INPUT OUTPUT INC
Form 10-Q/A
August 15, 2005

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q/A
(Amendment No. 1)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2005

OR

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

COMMISSION FILE NUMBER 1-12691

INPUT/OUTPUT, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE (State or other jurisdiction of incorporation or organization)	22-2286646 (I.R.S. Employer Identification No.)
12300 PARC CREST DR., STAFFORD, TEXAS (Address of principal executive offices)	77477 (Zip Code)

REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE: (281) 933-3339

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: R No: £

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes: R No: £

At April 29, 2005, there were 78,669,143 shares of common stock, par value $0.01 per share, outstanding.

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EXPLANATORY NOTE

This Form 10-Q/A (Amendment No. 1) amends our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, as initially filed with the Securities and Exchange Commission (the SEC) on May 9, 2005, and is being filed to reflect the restatement of our consolidated financial statements for the quarterly period ended March 31, 2005, as discussed in Note 1 hereto.

On August 3, 2005, we announced that we expected to revise our financial statements for the first fiscal quarter of 2005, as a result of our determination that royalty expenses incurred by GX Technology Corporation (GXT), a privately-owned company acquired by us in June 2004, were incorrectly recorded in that period. In our internal review of the financial results of GXT for the second fiscal quarter of 2005, we discovered that royalty expenses of approximately $795,000 relating to licenses of GXT s multi-client seismic survey data should have been recorded in our interim unaudited financial statements for the first quarter of 2005. This error occurred due to the miscalculation of GXT royalty expenses. Similar miscalculations did not have a material impact upon our reported results for the year ended December 31, 2004, any interim periods in 2004, or any prior periods. Therefore, we have not restated any of our consolidated financial statements for 2004, any interim periods in 2004, or prior periods.

As discussed above, we are restating our consolidated financial statements for the first quarter of 2005 and filing this Form 10-Q/A as a result of the miscalculation of the GXT royalty expenses in the first quarter 2005 financial statements. In this Form 10-Q/A, we have also included other adjustments to the first quarter 2005 financial statements, aggregating to a $40,000 reduction in net loss that we consider to be immaterial individually and in the aggregate, but that were appropriate to include in an otherwise-required restatement of the period. See Note 1 of *Notes to Unaudited Consolidated Financial Statements* for further explanation regarding the adjustments we consider to be immaterial. Below is a general description of the principal adjustments and changes made as a result of the restatement of the consolidated financial statements for the first quarter of 2005, as reflected in this Form 10-Q/A:

The amendments restate the consolidated balance sheet at March 31, 2005 and the notes related thereto as contained under Item 1. Unaudited Financial Statements .

The amendments restate the consolidated statement of operations for the three months ended March 31, 2005 and the notes related thereto as contained under Item 1. Unaudited Financial Statements .

The amendments restate the consolidated statement of cash flows for the three months ended March 31, 2005 and the notes related thereto as contained under Item 1. Unaudited Financial Statements .

The amendments revise Note 1 to the consolidated financial statements to add disclosure regarding the restatement that is the subject of these amendments and to summarize the cumulative amounts of the restatement.

The amendments revise the applicable disclosures under - Executive Summary and - Results of Operations under Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations .

The amendments revise Risk Factors We are exposed to risks relating to the effectiveness of our internal controls under Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations to add language regarding the GXT royalty expenses adjustment.

The amendments revise Item 4. Controls and Procedures .

As part of our continuous process of reviewing and improving internal control over financial reporting, during the second quarter of 2005 we implemented and enhanced certain internal control procedures regarding GXT s royalty expense calculations related to its multi-client data library, designed to provide reasonable assurance against any miscalculations of GXT royalty expenses. We replaced two financial and accounting positions at GXT with a new Vice President of Finance and a new Financial Controller at the GXT level. We also enhanced procedures for better segregation and identification of information regarding multi-client survey projects and other projects. We also implemented or enhanced processes for assigning specific responsibilities for the regular review of project terms and management review procedures of the calculations and conclusions made by accounting personnel and modifying and confirming the relevant reports for these projects and preparation of the reports.

As a result of these procedures implemented at GXT during the second quarter, we discovered errors in the calculation of GXT royalty expenses that caused the restatement under this Amendment No. 1. We acquired GXT in June 2004, and GXT s internal control over financial reporting was excluded from our assessment of our internal control over financial reporting as of December 31, 2004, in reliance on guidance contained in an interpretive release issued by the staff of the SEC s Office of Chief Accountant and Division of Corporation Finance in June 2004. However, because the controls in effect at GXT at March 31, 2005 regarding the calculation and recording of GXT royalty expenses did not effectively and timely confirm the accuracy of GXT s royalty expense calculations, we have determined that there was a material weakness in our internal control over financial reporting as of March 31, 2005 regarding the calculation and recording of GXT royalty expenses, as currently defined by the Public Company Accounting Oversight Board.

Based on their evaluation of the effectiveness of the Company s disclosure controls and procedures as of March 31, 2005, our principal executive officer and principal financial officer had concluded that our disclosure controls and procedures were effective at that time to ensure that the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. Our first quarter Form 10-Q had contained disclosure of this conclusion. In light of the material weakness regarding the calculation and recording of GXT royalty expenses as of March 31, 2005, our principal executive officer and principal financial officer have now concluded that, as of March 31, 2005, our disclosure controls and procedures were not effective to ensure that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. This Form 10-Q/A contains these new disclosures regarding our disclosure controls and procedures as of March 31, 2005.

Based on the changes in procedure and process undertaken in the second quarter, we believe that the material weakness in our internal control over financial reporting regarding the calculation and recording of GXT royalty expenses had been remediated as of June 30, 2005. Accordingly, we intend to report in our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2005 that, based on their evaluation, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures were effective as of June 30, 2005 to ensure that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

As required by Rule 12b-15 under the Exchange Act, new certifications of our principal executive officer and principal financial officer are being filed as exhibits to this Form 10-Q/A under Item 6 of Part II.

For purposes of this Form 10-Q/A, and in accordance with Rule 12b-15 under the Exchange Act, each item in our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005 that was affected by this Amendment No. 1 has been amended and replaced in its entirety.

No attempt has been made in this Form 10-Q/A to modify or update other disclosures as presented in the original Form 10-Q, except as required to reflect such amendments. This Amendment No. 1 does not reflect events, other than those relating to the revisions, that have occurred after May 9, 2005, the date the Quarterly Report on Form 10-Q was originally filed, except that the information and disclosure contained in Part I, Item 4 Controls and Procedures has been brought to the current date of this filing. Information with respect to events occurring after May 9, 2005 has been or will be set forth, as appropriate, in our subsequent periodic filings, including our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K. Any reference to facts and circumstances at a current date refer to such facts and circumstances as of such original filing date.

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INPUT/OUTPUT, INC. AND SUBSIDIARIES

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FOR THE QUARTER ENDED MARCH 31, 2005

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INPUT/OUTPUT, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	March 31, 2005 (Restated)	December 31, 2004
	(In thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,628	$ 14,935
Restricted cash	2,092	2,345
Accounts receivable, net	62,907	61,598
Current portion of notes receivable, net	10,499	10,784
Unbilled revenue	10,408	7,309
Inventories	85,239	86,659
Prepaid expenses and other current assets	9,741	7,974
Total current assets	208,514	191,604
Notes receivable	3,223	4,143
Property, plant and equipment, net	43,048	45,239
Multi-client data library, net	10,240	9,572
Deferred income taxes	469	480
Investment at cost	3,500	3,500
Goodwill	148,998	147,066
Intangible and other assets, net	75,540	77,512
Total assets	$ 493,532	$ 479,116
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and current maturities of long-term debt and lease obligations	$ 5,341	$ 6,564
Accounts payable	31,101	40,856
Accrued expenses	27,749	26,686
Deferred revenue	9,240	8,423
Total current liabilities	73,431	82,529
Long-term debt and lease obligations, net of current maturities	78,531	79,387
Other long-term liabilities	1,180	2,688
Cumulative convertible preferred stock	30,000	
Stockholders equity:		
Common stock, $0.01 par value; authorized 100,000,000 shares; outstanding 78,666,018 shares at March 31, 2005 and 78,561,675 shares at December 31, 2004, net of treasury stock	796	795

Additional paid-in capital	481,197	480,845
Accumulated deficit	(165,528)	(161,516)
Accumulated other comprehensive income	1,506	2,449
Treasury stock, at cost, 794,263 shares at March 31, 2005 and 784,009 shares at December 31, 2004	(5,909)	(5,844)
Unamortized restricted stock compensation	(1,672)	(2,217)
Total stockholders equity	310,390	314,512
Total liabilities and stockholders equity	$ 493,532	$ 479,116

See accompanying Notes to Unaudited Consolidated Financial Statements.

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INPUT/OUTPUT, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended March 31, 2005 (Restated)	Three Months Ended March 31, 2004
	(In thousands, except share and per share data)	
Net sales	$ 66,837	$ 36,287
Cost of sales	51,697	24,318
Gross profit	15,140	11,969
Operating expenses (income):		
Research and development	4,555	3,783
Marketing and sales	7,686	3,299
General and administrative	6,305	4,693
Gain on sale of assets	(5)	(850)
Total operating expenses	18,541	10,925
Income (loss) from operations	(3,401)	1,044
Interest expense	(1,744)	(1,496)
Interest income	71	469
Other income	41	16
Income (loss) before income taxes	(5,033)	33
Income tax (benefit) expense	(1,215)	591
Net loss	(3,818)	(558)
Preferred dividend	194	
Net loss applicable to common shares	$ (4,012)	$ (558)
Basic and diluted net loss per common share	$ (0.05)	$ (0.01)
Weighted average number of basic and diluted common shares outstanding	78,643,713	52,113,438

See accompanying Notes to Unaudited Consolidated Financial Statements.

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INPUT/OUTPUT, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three Months Ended March 31, 2005 (Restated)	Three Months Ended March 31, 2004
	(In thousands)	
Cash flows from operating activities:		
Net loss	$ (3,818)	$ (558)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization (other than multi-client library)	6,676	2,422
Amortization of multi-client library	1,968	
Amortization of restricted stock and other stock compensation	436	39
Reduction of tax reserves	(1,303)	
Bad debt expense	343	97
Gain on sale of fixed assets	(5)	(850)
Change in operating assets and liabilities:		
Accounts and notes receivable	(609)	381
Unbilled revenue	(3,099)	
Inventories	(55)	(4,996)
Accounts payable and accrued expenses	(10,033)	1,396
Deferred revenue	817	(26)
Other assets and liabilities	(3,083)	429
Net cash used in operating activities	(11,765)	(1,666)
Cash flows from investing activities:		
Purchase of property, plant and equipment	(1,050)	(675)
Investment in multi-client data library	(2,636)	
Proceeds from the sale of fixed assets		1,504
Proceeds from collection of long-term note receivable		5,800
Business acquisition		(38,404)
Liquidation of Energy Virtual Partners, Inc.		117
Net cash used in investing activities	(3,686)	(31,658)
Cash flows from financing activities:		
Payments on notes payable, long-term debt and lease obligations	(2,156)	(1,002)
Proceeds from preferred stock offering	30,000	
Payment of preferred dividends	(194)	
Proceeds from employee stock purchases and exercise of stock options	629	188
Purchases of treasury stock	(65)	(79)
Net cash provided by (used in) financing activities	28,214	(893)

Effect of change in foreign currency exchange rates on cash and cash equivalents	(70)	(290)
Net increase (decrease) in cash and cash equivalents	12,693	(34,507)
Cash and cash equivalents at beginning of period	14,935	59,507
Cash and cash equivalents at end of period	$ 27,628	$ 25,000

See accompanying Notes to Unaudited Consolidated Financial Statements.

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INPUT/OUTPUT, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The consolidated balance sheet of Input/Output, Inc. and its subsidiaries (collectively referred to as the Company or I/O) at December 31, 2004 has been derived from the Company s audited consolidated financial statements at that date. The consolidated balance sheet at March 31, 2005 (restated - see below), the consolidated statements of operations for the three months ended March 31, 2005 (restated - see below) and 2004, and the consolidated statements of cash flows for the three months ended March 31, 2005 (restated - see below) and 2004 have been prepared by the Company without audit. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for the three months ended March 31, 2005 (restated - see below) are not necessarily indicative of the operating results for a full year or of future operations.

These consolidated financial statements have been prepared using accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and applicable rules of Regulation S-X of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States have been omitted. The accompanying consolidated financial statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2004. Certain amounts previously reported in the consolidated financial statements have been reclassified to conform to the current period s presentation.

Restatement of Financial Statement as of and for the Three Months Ended March 31, 2005

The consolidated balance sheet at March 31, 2005 and the consolidated statements of operations and of cash flows for the three months ended March 31, 2005 are being restated as a result of errors in the calculation of royalty expenses related to the multi-client data libraries of GX Technology Corporation (GXT), a subsidiary acquired by the Company in June 2004. In its internal review of the financial results of GXT for the second fiscal quarter of 2005, the Company discovered that royalty expenses of approximately $795,000 relating to licenses of GXT s multi-client seismic survey data should have been recorded in the interim unaudited financial statements for the first quarter of 2005. During this review, the Company also discovered that GXT royalty expenses of approximately $139,000 had not been properly recorded in 2004, and because the miscalculated amount did not have a material impact on the Company s reported results for the year ended December 31, 2004 or any interim period in 2004, the Company has reflected the correction for this amount in its restated results for the first quarter of 2005. The Company has also included in its restated results for the first quarter of 2005 certain other adjustments totaling $179,000 (reduction of expense), which the Company considers to be immaterial individually and in the aggregate, but that were appropriate to include in an otherwise-required restatement of the period.

During the second quarter of 2005, the Company implemented and enhanced certain internal control procedures regarding GXT s royalty expense calculations related to its multi-client data library, designed to provide reasonable assurance against any miscalculations of GXT royalty expenses. The procedures include the timely review and confirmation of the royalty expense calculations and the transactions and underlying documentation supporting the expense calculations. As a result of these procedures, the Company discovered the errors in the calculation of GXT royalty expenses.

A summary of the restatements included in this amended filing are:

As Previously

	Reported (Unaudited)	Adjustments	As Restated (Unaudited)
	(In thousands, except per share data)		
Balance Sheet as of March 31, 2005			
Current portion of notes receivable, net	$ 10,704	$ (205)	$ 10,499
Inventories	85,333	(94)	85,239
Total current assets	208,813	(299)	208,514
Property, plant and equipment	42,999	49	43,048
Multi-client data library	10,285	(45)	10,240
Goodwill	148,637	361	148,998
Total assets	493,466	66	493,532
Accounts payable	31,221	(120)	31,101
Accrued expenses	26,641	1,108	27,749
Total current liabilities	72,443	988	73,431
Additional paid-in capital	481,364	(167)	481,197
Accumulated deficit	(164,773)	(755)	(165,528)
Total stockholders equity	311,312	(922)	310,390
Total liabilities and stockholders equity	493,466	66	493,532
Statement of Operations for the three months ended March 30, 2005			
Net sales	$ 66,837	$	$ 66,837
Costs of sales	50,993	704	51,697
Gross profit	15,844	(704)	15,140
Research and development	4,643	(88)	4,555
General and administrative	6,322	(17)	6,305
Total operating expenses	18,646	(105)	18,541
Income (loss) from operations	(2,802)	(599)	(3,401)
Interest expense	(1,793)	49	(1,744)
Interest income	276	(205)	71
Income (loss) before income taxes	(4,278)	(755)	(5,033)
Net loss	(3,063)	(755)	(3,818)
Net loss applicable to common shares	(3,257)	(755)	(4,012)
Basic and diluted net loss per common share	$ (0.04)	$ (0.01)	$ (0.05)
Statement of Cash Flows for the three months ended March 30, 2005			
Net loss	$ (3,063)	$ (755)	$ (3,818)
Adjustments to reconcile net loss to cash used in operating activities:			
Bad debt expense	138	205	343
Change in operating assets and liabilities:			
Inventories	(149)	94	(55)
Accounts payable and accrued expenses	(10,916)	883	(10,033)
Other assets and liabilities	(2,660)	(423)	(3,083)
Net cash used in operating activities	(11,769)	4	(11,765)
Purchase of property, plant and equipment	(1,001)	(49)	(1,050)
Investment in multi-client data library	(2,681)	45	(2,636)
Net cash used in investing activities	(3,682)	(4)	(3,686)

(2) Summary of Significant Accounting Policies and Estimates

Refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2004 for a complete discussion of the Company s significant accounting policies and estimates. Since the Company s last annual filing the Company has changed its estimate regarding the useful economic life of its multi-client data library.

In the first quarter of 2005, the Company determined that the estimated useful economic life of its multi-client data library is four years from the date a multi-client data library becomes available for commercial sale. Previously, the estimated useful life of a multi-client data library once it became available for commercial sale was two years for 2-D projects and three years for 3-D projects. Therefore, the Company s method of amortizing the costs of a multi-client data library available for commercial sale is the greater of (i) the percentage of actual revenue to the total estimated revenue multiplied by the estimated total cost of the project or (ii) the straight-line basis over a four-year period. The change in estimate was determined based upon GX Technology Corporation s (GXT) further historical experience in marketing and selling its multi-client data libraries, in addition to a review of industry standards regarding such useful economic lives. The change did not have a material impact to the Company s results of operations during the first quarter of 2005.

(3) Pro forma Results of Acquisitions

In June 2004, the Company purchased all the equity interest in GXT and in February 2004, the Company purchased all the share capital of Concept Systems Holding Limited (Concept Systems). The consolidated results of operations of the Company include the results of GXT and Concept Systems from the dates of acquisition. As discussed in Note 1, the financial statements of the three months ended March 31, 2005 are being restated as a result of errors in the calculation of royalty expenses related to the multi-client data library of GXT. As a result, the pro forma information for the three months ended March 31, 2004 is also being restated to give effect to a correction of the royalty expense of that pre-acquisition period that increases net loss by $228,000 ($0.01 per share). The following summarized unaudited pro forma consolidated income statement information for the three months ended March 31, 2004, assumes that the GXT and Concept Systems acquisitions had occurred as of the beginning of the period presented. The Company has prepared these unaudited pro forma financial results for comparative purposes only. These unaudited pro forma financial results may not be indicative of the results that would have occurred if we had completed the acquisitions as of the beginning of the period presented or the results that will be attained in the future. Amounts presented below are in thousands, except for the per share amounts:

	As Previously Reported Pro forma Three Months Ended March 31, 2004	Adjustment	As Restated Pro forma Three Months Ended March 31, 2004
Net sales	$ 57,760	$	$ 57,760
Income from operations	$ 1,668	$ (228)	$ 1,440
Net loss applicable to common shares	$ (162)	$ (228)	$ (390)
Basic and diluted net loss per common share	$ (0.00)	$ (0.01)	$ (0.01)

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(4) Stock-Based Compensation

The Company has elected to continue to follow the intrinsic value method of accounting for equity-based compensation as prescribed by APB Opinion No. 25. If the Company had adopted SFAS No. 123, net loss applicable to common shares, basic and diluted net loss per common share for the periods presented would have changed as follows (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2005 (Restated)	2004
Net loss applicable to common shares	$ (4,012)	$ (558)
Add: Stock-based employee compensation expense included in reported net loss applicable to common shares	436	39
Deduct: Stock-based employee compensation expense determined under fair value methods for all awards	(1,350)	(657)
Pro forma net loss applicable to common shares	$ (4,926)	$ (1,176)
Basic and diluted net loss per common share as reported	$ (0.05)	$ (0.01)
Pro forma basic and diluted net loss per common share	$ (0.06)	$ (0.02)

The fair value of each option was determined using the Black-Scholes option valuation model. The key variables used in valuing the options were as follows: average risk-free interest rate based on 5-year Treasury bonds, an estimated option term of five years, no dividends and expected stock price volatility of 60% during the three months ended March 31, 2005 and 2004.

(5) Segment and Product Information

The Company evaluates and reviews results based on four segments (Land Imaging Systems, Marine Imaging Systems, Data Management Solutions and Seismic Imaging Solutions) to allow for increased visibility and accountability of costs and more focused customer service and product development. The Company measures segment operating results based on income (loss) from operations. Intersegment sales are insignificant for all periods presented.

A summary of segment information for the three months ended March 31, 2005 and 2004 is as follows (in thousands):

	Three Months Ended March 31,	
	2005	2004
Net sales:		
Land Imaging Systems	$ 30,557	$ 20,637
Marine Imaging Systems	10,873	11,460
Data Management Solutions	3,151	2,281
Seismic Imaging Solutions	22,256	1,508

Corporate and Other		401
Total	$ 66,837	$ 36,287
Income (loss) from operations:	**(Restated)**	
Land Imaging Systems	$ 3,058	$ 1,660
Marine Imaging Systems	1,093	2,790
Data Management Solutions	(124)	922
Seismic Imaging Solutions	(1,038)	81
Corporate and Other	(6,390)	(4,409)
Total	$ (3,401)	$ 1,044

A summary of net sales by products and services is as follows (in thousands):

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	Three Months Ended March 31, 2005	2004
Equipment and system sales	$ 39,473	$ 31,145
Multi-client data library sales (including underwriting revenues)	12,527	
Imaging services	9,283	975
Other revenues	5,554	4,167
Total	$ 66,837	$ 36,287

(6) Accounts and Notes Receivable

A summary of accounts receivable is as follows (in thousands):

	March 31, 2005	December 31, 2004
Accounts receivable, principally trade	$ 66,175	$ 64,751
Less allowance for doubtful accounts	(3,268)	(3,153)
Accounts receivable, net	$ 62,907	$ 61,598

Notes receivable are collateralized by the products sold, bear interest at contractual rates ranging from 5.1% to 8.0% per year and are due at various dates through 2006. The weighted average interest rate at March 31, 2005 was 6.1%. A summary of notes receivable, accrued interest and allowance for doubtful notes is as follows (in thousands):

	March 31, 2005 (Restated)	December 31, 2004
Notes receivable and accrued interest	$ 19,619	$ 20,820
Less allowance for doubtful notes	(5,897)	(5,893)
Notes receivable, net	13,722	14,927
Less current portion of notes receivable, net	10,499	10,784
Long-term notes receivable	$ 3,223	$ 4,143

In 2004, the Company sold a VectorSeis® Ocean system for seabed data acquisition. A portion of the purchase was financed by the Company through a series of notes receivable. During 2004, this system experienced unexpected warranty issues causing the customer to delay its deployment of this system. As a result of these issues, the customer has delayed payments under the notes. The outstanding balance of the notes and accounts receivable due from this customer at March 31, 2005 was $10.4 million. The Company expects to be paid on all its obligations in full. Therefore, no allowance has been established for this customer.

(7) Inventories

A summary of inventories, net of reserves, is as follows (in thousands):

	March 31, 2005 (Restated)	December 31, 2004
Raw materials and subassemblies	$ 32,915	$ 30,039
Work-in-process	4,653	5,100
Finished goods	47,671	51,520
Total	$ 85,239	$ 86,659

As part of the Company s business plan, the Company is increasing the use of contract manufacturers as an alternative to in-house manufacturing. Under certain of the Company s outsourcing arrangements, its manufacturing outsourcers first utilize the Company s on-hand inventory, then directly purchase inventory at agreed-upon quantities and lead times in order to meet the Company s scheduled deliveries. If demand proves to be less than the Company originally forecasted and the Company cancels its committed purchase orders, its outsourcer has the right to require the Company to purchase inventory which it had purchased on the Company s behalf.

(8) Non-Cash Investing and Financing Activities

In February 2004, the Company acquired all of the share capital of Concept Systems. As part of the consideration, the Company issued 1,680,000 of its common shares, valued at $10.8 million. Also, during the three months ended March 31, 2005 and 2004,

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respectively, the Company transferred $1.2 million and $2.6 million, respectively, of inventory at cost, to property, plant and equipment.

(9) Notes Payable, Long Term Debt and Lease Obligations

The Company has entered into a series of equipment loans that are due in installments for the purpose of financing the purchase of computer equipment, in the form of capital leases expiring in various years through 2007. Interest charged under these loans range from 3.5% to 13.9% and the leases are collateralized by liens on the computer equipment. The assets and liabilities under these capital leases are recorded at the lower of the present value of the minimum lease payments or the fair value of the assets. The assets are depreciated over the lesser of their related lease terms or their estimated productive lives. The unpaid balance at March 31, 2005 was $5.4 million.

The Company issued $60.0 million of convertible senior notes, which mature on December 15, 2008. The notes bear interest at an annual rate per annum of 5.5%, payable semi-annually. The notes, which are not redeemable prior to their maturity, are convertible into the Company s common stock at an initial conversion rate of 231.4815 shares per $1,000 principal amount of notes (a conversion price of $4.32 per share), which represents 13,888,890 total common shares. The Company paid $3.5 million in underwriting and professional fees, which have been recorded as deferred financing costs and are being amortized over the term of the notes.

In August 2001, the Company sold its corporate headquarters and manufacturing facility located in Stafford, Texas for $21.0 million. Simultaneously with the sale, the Company entered into a non-cancelable lease with the purchaser of the property. The lease has a twelve-year term with three consecutive options to extend the lease for five years each. The Company has no purchase option under the lease. As a result of the lease terms, the commitment was recorded as a twelve-year, $21.0 million lease obligation with an implicit interest rate of 9.1% per annum. The unpaid balance at March 31, 2005 was $17.6 million. The Company paid $1.7 million in commissions and professional fees, which have been recorded as deferred financing costs and are being amortized over the twelve-year term of the lease obligation. At June 30, 2003, the Company failed to meet the tangible net worth requirement under this lease. Therefore, in the third quarter of 2003, the Company provided a letter of credit to the landlord of the property in the amount of $1.5 million. To secure the issuance of the letter of credit, the Company was required to deposit $1.5 million with the issuing bank. This letter of credit will remain outstanding until the Company is back in compliance with such tangible net worth requirement for eight consecutive quarters, or until the expiration of the eighth year of the lease in 2009. The deposit has been classified as a long-term other asset.

A summary of future principal obligations under the notes payable, long-term debt and capital lease obligations as of March 31, 2005 is as follows (in thousands):

Years Ended December 31,	**Notes Payable and Long-term Debt**	**Capital Lease Obligations**
2005	$ 1,769	$ 2,895
2006	1,484	2,141
2007	1,625	746
2008	61,779	
2009	2,067	
2010 and thereafter	9,779	

Total	$	78,503	5,782
Imputed Interest			(413)
Net present value of capital lease obligations			5,369
Current portion of capital lease obligations			3,214
Long-term portion of capital lease obligations		$	2,155

(10) Cumulative Convertible Preferred Stock

In February 2005, the Company issued 30,000 shares of a newly designated Series D-1 Cumulative Convertible Preferred Stock (Series D-1 Preferred Stock) in a privately-negotiated transaction and received $30 million in proceeds. The Company has and will continue to use the proceeds from the issuance of the Series D-1 Preferred Stock for general corporate purposes, including working capital, and for potential business opportunities. Dividends, which are contractually obligated to be paid quarterly, may be paid, at the option of the Company, either in cash or by the issuance of the Company s common stock. Dividends are paid at a rate equal to the stated value of $1,000 per share multiplied by the greater of (i) five percent per annum or (ii) the three-month LIBOR rate on the last day of the immediately preceding calendar quarter plus two and one-half percent per annum. On March 31, 2005, the Company paid a cash dividend of $0.2 million. The Series D-1 Preferred Stock may be converted, at the holder s election, into 3,812,428 shares of the Company s common stock, subject to adjustment, at an initial conversion price of $7.869 per share, also subject to adjustment in certain events.

The Company also granted the right, commencing August 16, 2005 and expiring on February 16, 2008 (subject to extension), to purchase up to an additional 40,000 shares of Series D Preferred Stock, having similar terms and conditions as the Series D-1 Preferred Stock, and having a conversion price equal to 122% of the prevailing market price of the Company s common stock at the time of its issuance, but not less than $6.31 per share (subject to adjustment in certain events).

(11) Net Loss per Common Share

Basic net loss per common share is computed by dividing net loss applicable to common shares by the weighted average number of common shares outstanding during the period. Diluted net loss per common share is determined on the assumption that outstanding dilutive stock options have been exercised and the aggregate proceeds were used to reacquire common stock using the average price of such common stock for the period. The total number of options outstanding at March 31, 2005 and 2004 were 7,114,410 and 5,719,131, respectively. In December 2003, the Company issued $60.0 million of senior notes convertible into its common stock, which represents 13,888,890 common shares that may be acquired upon full conversion. In February 2005, the Company issued 30,000 shares of Series D-1 Cumulative Convertible Preferred Stock which may be converted, at the holder s election, into 3,812,428 total common shares (subject to adjustment). Basic and diluted net loss per share are the same for the three months ended March 31, 2005 and 2004, as all potential common shares were anti-dilutive.

(12) Deferred Income Tax

The Company continues to record a valuation allowance for substantially all of its net deferred tax assets, which are primarily net operating loss carryforwards. The Company currently does not recognize a benefit from net operating losses. The establishment of this valuation allowance does not affect the Company s ability to reduce future tax expense through utilization of prior years net operating losses. Income tax expense for the three months ended March 31, 2004 reflects state and foreign taxes. The income tax benefit for the three months ended March 31, 2005, reflects state and foreign taxes in addition to a $1.3 million credit due to the resolution of a foreign tax matter being less than the Company s reserve.

The valuation allowance was calculated in accordance with the provisions of SFAS No. 109, *Accounting for Income Taxes,* which places primary importance on the Company s cumulative operating results in the most recent three-year period when assessing the need for a valuation allowance. The Company s results for those periods were heavily affected by industry conditions, and deliberate and planned business restructuring activities in response to the prolonged downturn in the seismic equipment market, as well as heavy expenditures on research and development. Nevertheless, recent losses represented sufficient negative evidence to establish an additional valuation allowance. The Company has continued to reserve for substantially all of its net deferred tax assets and will continue until there is sufficient positive evidence to warrant reversal.

(13) Comprehensive Net Loss

The components of comprehensive net loss are as follows (in thousands):

	Three Months Ended

	March 31, 2005 (Restated)	March 31, 2004
Net loss applicable to common shares	$ (4,012)	$ (558)
Foreign currency translation adjustment	(943)	(383)
Comprehensive net loss	$ (4,955)	$ (941)

(14) Commitments and Contingencies

Legal Matters: On January 12, 2005, a putative class action lawsuit was filed against I/O, its chief executive officer, its chief financial officer and the president of GXT in the U.S. District Court for the Southern District of Texas, Houston Division. The action, styled *Harold Read, individually and on behalf of all others similarly situated v. Input/Output, Inc, Robert P. Peebler, J. Michael Kirksey, and Michael K. Lambert,* alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule

10b-5 thereunder. The action was filed purportedly on behalf of purchasers of I/O s common stock who purchased shares during the period from May 10, 2004 through January 4, 2005. The complaint seeks damages in an unspecified amount plus costs and attorneys fees. The complaint alleges misrepresentations and omissions in public announcements and filings concerning the Company s business, sales and products. On February 4 and 10, 2005, and March 15, 2005, three similar lawsuits were filed in the U.S. District Court for the Southern District of Texas, Houston Division. The three complaints, styled (i) *Matt Brody, individually and on behalf of all others similarly situated v. Input/Output, Inc, Robert P. Peebler and J. Michael Kirksey,* (ii) *Giovanni Arca vs. Input/Output, Inc., Robert P. Peebler, J. Michael Kirksey, and Michael K. Lambert,* and (iii) *Schneur Grossberger, individually and on behalf of all others similarly situated v. Input/Output, Inc., Robert P. Peebler, J. Michael Kirksey, and Michael K. Lambert,* contain factual allegations similar to those in the *Read* complaint. The *Brody* complaint was voluntarily dismissed by the plaintiff in that case on April 28, 2005. The defendants have not been served with process in any of the remaining putative class action cases. No discovery has been conducted by the parties in any of the cases, and discovery will be stayed should the defendants file a motion to dismiss until there is a ruling on that motion. Based on the Company s review of the complaints, management believes the lawsuits are without merit and intends to defend the Company and its officers named as parties vigorously. However, management is unable to determine whether the ultimate resolution of these cases will have a material adverse impact on the Company s financial condition, results of operations or liquidity.

A shareholder derivative lawsuit (*Kovalsky v. Robert P. Peebler, et al.*, No. 2005-17565) was filed on March 16, 2005 in the District Court of Harris County, Texas, 189th Judicial District, against certain of the Company s officers and all of the members of its board of directors as defendants, and against the Company as a nominal defendant. The complaint alleges breach of the officers and directors fiduciary duties by failing to correct publicly reported financial results and guidance, abuse of control, gross mismanagement, unjust enrichment and corporate waste. The plaintiff seeks judgment against the defendants for unspecified damages sustained by the Company, restitution, disgorgement of profits, benefits and compensation allegedly obtained by the defendants and attorneys and experts fees and costs. Based on the Company s review of the *Kovalsky* complaint, management believes that the derivative suit is without merit and intends to defend vigorously the Company and its officers and directors named as parties in this action. However, management is unable to determine whether the ultimate resolution of this case will have a material adverse impact on the Company s financial condition, results of operations or liquidity.

In October 2002, the Company filed a lawsuit against Paulsson Geophysical Services, Inc. (PGSI) and its owner in the 286th District Court for Fort Bend County, Texas, seeking recovery of approximately $0.7 million that was unpaid and due to the Company resulting from the sale of a custom product that PGSI asked the Company to construct in 2001. In 2002, the Company fully reserved for all amounts due from PGSI with regard to this sale. After the Company filed suit to recover the PGSI receivable, PGSI alleged that the delivered custom product was defective and counter-claimed against the Company, asserting breach of contract, breach of warranty and other related causes of action. The case was tried to a jury during May 2004. The jury returned a verdict in June 2004, the results of which would not have supported a judgment awarding damages to either the Company or the defendants. In August 2004, the presiding judge overruled the jury verdict and ordered a new trial. The Company and the defendants have not yet scheduled a new trial and continue to discuss the dispute. Company management continues to believe that the ultimate resolution of the case will not have a material adverse impact on the financial condition or liquidity of the Company.

The Company has been named in various lawsuits or threatened actions that are incidental to its ordinary business. Such lawsuits and actions could increase in number as the Company s business expands and the Company grows larger. Litigation is inherently unpredictable. Any claims against the Company, whether meritorious or not, could be time consuming, cause the Company to incur costs and expenses, require significant amounts of management time and result in the diversion of significant operational resources. The results of these lawsuits and actions cannot be predicted with certainty. Management believes that the ultimate resolution of these matters will not have a material adverse impact on the financial condition or liquidity of the Company.

Product Warranty Liabilities: The Company generally warrants that all manufactured equipment will be free from defects in workmanship, materials and parts. Warranty periods generally range from 90 days to three years from the date of original purchase, depending on the product and equipment. The Company provides for estimated warranty costs as a charge to cost of sales at time of sale, which is when estimated future expenditures associated with such contingencies become probable and reasonably estimated. However, new information may become available, or circumstances (such as applicable laws and regulations) may change, thereby resulting in an increase or decrease in the amount required to be accrued for such matters (and therefore a decrease or increase in reported net income in the period of such change). A summary of warranty activity is as follows (in thousands):

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Balance at beginning of period	$ 3,832	$ 3,433
Accruals for warranties issued during the period	1,271	221
Settlements made (in cash or in kind) during the period	(1,322)	(504)
Balance at end of period	$ 3,781	$ 3,150

(15) Recent Accounting Pronouncements

In March 2004, the FASB issued EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF Issue No. 03-1 included new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-1; however, the disclosure requirements remain effective and have been adopted for the Company s year ended December 31, 2004. The Company will evaluate the effect, if any, of EITF Issue No. 03-1 when final guidance is released.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs An Amendment of ARB No. 43, Chapter 4,* which requires that abnormal amounts of idle facility expense, freight, handling costs and spoilage should be expensed as incurred and not included in overhead, and that allocation of fixed production overheads to conversion costs should be based on normal capacity of the production facilities. The provisions in SFAS No. 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not believe that the adoption of SFAS No. 151 will have a significant impact on the Company s financial statements.

In December 2004, the FASB issued SFAS No. 123 (revised 2004) *Share-Based Payment* (SFAS 123R), which replaces SFAS No. 123 and supersedes APB Opinion No. 25. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. Currently, the Company will be required to adopt SFAS 123R effective as of January 1, 2006. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The Company is evaluating the requirements of SFAS 123R and expects that the adoption of SFAS 123R will have a material impact on its consolidated results of operations and earnings per share. The Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, and has not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

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

See Note 1 of *Notes to Unaudited Consolidated Financial Statements* for explanation on the restatement of financial statements as of and for the three months ended March 31, 2005.

Executive Summary

We are a leading seismic services company, providing seismic data acquisition equipment, software and planning and seismic processing services to the global oil and gas industry.

During 2004, we accomplished a major repositioning of our business. Formerly, we were primarily an equipment and technology provider; now we offering our customers full-seismic imaging solutions. In February 2004, we acquired Concept Systems Holdings Limited (Concept Systems), an Edinburgh, Scotland-based provider of software, systems and services for towed streamer, seabed and land seismic operations. In June 2004, we acquired GX Technology Corporation (GXT), a leading provider of seismic imaging technology, data processing and subsurface imaging services to oil and gas companies. Both acquisitions were completed as part of our strategy to expand the range of products and services we can provide to our existing customers and new end-user customers.

We operate our company through four business segments: Land Imaging Systems, Marine Imaging Systems, Data Management Solutions and Seismic Imaging Solutions. The following table provides an overview of key financial metrics for our company as a whole and our four business segments during the three months ended March 31, 2005:

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	I/O Consolidated	Land Imaging Systems	Marine Imaging Systems	Data Management Solutions	Seismic Imaging Solutions	Other
Net sales	$ 66,837	$ 30,557	$ 10,873	$ 3,151	$ 22,256	$
Income (loss) from operations (Restated)	$ (3,401)	$ 3,058	$ 1,093	$ (124)	$ (1,038)	$ (6,390)*
Net loss applicable to common shares (Restated)	$ (4,012)	**	**	**	**	**
Basic and diluted net loss per common share (Restated)	$ (0.05)					

* Represents corporate general and administrative expenses not allocated to any segment.

** Net income (loss) applicable to common shares by business segment is not considered a key financial metric.

Our Land Imaging Systems segment recorded net sales of $30.6 million in the first quarter of 2005 compared to $20.6 million in the first quarter of 2004, largely due to increased sales of land systems and vibrator trucks. Gross margins decreased by 3%, to 22% this year compared to 25% in 2004 s first quarter, reflecting the increased percentage of sales of these more mature, lower-margin products. Our Marine Imaging Systems segment saw a decrease in net sales for the quarter, from $11.5 million for the three months ended March 31, 2004 to $10.9 million for 2005 s first quarter. However, 2005 s net sales did not include $3.1 million in revenues we recorded in 2004 s first quarter from the sale of our VectorSeis Ocean system; excluding the VectorSeis Ocean revenues, this segment s business grew by 30%, reflecting an improving marine seismic market.

GXT s, which is included within our Seismic Imaging Solutions segment, net sales for the first quarter of 2005 were $20.7 million. Gross margins from GXT were only 13% for the first quarter of 2005. However, during the first quarter, GXT saw growing demand for its processing services, and we believe GXT s revenues and gross margins will improve in subsequent periods in 2005 because of the increased demand and the resulting greater capacity absorption.

Operating expenses were higher in the first quarter of 2005 when compared with the first quarter of 2004, due primarily to our acquisitions in 2004. However, as a percentage of revenues, operating expenses fell by 2%, to 28%, in 2005, compared to 2004 s first quarter s 30% of revenues.

Cash and cash equivalents for the three months ended March 31, 2005 totaled $27.6 million, an increase of $12.7 million from the December 31, 2004 balance of $14.9 million, due to our issuance in February 2005 of 30,000 shares of a newly designated Series D-1 Cumulative Convertible Preferred Stock (Series D-1 Preferred Stock) in a privately-negotiated transaction. We received $30.0 million in proceeds from this sale. Net cash used in operating activities was $11.8 million for the first quarter of 2005, an increase compared to $1.7 million for 2004 s first quarter, principally due to changes in working capital items. During the first quarter of 2005, we experienced a decrease in accounts payable and accrued expenses due to our payments to vendors for inventory we received during the fourth quarter of 2004, and an increase in unbilled revenues.

Our ability in future periods to produce positive cash flows from operations and consistent levels of profitability, grow our business and service our debt and our other cash obligations, will depend to a large degree upon:

- our success in our marketing and business development efforts to accelerate the rate of diffusion of our new products and services into the marketplace;
- achieving an improved balance of sales in our GXT product and service lines,

introducing and technologically enhancing our products and services offered,

penetrating new markets for our products and services,

continuing to improve our margins on our sales and

continuing to reduce our overall costs.

We intend that the discussion of our financial condition and results of operations that follows will provide information that will assist in understanding our consolidated financial statements, the changes in certain key items in those financial statements from quarter to quarter, and the primary factors that accounted for those changes.

For a discussion of factors that could impact our future operating results and financial condition, see the section entitled Risk Factors below.

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Results of Operations

Three Months Ended March 31, 2005 Compared to Three Months Ended March 31, 2004

Net Sales: Net sales of $66.8 million for the three months ended March 31, 2005 increased $30.6 million compared to the corresponding period last year. Approximately 31% of this increase in net sales was primarily due to increases within our historical Land and Marine Imaging Systems segments. Net sales within our Land Imaging Systems segment increased $9.9 million to $30.6 million compared to the corresponding period of last year. The increase is due to an increase in sales of our vibrator truck product lines, which we sold 29 vibrator trucks during the three months ended March 31, 2005 compared to four during the three months ended March 31, 2004. We expect sales of vibrator trucks, a mature product line, will decline during the second quarter of 2005. Land Imaging Systems also had an increase in system sales, including our System Four Digital-Analog system which was commercialized in second quarter of 2004. However, our Sensor geophone sales decreased by approximately $2.0 million in the first quarter of 2005 compared to 2004 s first quarter. Our Sensor geophones unit recorded record net sales in 2004, which may prove difficult to replicate.

Our Marine Imaging Systems net sales decreased $0.6 million to $10.9 million when compared to the segment s net sales during the three months ended March 31, 2004. This decline was due to the sale of our VectorSeis Ocean-Bottom acquisition system for $3.1 million during the three months ended March 31, 2004; there were no comparable sales during the three months ended March 31, 2005. Excluding the VectorSeis Ocean-Bottom sale in 2004, net sales of our historical marine products increased in 2005 over first quarter 2004 s comparable net sales by $2.5 million, evidencing an improving marine seismic market.

The remaining 69% of our increase in net sales was due to our acquisition of GXT (in June 2004) and Concept Systems (in February 2004). During the three months ended March 31, 2005, GXT and Concept Systems contributed $20.7 million and $3.2 million, respectively, to our net sales. During the three months ended March 31, 2004, Concept Systems net sales were $2.3 million. GXT ended 2004 with a lower than expected backlog within its processing business, resulting in significant spare capacity within its operations entering the first quarter of 2005. As a result of this spare capacity, GXT s first quarter results were lower than anticipated. However, since the end of 2004, we have seen GXT s backlog of processing projects improve significantly, which should indicate a stronger and more balanced portfolio of revenues between proprietary processing, multi-client surveys and data sales.

Gross Profit and Gross Profit Percentage: Gross profit of $15.1 million for the three months ended March 31, 2005 increased $3.2 million, compared to the corresponding period last year. The improvement in gross profit was mainly driven by the contributions from GXT. Gross profit percentage for the three months ended March 31, 2005 was 23% compared to 33% in the prior year. Gross profit percentage for the three months ended March 31, 2005, was lower as delays in higher margin systems sales were replaced with lower margin sales of vibrator trucks and other mature products.

Research and Development: Research and development expense of $4.6 million for the three months ended March 31, 2005 increased $0.8 million compared to the corresponding period last year. This increase is mainly due to the acquisitions of GXT and Concept Systems, which added $0.8 million and $0.1 million, respectively, to our research and development expenses.

Marketing and Sales: Marketing and sales expense of $7.7 million for the three months ended March 31, 2005 increased $4.4 million compared to the corresponding period last year. The increase is partially a result of the acquisition of GXT, which added $2.5 million to our marketing and sales expense. Excluding these expenses of GXT, our sales and marketing expenses increased approximately $1.9 million, primarily related to an increase in sales commissions resulting from increases in revenues and sales personnel, an increase in business development personnel within our product groups, an increase in corporate marketing and advertising expenses and expenses related to our sales representative offices in Moscow and Beijing. We will continue to invest heavily in our marketing efforts as we penetrate markets for our new products.

General and Administrative: General and administrative expense of $6.3 million for the three months ended March 31, 2005 increased $1.6 million compared to the corresponding period last year. The increase in general and administrative expense is primarily a result of the acquisitions of GXT and Concept Systems, which added $0.4 million and $0.3 million, respectively, to our general and administrative expenses and fees associated with the implementation of requirements under the Sarbanes-Oxley Act of 2002.

Net Interest Expense: Total net interest expense of $1.7 million for the three months ended March 31, 2005 increased $0.6 million over the corresponding period last year. The increase is largely due to $0.2 million of interest due on certain of our accounts payable to our significant vendors, as well as a $0.2 million decrease in interest income as a result of our write-down of the LARGE note receivables in 2004. Also, we acquired GXT in June 2004, which typically finances its equipment purchases through capital leases. At March 31, 2005, GXT had $5.4 million outstanding under their capital leases, having rates ranging from 3.5% to 13.9%, resulting in an increase to our interest expense of $0.1 million during the three months ended March 31, 2005.

Income Tax (Benefit) Expense: Income tax benefit for the three months ended March 31, 2005 was $1.2 million compared to an income tax expense of $0.6 million for three months ended March 31, 2004. This benefit was primarily due to the closure of a foreign tax matter, which resulted in a $1.3 million reduction in our reserve. Excluding this tax benefit, income tax expense for the three months ended March 31, 2005 and 2004 reflected only state and foreign taxes. We continue to maintain a valuation allowance for substantially all of our net deferred tax assets.

Liquidity and Capital Resources

In February 2005, we issued 30,000 shares of a newly designated Series D-1 Cumulative Convertible Preferred Stock (Series D-1 Preferred Stock) in a privately-negotiated transaction and received $30 million in proceeds. We have and will continue to use the proceeds from this issuance for general corporate purposes, including working capital, and for potential business opportunities. We have no present commitment or ongoing negotiations with respect to any potential acquisition. The Series D-1 Preferred Stock may be converted, at the holder s election, into 3,812,428 shares of our common stock, subject to adjustment, at an initial conversion price of $7.869 per share, also subject to adjustment in certain events.

We also granted the right, commencing August 16, 2005 and expiring on February 16, 2008 (subject to extension), to purchase up to an additional 40,000 shares of one or more additional series of Series D Preferred Stock, having similar terms and conditions as the Series D-1 Preferred Stock, and having a conversion price equal to 122% of the prevailing market price of our common stock at the time of its issuance, but not less than $6.31 per share (subject to adjustment in certain events).

The issuance of the Series D-1 Preferred Stock resulted from our evaluation that began in late 2004 of our long-term and short-term capital needs. In connection with our assessment of 2004 s results of operations, we evaluated the amount of working capital required to manufacture certain of our sophisticated VectorSeis systems, projections of our short-term and long-term working capital requirements, the potential for unanticipated delays in the adoption of new technologies, certain research and development opportunities and market trends in the seismic industry, and determined that an infusion of additional long-term capital would be desirable.

Also, in April 2005, we received a commitment letter for a $25 million revolving line of credit, which we expect to close in May of this year. We believe this revolving line of credit provides us with further financial flexibilities for our short-term and long-term operational objectives. We can give no assurances that this additional financing source will be closed, and if so, whether the final terms will be advantageous to us or whether the borrowing base will be sufficient for those purposes. However, based upon our forecasts and our liquidity requirements for the near term, we believe that the combination of our projected internally generated cash, the availability of this revolving line of credit and our working capital (including cash and cash equivalents on hand), will provide further flexibility in meeting our growth plans and liquidity requirements for the next twelve months.

Cash Flow from Operations

We have historically financed operations from internally generated cash and funds from equity and debt financings. Cash and cash equivalents were $27.6 million at March 31, 2005, an increase of $12.7 million, compared to December 31, 2004, principally as a result of the preferred stock placement. Net cash used in operating activities was

$11.8 million for the three months ended March 31, 2005, compared to cash used in operating activities of $1.7 million for the three months ended March 31, 2004. The net cash used in our operating activities for the three months ended March 31, 2005 was primarily due to decreases in our payables and accrued expenses, which was due to our payments to vendors for inventory received during the previous quarter, and an increase in our unbilled revenues.

Cash Flow from Investing Activities

Net cash flow used in investing activities was $3.7 million for the three months ended March 31, 2005, compared to $31.7 million for the three months ended March 31, 2004, principally as a result of the Concept Systems acquisition in February 2004. We purchased $1.0 million of equipment and invested $2.6 million in our multi-client data library during the three months ended March 31, 2005. We expect to expend an additional $10 million to $20 million for equipment purchases and investment in our multi-client data library during the remaining nine months of 2005. The range of expenditures is primarily related to our multi-client data library which will be determined based upon the level of underwriting obtained.

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Cash Flow from Financing Activities

Net cash flow provided by financing activities was $28.2 million for the three months ended March 31, 2005, compared to $0.9 million of cash used in financing activities for the three months ended March 31, 2004. This net cash flow was primarily related to our preferred stock offering in February 2005, which we paid $0.2 million of preferred dividends during the quarter. Also, during the three months ended March 31, 2005 we made scheduled payments of $2.2 million on our notes payable, long-term debt and lease obligations, and employees exercised their stock options resulting in proceeds to us of $0.6 million.

Inflation and Seasonality

Inflation in recent years has not had a material effect on our costs of goods or labor, or the prices for our products or services. Traditionally, our business has been seasonal, with strongest demand in our first and fourth quarters, and weakest demand in the second and third quarters of our fiscal year. Additionally, GXT s imaging services are typically slower in the third quarter. This seasonality is primarily attributable to the typical budgetary cycles of our seismic contractor and oil and gas exploration and production company customers.

Critical Accounting Policies and Estimates

Refer to our Annual Report on Form 10-K for the year ended December 31, 2004 for a complete discussion of our significant accounting policies and estimates. Since that Form 10-K filing we have changed our methodology for estimates regarding the useful economic life of our multi-client data library.

In the first quarter of 2005, we determined that the estimated useful economic life of our multi-client data library is four years from the date a multi-client data library becomes available for commercial sale. Previously, the estimated useful life of a multi-client data library once it became available for commercial sale was two years for 2-D projects and three years for 3-D projects. Therefore, our method of amortizing the costs of a multi-client data library available for commercial sale is the greater of (i) the percentage of actual revenue to the total estimated revenue multiplied by the estimated total cost of the project or (ii) the straight-line basis over a four-year period. The change in estimate was determined based upon GXT s further historical experience in marketing and selling its multi-client data libraries, in addition to a review of industry standards regarding such useful economic lives. Therefore, it can be expected that the overall average amortization rate for the costs of an available-for-sale multi-client data library for future periods will decrease when compared to prior periods; however, the change did not have a material impact to our results of operations during the first quarter of 2005.

Credit Risk

Historically, our principal customers have been seismic contractors that operate seismic data acquisition systems and related equipment to collect data in accordance with their customers specifications or for their own seismic data libraries. However, through the acquisition of GXT, we have diversified our customer base to include major integrated and independent oil and gas companies. For the three months ended March 31, 2005 and for all of 2004, approximately 7% and 15%, respectively, of our consolidated net sales were equipment sales to one Chinese customer. Approximately $8.2 million, or 13%, of our total accounts receivable at March 31, 2005 related to this same customer. The loss of this customer or deterioration in our relationship with it could have a material adverse effect on our results of operations and financial condition.

In 2004, we sold a VectorSeis Ocean-Bottom system for seabed data acquisition. A portion of the purchase was financed by us through a series of notes receivable. During 2004, this system experienced unexpected warranty issues causing the customer to delay its deployment of this system. As a result of these issues, the customer has delayed payments under the notes. The outstanding balance of the notes and accounts receivable due from this customer at March 31, 2005 was $10.4 million. We expect to be paid on all amounts due. Therefore, no allowance has been established for this customer.

For the three months ended March 31, 2005, we recognized $6.3 million of sales to customers in the Commonwealth of Independent States, or former Soviet Union (CIS), $3.9 million of sales to customers in Latin American countries, $15.5 million of sales to customers in Europe, $8.0 million of sales to customers in the Middle East, $3.0 million of sales to customers in Asia Pacific and $7.8 million of sales to customers in Africa. The majority of our foreign sales are denominated in U.S. dollars. In recent years, the CIS and certain Latin American countries have experienced economic problems and uncertainties. To the extent that world events or economic conditions negatively affect our future sales to customers in these and other regions of the world or the collectibility of our existing receivables, our future results of operations, liquidity and financial condition may be adversely affected. We currently require customers in these higher risk countries to provide their own financing and in some cases assist the customer in organizing international financing and Export-Import credit guarantees provided by the United States government. We do not currently extend long-term credit through notes or otherwise to companies in countries we consider to be inappropriate for credit risk purposes.

Risk Factors

This report contains statements concerning our future results and performance and other matters that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These statements involve known and unknown risks, uncertainties, and other factors that may cause our or our industry s results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by such forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, intend, expect, plan, anti believe, estimate, predict, potential, or continue or the negative of such terms or other comparable terminology.

Examples of other forward-looking statements contained in this report include statements regarding:

- expected revenues, operating profit and net income;
- expected gross margins for our products and services;
- future growth rates for certain of our products and services;
- future levels of capital expenditures;
- expectations of successfully marketing our products and services to oil and gas company end-users;
- anticipated timing and success of commercialization and capabilities of products and services under development, and start-up costs associated therewith;
- potential future acquisitions;
- success in integrating our acquired businesses;
- our expectations regarding future mix of business and future asset recoveries;
- future cash needs and future sources of cash, including anticipated revolving line of credit availability;
- the adequacy of our future liquidity and capital resources;
- future demand for seismic equipment and services;
- future seismic industry fundamentals;
- future oil and gas commodity prices;
- future opportunities for new products and projected research and development expenses;

the outcome of pending or threatened disputes and other contingencies;

future worldwide economic conditions;

our expectations regarding realization of deferred tax assets;

our beliefs regarding accounting estimates we make; and

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results from our current or future strategic alliances.

These forward-looking statements reflect our best judgment about future events and trends based on the information currently available to us. Our results of operations can be affected by inaccurate assumptions we make or by risks and uncertainties known or unknown to us. Therefore, we cannot guarantee the accuracy of the forward-looking statements. Actual events and results of operations may vary materially from our current expectations and assumptions. While we cannot identify all of the factors that may cause actual results to vary from our expectations, we believe the following factors should be considered carefully:

Our operating results may fluctuate from period to period and we are subject to seasonality factors.

Our operating results are subject to fluctuations from period to period, as a result of new product or service introductions, the timing of significant expenses in connection with customer orders, unrealized sales, the product mix sold and the seasonality of our business. Because many of our products feature a high sales price and are technologically complex, we generally have experienced long sales cycles for these products and historically incur significant expense at the beginning of these cycles for component parts and other inventory necessary to manufacture a product in anticipation of a future sale, which may not ultimately occur. In addition, the revenues from our sales can vary widely from period to period due to changes in customer requirements. These factors can create fluctuations in our net sales and results of operations from period to period. Variability in our overall gross margins for any quarter, which depend on the percentages of higher-margin and lower-margin products and services sold in that quarter, compounds these uncertainties. As a result, if net sales or gross margins fall below expectations, our operating results and financial condition will likely be adversely affected. Additionally, our business is seasonal in nature, with weakest demand typically experienced in the second and third calendar quarters, and the strongest demand typically in the first and fourth calendar quarters of each year.

Due to the relatively high sales price of many of our products and data libraries and relatively low unit sales volume, our quarterly operating results have historically fluctuated from period to period due to the timing of orders and shipments and the mix of products and services sold. This uneven pattern has made financial predictions for any given period difficult, increases the risk of unanticipated variations in our quarterly results and financial condition and places challenges on our inventory management. Also, delays in ordering products or in shipping or delivering products in a given quarter could significantly affect our results of operations for that quarter. Fluctuations in our quarterly operating results may cause greater volatility in the price of our common stock and convertible notes.

We are exposed to risks related to complex, highly technical products.

System reliability is an important competitive consideration for seismic data acquisition systems. Our customers often require demanding specifications for product performance and reliability. Because many of our products are complex and often use unique advanced components, processes, technologies and techniques, undetected errors and design and manufacturing flaws may occur. Even though we attempt to assure that our systems are always reliable in the field, the many technical variables related to their operations can cause a combination of factors that can and have, from time to time, caused performance issues with certain of our products. Product defects result in higher product service, warranty and replacement costs and may affect our customer relationships and industry reputation, all of which may adversely impact our results of operations. Despite our testing and quality assurance programs, undetected errors may not be discovered until the product is purchased and used by a customer in a variety of field conditions. If our customers deploy our new products and they do not work correctly, our relationship with our customers may be materially and adversely affected.

Both our new VectorSeis System Four Digital-Analog land acquisition system and VectorSeis Ocean-redeployable seabed acquisition system experienced a number of undetected errors or bugs when first introduced. This is not unusual in the development and release of new technologically-advanced products. Also, the inexperience of customers in using these new products exacerbates these problems. We believe that our System Four Digital-Analog land acquisition system contains significant design improvements in both field troubleshooting and reliability compared to legacy analog land acquisition systems, and that the system has now generally achieved expected reliability and performance levels. However, until we have more field experience with the product in a wide variety of operational conditions, we cannot be certain that problems will not arise. We believe the VectorSeis Ocean seabed system is the first system of its type, integrating digital sensors, radio telemetry, data management and quality control systems, all deployed on the seabed. As a result of its recent development and advanced and complex nature, we continue to experience occasional unrelated performance issues with the VectorSeis Ocean seabed system and continue to refine the system and its components to reflect field experiences encountered in their operation.

During 2004, we sold our first VectorSeis Ocean redeployable seabed acquisition system to Reservoir Exploration Technology AS (RXT), a Norwegian start-up seismic contractor. RXT is under contract with our subsidiary, GXT, to obtain seismic data for a major oil company. RXT is using the VectorSeis Ocean seabed system to acquire the data. If for any reason RXT were unable to complete its obligations to acquire the seismic data as required by the oil company, GXT could potentially be liable to the oil company for certain contractual remedies, including reimbursing the oil company for the excess cost for acquiring the data by other means, which could possibly cause a loss to GXT on the contract.

We derive a substantial amount of our revenues from foreign sales, which pose additional risks.

Sales to customers outside of North America accounted for approximately 67% of our consolidated net sales for the three months ended March 31, 2005, and we believe that export sales will remain a significant percentage of our revenue. United States export restrictions affect the types and specifications of products we can export. Additionally, to complete certain sales, United States laws may require us to obtain export licenses, and we cannot assure you that we will not experience difficulty in obtaining these licenses. Operations and sales in countries other than the United States are subject to various risks peculiar to each country. With respect to any particular country, these risks may include:

- expropriation and nationalization;
- political and economic instability;
- armed conflict and civil disturbance;
- currency fluctuations, devaluations and conversion restrictions;
- confiscatory taxation or other adverse tax policies;
- tariff regulations and import/export restrictions;
- customer credit risk;
- governmental activities that limit or disrupt markets, or restrict payments or the movement of funds; and
- governmental activities that may result in the deprivation of contractual rights.

There is a risk that our collections cycle will lengthen due to the increased level of our sales to foreign customers, particularly those in China and the CIS.

The majority of our foreign sales are denominated in United States dollars. An increase in the value of the dollar relative to other currencies will make our products more expensive, and therefore less competitive, in foreign markets.

In addition, we are subject to taxation in many jurisdictions and the final determination of our tax liabilities involves the interpretation of the statutes and requirements of taxing authorities worldwide. Our tax returns are subject to routine examination by taxing authorities, and these examinations may result in assessments of additional taxes, penalties and/or interest.

The loss of any significant customer could materially and adversely affect our results of operations and financial condition.

We have traditionally relied on a relatively small number of significant customers. Consequently, our business is exposed to the risks related to customer concentration. For the three months ended March 31, 2005 and for the entire year of 2004, approximately 7% and 15%, respectively, of our consolidated net sales related to one Chinese customer. The loss of any of our significant customers or deterioration in our relations with any of them could materially and adversely affect our results of operations and financial condition.

The GXT and Concept Systems acquisitions have increased our exposure to the risks experienced by more technology-intensive companies.

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The businesses of GXT and Concept Systems, being more concentrated in software, processing services and proprietary technologies than our traditional business, have exposed us to the risks typically encountered by smaller technology companies that are more dependent on proprietary technology protection and research and development. These risks include:

- future competition from more established companies entering the market;
- product obsolescence;
- dependence upon continued growth of the market for seismic data processing;
- the rate of change in the markets for GXT s and Concept Systems technology and services;
- research and development efforts not proving sufficient to keep up with changing market demands;
- dependence on third-party software for inclusion in GXT s and Concept Systems products and services;
- misappropriation of GXT s or Concept Systems technology by other companies;
- alleged or actual infringement of intellectual property rights that could result in substantial additional costs;
- difficulties inherent in forecasting sales for newly developed technologies or advancements in technologies;
- recruiting, training and retaining technically skilled personnel that could increase the costs for GXT or Concept Systems, or limit their growth; and
- the ability to maintain traditional margins for certain of their technology or services.

We may not realize the anticipated benefits of our acquisitions of GXT or Concept Systems or be successful in integrating their operations, personnel or technology.

There can be no assurance that the anticipated benefits of our acquisitions of GXT or Concept Systems will be realized or that our integration of their operations, personnel and technology will be successful. Likewise, no assurances can be given that our business plan with respect to GXT s or Concept Systems services and products will prove successful. The integration of these companies into our operations will require the experience and expertise of managers and key employees of GXT and Concept Systems who are expected to be retained by us. There can be no assurance that these managers and key employees of GXT and Concept Systems retained by us will remain with us for the time period necessary to successfully integrate their companies into our operations.

We may not gain rapid market acceptance for our VectorSeis products, which could materially and adversely affect our results of operations and financial condition.

We have spent considerable time and capital developing our VectorSeis product lines. Because VectorSeis products rely on a new digital sensor, our ability to sell our VectorSeis products will depend on acceptance of our digital sensor and technology solutions by geophysical contractors and exploration and production companies. If our customers do not believe that our digital sensor delivers higher quality data with greater operational efficiency, our results of operations and financial condition will be materially and adversely affected.

Future technologies and businesses that we may acquire may be difficult to integrate, disrupt our business, dilute stockholder value or divert management attention.

An important aspect of our current business strategy is to seek new technologies, products and businesses to broaden the scope of our existing and planned product lines and technologies. While we believe that these acquisitions complement our technologies and our general business strategy, there can be no assurance that we will achieve the expected benefit of these acquisitions. In addition, these acquisitions may result in unexpected costs, expenses and liabilities.

Acquisitions expose us to:

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- increased costs associated with the acquisition and operation of the new businesses or technologies and the management of geographically dispersed operations;
- risks associated with the assimilation of new technologies, operations, sites and personnel;
- the possible loss of key employees and costs associated with their loss;
- risks that any technology we acquire may not perform as well as we had anticipated;
- the diversion of management s attention and other resources from existing business concerns;
- the potential inability to replicate operating efficiencies in the acquired company s operations;
- potential impairments of goodwill and intangible assets;
- the inability to generate revenues to offset associated acquisition costs;
- the requirement to maintain uniform standards, controls, and procedures;
- the impairment of relationships with employees and customers as a result of any integration of new and inexperienced management personnel; and
- the risk that acquired technologies do not provide us with the benefits we anticipated.

Integration of the acquired businesses requires significant efforts from each entity, including coordinating existing business plans and research and development efforts. Integrating operations may distract management s attention from the day-to-day operation of the combined companies. If we are unable to successfully integrate the operations of acquired businesses, our future results will be negatively impacted.

We have developed outsourcing arrangements with third parties to manufacture some of our products. If these third parties fail to deliver quality products or components at reasonable prices on a timely basis, we may alienate some of our customers and our revenues, profitability and cash flow may decline.

As part of our strategic direction, we are increasing our use of contract manufacturers as an alternative to our own manufacture of products. As an example, in December 2004, we sold to another company our Applied MEMS business that manufactures MEMS products that are a necessary component in many of our products. If, in implementing any outsource initiative, we are unable to identify contract manufacturers willing to contract with us on competitive terms and to devote adequate resources to fulfill their obligations to us or if we do not properly manage these relationships, our existing customer relationships may suffer. In addition, by undertaking these activities, we run the risk that the reputation and competitiveness of our products and services may deteriorate as a result of the reduction of our control over quality and delivery schedules. We also may experience supply interruptions, cost escalations and competitive disadvantages if our contract manufacturers fail to develop, implement, or maintain manufacturing methods appropriate for our products and customers.

If any of these risks are realized, our revenues, profitability and cash flow may decline. In addition, as we come to rely more heavily on contract manufacturers, we may have fewer personnel resources with expertise to manage problems that may arise from these third-party arrangements.

Technological change in the seismic industry requires us to make substantial research and development expenditures.

The markets for our products are characterized by changing technology and new product introductions. We must invest substantial capital to maintain a leading edge in technology, with no assurance that we will receive an adequate rate of return on such investments. If we are unable to develop and produce successfully and timely new and enhanced products and services, we will be unable to compete in the future and our business, our results of operations and financial condition will be materially and adversely affected.

Our outsourcing relationships may require us to purchase inventory when demand for products produced by third-party manufacturers is low.

Under a few of our outsourcing arrangements, our manufacturing outsourcers purchase agreed-upon inventory levels to meet our forecasted demand. Since we typically operate without a significant backlog of orders for our products, our manufacturing plans and inventory levels are principally based on sales forecasts. If demand proves to be less than we originally forecasted, these manufacturing outsourcers have the right to require us to purchase any excess or obsolete inventory. Should we be required to purchase inventory under these provisions, we may be required to hold inventory that we may never utilize.

We may be unable to obtain broad intellectual property protection for our current and future products and we may become involved in intellectual property disputes.

We rely on a combination of patent, copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary technologies. We believe that the technological and creative skill of our employees, new product developments, frequent product enhancements, name recognition and reliable product maintenance are the foundations of our competitive advantage. Although we have a considerable portfolio of patents, copyrights and trademarks, these property rights offer us only limited protection. Our competitors may attempt to copy aspects of our products despite our efforts to protect our proprietary rights, or may design around the proprietary features of our products. Policing unauthorized use of our proprietary rights is difficult, and we are unable to determine the extent to which such use occurs. Our difficulties are compounded in certain foreign countries where the laws do not offer as much protection for proprietary rights as the laws of the United States.

Third parties inquire and claim from time to time that we have infringed upon their intellectual property rights. Any such claims, with or without merit, could be time consuming, result in costly litigation, result in injunctions, require product modifications, cause product shipment delays or require us to enter into royalty or licensing arrangements. Such claims could have a material adverse affect on our results of operations and financial condition.

Further consolidation among our significant customers could materially and adversely affect us.

Historically, a relatively small number of customers has accounted for the majority of our net sales in any period. In recent years, our traditional seismic contractor customers have been rapidly consolidating, thereby consolidating the demand for our products. The loss of any of our significant customers to further consolidation could materially and adversely affect our results of operations and financial condition.

Our operations, and the operations of our customers, are subject to numerous government regulations, which could adversely limit our operating flexibility.

Our operations are subject to laws, regulations, government policies and product certification requirements worldwide. Changes in such laws, regulations, policies or requirements could affect the demand for our products or result in the need to modify products, which may involve substantial costs or delays in sales and could have an adverse effect on our future operating results. Our export activities are also subject to extensive and evolving trade regulations. Certain countries are subject to restrictions, sanctions and embargoes imposed by the United States government. These restrictions, sanctions and embargoes also prohibit or limit us from participating in certain business activities in those countries. Our operations are subject to numerous local, state and federal laws and regulations in the United States and in foreign jurisdictions concerning the containment and disposal of hazardous materials, the remediation of contaminated properties and the protection of the environment. These laws have been changed frequently in the past, and there can be no assurance that future changes will not have a material adverse effect on us. In addition, our customers operations are also significantly impacted by laws and regulations concerning the protection of the environment and endangered species. Consequently, changes in governmental regulations applicable to our customers may reduce demand for our products. For instance, regulations regarding the protection of marine mammals in the Gulf of Mexico may reduce demand for our airguns and other marine products. To the extent that our customer s operations are disrupted by future laws and regulations, our business and results of operations may be materially and ad