change:	**2001**	**(1,342)**	**(2,831)**	**(1,442)**	**(852)**	**(6,467)**
	2000	10,453	12,928	9,037	4,620	37,038
Net income (loss):	**2001**	**(1,342)**	**(2,831)**	**(1,442)**	**(852)**	**(6,467)**
	2000	7,154	12,928	9,037	4,620	33,739
Earnings (loss) per share before cumulative effect of accounting change:						
Basic	**2001**	**(.07)**	**(.14)**	**(.07)**	**(.04)**	**(.32)**
	2000	.52	.64	.45	.23	1.83
Diluted	**2001**	**(.07)**	**(.14)**	**(.07)**	**(.04)**	**(.32)**
	2000	.49	.61	.43	.22	1.76

*Amounts for 2000 restated. See Note 2, Change in Accounting for Revenue Recognition.

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Report of Ernst & Young LLP, Independent Auditors

The Board of Directors and Stockholders
Cohu, Inc.

We have audited the accompanying consolidated balance sheets of Cohu, Inc. as of December 31, 2001 and 2000, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2001. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cohu, Inc. at December 31, 2001 and 2000, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Notes 1 and 2 to the consolidated financial statements, in 2000 the Company changed its method of revenue recognition.

/s/ ERNST & YOUNG LLP

San Diego, California
January 28, 2002

Index to Exhibits

14. (c) The following exhibits are filed as part of, or incorporated into, the 2001 Cohu, Inc. Annual Report on Form 10-K:

Exhibit No.	Description
3.1	Amended and Restated Certificate of Incorporation of Cohu, Inc. incorporated herein by reference to Exhibit 3.1(a) from the Cohu, Inc. Form 10-Q for the quarterly period ended June 30, 1999
3.1(a)	Certificate of Amendment of Amended and Restated Certificate of Incorporation of Cohu, Inc. incorporated herein by reference from the Cohu, Inc. Form S-8 filed June 30, 2000, Exhibit 4.1(a)
3.2	Amended and Restated Bylaws of Cohu, Inc. incorporated herein by reference to Exhibit 3.2 from the Cohu, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on December 12, 1996
4.1	Rights Agreement dated November 15, 1996, between Cohu, Inc. and ChaseMellon Shareholder Services, L.L.C, as Rights Agent, incorporated herein by reference from the Cohu Form 8-K, filed December 12, 1996, Exhibit 4.1
10.1	Description of Cohu, Inc. Executive Incentive Bonus Plan, incorporated herein by reference from the Cohu 1990 Form 10-K, Exhibit 10.3*
10.2	Cohu, Inc. 1992 Stock Option Plan, incorporated herein by reference from the Cohu Proxy Statement for its 1992 Annual Meeting of Stockholders*
10.3	Cohu, Inc. 1994 Stock Option Plan, incorporated herein by reference from the Cohu Proxy Statement for its 1995 Annual Meeting of Stockholders*
10.4	Cohu, Inc. 1996 Stock Option Plan, incorporated herein by reference from the Cohu Proxy Statement for its 1996 Annual Meeting of Stockholders*
10.5	Business Loan Agreement between Bank of America, N.A. and Cohu, Inc. dated June 15, 1998, incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 1998, Exhibit 10.1
10.5.1	Amendment No. 3, dated April 26, 2001, to Business Loan Agreement dated June 15, 1998 between Cohu, Inc. and Bank of America, N.A., incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 2001, Exhibit 10.1
10.6	Termination Agreement between Cohu, Inc. and John H. Allen, incorporated herein by reference from the Cohu 1996 Form 10-K, Exhibit 10.11*
10.7	Cohu, Inc. 1996 Outside Directors Stock Option Plan (as amended), incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 2001, Exhibit 10.5*
10.8	Cohu, Inc. 1997 Employee Stock Purchase Plan (as amended), incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 2001, Exhibit 10.4*
10.9	Cohu, Inc. Deferred Compensation Plan incorporated herein by reference from the Cohu Form 10-Q for the quarter ended September 30, 2001*
10.10	Cohu, Inc. 1998 Stock Option Plan, incorporated herein by reference from the Cohu Form S-8 filed June 30, 2000, Exhibit 4.4*
10.11	Termination Agreement between Cohu, Inc. and James A. Donahue, incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 1998, Exhibit 10.2*

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Exhibit No.	Description
10.12	Lease Assignment Agreement dated June 25, 1999 by and between Cohu, Inc., Cubic Defense Systems, Inc. and Thomas G. Plein and Diane L. Plein, incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 1999, Exhibit 10.2
10.12.1	Option to extend lease agreement dated June 25, 1999 by and between Cohu, Inc. and Thomas G. Plein and Diane L. Plein, incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 2000, Exhibit 10.2
10.13	Employment Agreement between Cohu, Inc. and Charles A. Schwan, incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 2000, Exhibit 10.3*
10.14	Non-Recourse Promissory Note Secured by Deed of Trust between Delta Design, Inc. and T.C. Kearny Villa, L.P., dated April 11, 2001 incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 2001, Exhibit 10.2
10.15	Agreement of Purchase and Sale and Joint Escrow Instructions between Cohu, Inc. and T.C. Kearny Villa, L.P., dated April 11, 2001, incorporated herein by reference from the Cohu Form 10-Q for the quarter ended June 30, 2001, Exhibit 10.3
10.16	Asset Purchase Agreement between Delta Design, Inc. and Schlumberger Technologies, Inc. dated as of July 16, 2001 incorporated herein by reference from the Cohu Form 10-Q for the quarter ended September 30, 2001, Exhibit 10.1
10.17	Sublease Agreement between Cohu, Inc. and Anacomp, Inc. dated October 27, 2000 incorporated herein by reference from the Cohu 2000 Form 10-K, Exhibit 10.18
21	Cohu, Inc. has the following wholly owned subsidiaries:
	Delta Design, Inc., a Delaware corporation Fisher Research Laboratory, Inc., a Delaware corporation Broadcast Microwave Services, Inc., a Delaware corporation Delta Design (Littleton), Inc., a Delaware corporation Cohu Foreign Sales Ltd., a Barbados corporation
23	Consent of Ernst & Young LLP, Independent Auditors

* Management contract or compensatory plan or arrangement

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SIGNATURES

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

COHU, INC.

Date: March 4, 2002

By /s/ James A. Donahue

James A. Donahue
President & Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Charles A. Schwan Charles A. Schwan	Chairman of the Board, Director	March 4, 2002
/s/ James A. Donahue James A. Donahue	President & Chief Executive Officer, Director (Principal Executive Officer)	March 4, 2002
/s/ John H. Allen John H. Allen	Vice President, Finance & Chief Financial Officer, Secretary (Principal Financial & Accounting Officer)	March 4, 2002
/s/ James W. Barnes James W. Barnes	Director	March 4, 2002
/s/ Harry L. Casari Harry L. Casari	Director	March 4, 2002
/s/ Harold Harrigian Harold Harrigian	Director	March 4, 2002

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COHU, INC.
SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS
(in thousands)

Description	Balance at Beginning of Year	Additions Not Charged to Expense(1)	Additions (Reductions) Charged (Credited) to Expense	Deductions (Write-offs)	Balance at End of Year
Allowance for doubtful accounts:					
Year ended December 31, 1999	$ 1,338		$ 823	$ 180	$ 1,981
Year ended December 31, 2000	$ 1,981		$ 445	$ 199	$ 2,227
Year ended December 31, 2001	$ 2,227	$ 600	$ (741)	$ 197	$ 1,889
Reserve for excess and obsolete inventories:					
Year ended December 31, 1999	$18,422		$ 1,113	$ 3,676	$15,859
Year ended December 31, 2000	$15,859		$ 5,928	$ 4,267	$17,520
Year ended December 31, 2001	$17,520	$ 7,500	$ 15,854	$11,484	$29,390

(1) Additions resulting from purchase of Automated Systems assets in July 2001.

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