

SYPRIS SOLUTIONS INC  
Form 10-K  
March 14, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K**

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(Mark one)

- Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. For the fiscal year ended December 31, 2006.
- Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 0-24020

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**SYPRIS SOLUTIONS, INC.**

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of  
incorporation or organization)

101 Bullitt Lane, Suite 450

Louisville, Kentucky 40222  
(Address of principal executive

offices, including zip code)

61-1321992  
(I.R.S. Employer

Identification No.)

(502) 329-2000  
(Registrant's telephone number,

including area code)

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**Securities registered pursuant to Section 12(b) of the Act:**

**Common Stock, \$.01 par value**

(Title of Class)

**Securities registered pursuant to Section 12(g) of the Act:**

**None**

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.  Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold as of the last business day of the registrant's most recently completed second fiscal quarter (June 30, 2006) was \$90,168,612.

There were 18,901,875 shares of the registrant's common stock outstanding as of March 8, 2007.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the definitive Proxy Statement to be delivered to shareholders in connection with the Annual Meeting of Stockholders to be held April 24, 2007 are incorporated by reference into Part III to the extent described therein.

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In this Form 10-K, Sypris, SYPR, we, us and our refer to Sypris Solutions, Inc. and its subsidiaries and predecessors, collectively. Sypris Solutions and Sypris are our trademarks. All other trademarks, servicemarks or trade names referred to in this Form 10-K are the property of their respective owners.

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**PART I**

**Item 1. Business  
General**

We are a diversified provider of outsourced services and specialty products. We perform a wide range of manufacturing, engineering, design, testing and other technical services, typically under multi-year, sole-source contracts with corporations and government agencies in the markets for aerospace & defense electronics, truck components & assemblies, and for users of test & measurement equipment.

We focus on those markets where we have the expertise, qualifications and leadership position to sustain a competitive advantage. We target our resources to support the needs of industry leaders that embrace multi-year contractual relationships as a strategic component of their supply chain management. These contracts, many of which are sole-source by part number and are for terms of up to ten years, enable us to invest in leading-edge technologies to help our customers remain competitive. The productivity, flexibility and economies of scale that result become an important means for differentiating ourselves from the competition when it comes to cost, quality, reliability and customer service.

*Truck Components & Assemblies.* We are the principal supplier of manufacturing services for the forging and machining of medium and heavy-duty truck axle shafts and other drive train components in North America. We produce these axle shafts and components under multi-year, sole-source contracts with ArvinMeritor, Inc. (ArvinMeritor) and Dana Corporation (Dana), the two primary providers of drive train assemblies for use by the leading truck manufacturers, including Ford Motor Company (Ford), Freightliner LLC (Freightliner), Mack Trucks, Inc. (Mack), Navistar International Corporation (Navistar), PACCAR, Inc. (PACCAR) and Volvo Truck Corporation (Volvo). We supply ArvinMeritor with trailer axle beams for use by the leading trailer manufacturers, including Dorsey Trailer Company (Dorsey), Great Dane Limited Partnership (Great Dane), Hyundai Motor Company (Hyundai), Stoughton Trailers, LLC (Stoughton), Trailmobile Corporation (Trailmobile), Utility Trailer Manufacturing Company (Utility) and Wabash National Corporation (Wabash). We also supply Ford with light axle shafts for the F150, F250, F350 and Ranger series pickup trucks, the Expedition, Lincoln Navigator and the Mustang GT, and Traxle Manufacturing Inc. (Traxle) with forged axle shafts for the heavy duty truck market. We continue to support our customers' strategies to outsource non-core operations by supplying additional components and providing additional value added operations for drive train assemblies. Our truck components & assemblies business accounted for approximately 70% of net revenue in 2006.

*Aerospace & Defense Electronics.* We are an established supplier of manufacturing services for the production of complex circuit cards, high-level assemblies and subsystems. We have historically had long-term relationships with many of the leading aerospace & defense contractors, including Boeing Company (Boeing), General Dynamics Corporation (General Dynamics), Honeywell International, Inc. (Honeywell), Lockheed Martin Corporation (Lockheed), Northrop Grumman Corporation (Northrop Grumman) and Raytheon Company (Raytheon). We currently manufacture complex circuit card assemblies under multi-year contracts with Raytheon for programs involving a missile guidance system and an air defense network, and under a multi-year contract with Honeywell for main color display systems in the cockpit of a military aircraft. We also have a long-term relationship with the U.S. Government to design and build secure communications equipment and encryption devices. The defense budget for fiscal 2007 contains provisions to increase spending for space, smart weapons, surveillance, intelligence and secure communications, areas for which we have long provided essential services and products; however, funds were diverted in 2005 and 2006 to finance the armed forces and related equipment and expendable supplies for the war in Iraq, and we expect this to continue throughout 2007. Our aerospace & defense electronics business accounted for approximately 18% of net revenue in 2006.

*Test & Measurement Services.* We provide technical services for the calibration, certification and repair of test & measurement equipment in and outside the United States (U.S.). We have a multi-year contract with the Federal Aviation Administration (FAA) to calibrate and certify the equipment that is used to maintain the radar systems and directional beacons at over 460 airports in the U.S., the Caribbean and the South Pacific. We also have a contract with the National Weather Service to calibrate the equipment that is used to maintain the NEXRAD Doppler radar systems at over 120 advanced warning weather service radar stations in 45 states, the Caribbean and

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Guam. We also have a multi-year contract with AT&T Corporation (AT&T) to provide calibration and certification services at over 200 of its central and field switching locations. We are seeing an increased interest by large companies, such as Eastman Kodak Company (Kodak), in awarding multi-year contracts for calibration services in order to accelerate vendor reduction programs and reduce costs. Our test & measurement services business accounted for approximately 8% of net revenue in 2006.

## **Recent Developments**

On March 3, 2006 (Filing Date), our largest customer, Dana, and 40 of its U.S. subsidiaries, filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York. Dana's European, South American, Asia-Pacific, Canadian and Mexican subsidiaries were excluded from the Chapter 11 filing. On May 10, 2006, we reached an agreement with Dana (Agreement) under which both parties agreed, among other things, that Dana owed us approximately \$22.1 million, subject to reconciliation and that we owed Dana approximately \$11.8 million. Of this amount, the Agreement also provided us with a \$9.2 million progress payment on May 11, 2006, as well as reduced payment terms on a prospective basis. During the third quarter and in conjunction with the reconciliation under the Agreement, we successfully reconciled approximately \$9.9 million of payables to Dana against receivables from Dana. As of December 31, 2006, we had completed the reconciliation process with Dana under the Agreement. Accordingly, as of December 31, 2006 (excluding certain gain contingencies), net amounts expected to be collected from pre-petition Dana (Debtor in Possession) after remaining accounts payable offsets approximates \$1.1 million, although Dana has yet to pay such amounts. We also have a \$3.3 million refundable deposit with Dana for a specified business line yet to be transferred to us for which we are pursuing reimbursement.

In addition, on December 6, 2006, an independent arbitrator ruled that Dana had breached certain of its agreements with Sypris by failing to transfer certain volumes of business and by failing to pay the appropriate prices for the volumes that were transferred. As a result, the arbitrator awarded payments to Sypris totaling \$1.8 million plus \$0.1 million per month on an ongoing basis until such breaches are cured. On January 29, 2007, this award became final. We received a partial payment of \$0.9 million on March 7, 2007.

## **Industry Overview**

We believe the trend toward outsourcing is continuing across a wide range of industries and markets as outsourcing specialists assume a strategic role in the supply chain of companies of all types and sizes. We expect the growth in outsourcing expenditures to continue increasing at a rate far higher than the expansion in the overall economy.

We believe the trend toward outsourcing is continuing because outsourcing frequently represents a more efficient, lower cost means for manufacturing a product or delivering a service when compared to more vertically integrated alternatives. While the rate of acceptance of the outsourcing model may vary by industry, we believe the following benefits of outsourcing are driving this general trend.

*Reduced Total Operating Costs and Invested Capital.* Outsourcing specialists are frequently able to produce products and/or deliver services at a reduced total cost relative to that of their customers because of the ability to allocate the expense for a given set of fixed capacity, including assets, people and support systems, across multiple customers with diversified needs. In turn, these outsourcing specialists can achieve higher utilization of their resources and achieve greater productivity, flexibility and economies of scale.

*Access to Advanced Manufacturing Capabilities and Processes and Increased Productivity.* The ability to use a fixed set of production assets for a number of customers enables outsourcing specialists to invest in the latest technology as a means to further improve productivity, quality and cycle times. The magnitude of these investments can be prohibitive absent the volume and reliability of future orders associated with having a broad array of customers for the use of those assets.

*Focus on Core Competencies.* Companies are under intense competitive pressure to constantly rationalize their operations, invest in and strengthen areas in which they can add the greatest value to their customers and divest or outsource areas in which they add lesser value. By utilizing the services of outsourcing specialists, these companies can react more quickly to changing market conditions and allocate valuable capital and other resources to core activities, such as research and development, sales and marketing or product integration.

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*Improved Supply Chain Management.* We believe that the trend in outsourcing favors specialists that have the financial, managerial and capital resources to assume an increasingly greater role in the management of the supply chain for the customer. By utilizing fewer and more capable suppliers, companies are able to greatly simplify the infrastructure required to manage these suppliers, thereby reducing their costs, risks and logistical complexity, while improving margins, supply chain reliability, flexibility and long-term strategic planning.

### **Our Markets**

*Truck Components & Assemblies.* The truck components & assemblies market consists of the original equipment manufacturers, or OEMs, including DaimlerChrysler Corporation, Ford, Freightliner, General Motors Corporation, Mack, Navistar, PACCAR and Volvo, and a deep and extensive supply chain of companies of all types and sizes that are classified into different levels or tiers. The trailer market consists of OEMs including Dorsey, Great Dane, Hyundai, Stoughton, Trailmobile, Utility and Wabash. Tier I companies represent the primary suppliers to the OEMs and includes ArvinMeritor, Dana, Delphi Automotive Systems Corporation, Eaton Corporation, and Visteon Corporation (Visteon), among others. Many of the Tier I companies are confronted with excess capacity, high hourly wage rates, costly benefit packages and aging capital equipment. Below this group of companies reside numerous suppliers that either supply the OEMs directly or supply the Tier I companies. In all segments of the truck components & assemblies and the trailer markets, however, suppliers are under intense competitive pressure to improve product quality and to reduce capital expenditures, production costs and inventory levels.

In an attempt to gain a competitive advantage, many OEMs have been reducing the number of suppliers they utilize. These manufacturers are choosing stronger relationships with fewer suppliers that are capable of investing to support their operations. In response to this trend, many suppliers have combined with others to gain the critical mass required to support these needs. As a result, the number of Tier I suppliers is being reduced, but in many cases, the aggregate production capacity of these companies has yet to be addressed. We believe that as Tier I suppliers seek to eliminate excess capacity, they will increasingly choose outsourcing as a means to enhance their financial performance, and as a result, companies such as Sypris will be presented with new business and acquisition opportunities.

*Aerospace & Defense Electronics.* The consolidation of defense contractors over the past decade has added to the increased demand for outsourcing specialists. The consolidated companies, some of which have developed highly leveraged balance sheets as a result of mergers and acquisitions, have been motivated to seek new ways to raise margins, increase profitability and enhance cash flow. Accordingly, outsourcing specialists, including Sypris, have been successful in building new relationships with companies that previously relied more on internal resources. We believe this trend will continue, and that our extensive experience, clearances, certifications and qualifications in the manufacturing of aerospace & defense electronics will serve to differentiate us from many of the more traditional outsource suppliers. We also believe that we are well positioned to take advantage of additional outsourcing activity that may flow from the prime contractors that are awarded contracts related to increased defense appropriations and expenditures as a result of increased focus on national defense and homeland security.

The nature of providing outsourced manufacturing services to the aerospace & defense electronics industry differs substantially from the traditional commercial outsourced manufacturing services industry. The cost of failure can be extremely high, the manufacturing requirements are typically complex and products are produced in relatively small quantities. Companies that provide these manufacturing services are required to maintain and adhere to a number of strict and comprehensive certifications, security clearances and traceability standards.

*Test & Measurement Services.* The widespread adoption of the International Organization for Standardization (ISO) and Quality Standards (QS), among others, has been underway for many years. A critical component of basic manufacturing discipline and these quality programs is the periodic calibration and certification of the test and measurement equipment that is used to measure process performance. The investment in this equipment and the skills required to support the calibration and certification process has historically been performed offsite by the manufacturers of the equipment, or onsite by internal operations, even though the productive use of the assets and people is difficult to justify since equipment is often certified on an annual, or in some cases, biennial basis.

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We believe that test & measurement services will be increasingly outsourced to independent specialists who can use the manpower and equipment across a diversified base of customers, reduce investment requirements and improve profitability on a national scale.

### **Our Business Strategy**

Our objective is to improve our leadership position in each of our core markets by increasing the number of multi-year contracts with related customers and investing in highly automated production capacity to remain competitive on a global scale. We intend to serve our customers and achieve this objective by continuing to:

*Concentrate on our Core Markets.* We are the principal supplier of medium and heavy-duty truck axle shafts in North America. We have been an established supplier of manufacturing and technical services to major aerospace & defense companies and agencies of the U.S. Government for over 39 years. We are also the sole provider of calibration, certification and repair services for equipment used by the FAA to maintain the radar systems and directional beacons at each of the airports it serves in the U.S., the Caribbean and the South Pacific. We will continue to focus on those markets where we have the expertise, qualifications and leadership position to sustain a competitive advantage.

*Dedicate our Resources to Support Strategic Partnerships.* We will continue to dedicate our resources to support the needs of industry leaders that embrace multi-year contractual relationships as a strategic component of their supply chain management and have the potential for long-term growth. We prefer contracts that are sole-source by part number so we can work closely with the customer to the mutual benefit of both parties. ArvinMeritor and Dana have awarded us with sole-source supply agreements that run through 2013 and 2014, respectively. Historically, we entered into multi-year manufacturing services agreements with Boeing, Honeywell, Lockheed Martin, Northrop Grumman and Raytheon. Our success in establishing outsourcing partnerships with key customers has historically led to additional contracts, and we believe that if we continue to successfully perform on current contracts, we will have additional growth opportunities with these and other customers.

*Pursue the Strategic Acquisition of Customer-Owned Assets.* We will continue to pursue the strategic acquisition of customer-owned assets that serve to consolidate our position of leadership in our core markets, create or strengthen our relationships with leading companies and expand our range of value-added services in return for multi-year supply agreements. Since these assets are integrated with our core businesses, we generally are able to use these assets to support other customers, thereby improving asset utilization and achieving greater productivity, flexibility and economies of scale.

*Grow Through the Addition of New Value-Added Services.* We will continue to grow through the addition of new value-added manufacturing capabilities and the introduction of additional components in the supply chain that enable us to provide a more complete solution by improving quality and reducing product cost, inventory levels and cycle times for our customers. We offer a variety of state-of-the-art machining capabilities to our customers in the truck components & assemblies market that enable us to reduce labor and shipping costs and minimize cycle times for our customers over the long-term, providing us with significant additional growth opportunities in the future.

*Invest to Increase our Competitiveness and that of our Partners.* We will continue to invest in advanced manufacturing and process technologies to reduce the cost of the services we provide for our customers on an ongoing basis. We continue to expand and automate the services we provide to our customers in the truck components & assemblies market, with approximately \$136 million invested from 2000 to 2006. The automation substantially increased our output per man hour and enabled us to offer our customers reduced pricing that helped them to remain competitive on a global scale. Our ability to leverage this capability across a number of customers in the future will further improve our capacity utilization, absorption of overhead and reduce our manufacturing costs.

We believe that the number and duration of our strategic relationships enable us to invest in our business with greater certainty and with less risk than others that do not benefit from the type of longer term contractual commitments we receive from many of our major customers. The investments we make in support of these contracts provide us with the productivity, flexibility, technological edge and economies of scale that we believe will help to differentiate us from the competition in the future when it comes to cost, quality, reliability and customer service.

**Table of Contents****Our Services and Products**

We are a diversified provider of outsourced services and specialty products. Our services consist of manufacturing, technical and other services and products that are delivered as part of our customers' overall supply chain management. We provide our customers with services that exceed the scope of most manufacturing service companies, including software development, design services, prototype development, product re-engineering, feature enhancement, product ruggedization, cost reduction, product miniaturization, and electro-magnetic interference and shielding. The information below is representative of the types of products we manufacture, services we provide and the customers and industries for which we provide such products or services.

*Truck Components & Assemblies:*

|               |   |
|---------------|---|
| ArvinMeritor  | Axle shafts and drive train components for medium and heavy-duty trucks and axle beams for trailers.          |
| Axle Alliance | Axle shafts for heavy-duty trucks.  |
| Dana          | Axle shafts, drive train components and steer axle components for use in light, medium and heavy-duty trucks. |
| Ford          | Axle shafts for mustangs, light-duty trucks and super-duty trucks.  |
| Traxle        | Axle shafts for heavy-duty trucks.  |

*Aerospace & Defense Electronics:*

|                 |   |
|-----------------|---|
| Honeywell       | Complex circuit cards for the color display systems used in military aircraft.                    |
| U.S. Government | Encryption devices, secure communications equipment and recording systems.                        |
| Raytheon        | Complex circuit cards for use in a missile guidance system and an integrated air defense network. |

*Test & Measurement Services:*

|                                 |   |
|---------------------------------|---|
| AT&T                            | Calibration and certification at over 230 central and field switching locations.    |
| Federal Aviation Administration | Calibration and certification at over 460 airports or airways facilities.           |
| Lockheed Martin                 | Testing of electronic components for space and defense applications.                |
| National Weather Service        | Calibration and certification for over 120 advanced warning weather radar stations. |

**Manufacturing Services**

Our manufacturing services typically involve the fabrication or assembly of a product or subassembly according to specifications provided by our customers. We purchase raw materials or components from our customers and independent suppliers in connection with performing our manufacturing services. Our manufacturing capabilities are enhanced by advanced quality and manufacturing techniques, Lean Manufacturing, just-in-time procurement and continuous flow manufacturing, statistical process control, total quality management, stringent and real-time engineering change control routines and total cycle time reduction techniques.

*Industrial Manufacturing Services.* We provide our customers with a wide range of capabilities, including automated forging, extruding, machining, induction hardening, heat-treating and testing services to meet the exacting requirements of our customers. We also design and fabricate production tooling, manufacture prototype products and provide other value-added services for our customers. Our manufacturing services contracts for the truck components & assemblies markets are generally sole-source by part number. Part numbers may be specified for inclusion in a single model or a range of models. Where we are the sole-source provider by part number, we are the exclusive provider to our customer of the specific parts and for any replacements for these parts that may result from a design or model change for the duration of the manufacturing contract.

*Electronics Manufacturing Services.* We provide our customers with a broad variety of solutions, from low-volume prototype assembly to high-volume turnkey manufacturing. We employ a multi-disciplined engineering team that provides comprehensive manufacturing and design support to customers. The manufacturing solutions we offer include design conversion and enhancement, materials procurement, system assembly, testing and final system



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configuration. Our manufacturing services contracts for the aerospace & defense electronics market are generally sole-source by part number. Where we are the sole-source provider by part number, we are the exclusive provider to our customer of certain products for the duration of the manufacturing contract.

### **Technical Services**

*Test & Measurement Services.* We calibrate, repair and certify the test and measurement equipment that is used to maintain wireless communication equipment, control tower radar and direction beacons, NEXRAD Doppler advanced warning weather service radar systems, digital oscilloscopes, microwave equipment and fiber optic measuring equipment, among others. The applications cover the maintenance of cellular communications systems, air traffic control systems, broadband telecommunication systems and quality certification programs in manufacturing operations. We also perform a wide-range of testing services on a contract basis, including radio frequency, microwave and mixed signal component testing, environmental testing, dynamics testing and failure analysis, among others.

### **Products**

In addition to our outsourced services, we provide some of our customers with specialized products including digital and analog data systems and encryption devices used in military applications, magnetic meters and sensors used in commercial and laboratory environments and high-pressure closures and joints used in pipeline and chemical systems. As we look to grow our Aerospace & Defense segment, emphasis will be placed on funding of new products to broaden our portfolio and meet the needs of our customers.

### **Our Customers**

Our customers include large, established companies and agencies of the federal government. We provide some customers with a combination of outsourced services and products, while other customers may be in a single category of our service or product offering. Our five largest customers in 2006 were Dana, ArvinMeritor, Ford, Traxle and Raytheon. These five customers accounted for 70% and 67% of net revenue in 2006 and 2005 respectively. Our five largest customers in 2004 were ArvinMeritor, Dana, Honeywell, Raytheon and Visteon. These five customers accounted for 67% of net revenue in 2004. More specifically, for the year ended December 31, 2006, Dana and ArvinMeritor represented approximately 41% and 19% of our net revenue, respectively. Similar amounts for the 2005 and 2004 years ended for Dana were 39% and 36%, respectively, while ArvinMeritor was 15% for both the 2005 and 2004 years ended.

### **Geographic Areas**

Our operations are domiciled in the U.S. and Mexico. Our Mexican subsidiaries and affiliates are a part of our Industrial Group and manufacture and sell a number of products similar to those the Industrial Group produces in the U.S. In addition to normal business risks, operations outside the U.S. may be subject to a greater risk of changing political, economic and social environments, changing governmental laws and regulations, currency revaluations and market fluctuations.

Consolidated non-U.S. net revenues were \$86.2 million, or 17% and \$68.7 million, or 13% of our consolidated net revenues in 2006 and 2005, respectively. Similar amounts for 2004 were \$26.5 million, or 6% of our consolidated net revenue. In 2006, 2005, and 2004, our non-U.S. net income was \$5.8 million, \$4.9 million and \$2.5 million, respectively, as compared to a consolidated net loss of \$1.4 million in 2006 and net income of \$5.3 million and \$8.3 million in 2005 and 2004, respectively. You can find more information about our regional operating results in Note 18 Segment Information in Item 8 of this Form 10-K.

### **Sales and Business Development**

Our principal sources of new business originate from the expansion of existing relationships, referrals and direct sales through senior management, direct sales personnel, domestic and international sales representatives, distributors and market specialists. We supplement these selling efforts with a variety of sales literature, advertising in numerous trade media and participation in trade shows. We also utilize engineering specialists extensively to facilitate the sales process by working with potential customers to reduce the cost of the service they need. Our

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specialists achieve this objective by working with the customer to improve their product's design for ease of manufacturing, reducing the amount of set-up time or material that may be required to produce the product, or by developing software that can automate the test and/or certification process. The award of contracts or programs can be a lengthy process, which in some circumstances can extend well beyond 12 months. In addition, we have and intend to selectively acquire assets from our customers in exchange for multi-year supply agreements and then leverage the newly acquired manufacturing capabilities to additional customers.

Our objective is to increase the value of the services we provide to the customer on an annual basis beyond the contractual terms that may be contained in a supply agreement. To achieve this objective, we commit to the customer that we will continuously look for ways to reduce the cost, improve the quality, reduce the cycle time and improve the life span of the products and/or services we supply the customer. Our ability to deliver on this commitment over time is expected to have a significant impact on customer satisfaction, loyalty and follow-on business.

## **Backlog**

Our order backlog at December 31, 2006 was \$99.5 million as compared to order backlog at December 31, 2005 of \$101.9 million. Backlog for the Aerospace & Defense segment and the Test & Measurement segment at December 31, 2006 was \$94.0 million and \$5.5 million, respectively. Backlog for the Aerospace & Defense segment and the Test & Measurement segment at December 31, 2005 was \$98.2 million and \$3.7 million, respectively. Backlog consists of purchase orders with scheduled delivery dates and quantities. Total backlog at December 31, 2006 included \$91.6 million for orders that are expected to be filled within 12 months. Our backlog has varied from quarter to quarter and may vary significantly in the future as a result of the timing of significant new orders and/or shipments, order cancellations, material availability and other factors.

## **Competition**

The outsourced manufacturing services markets that we serve are highly competitive, and we compete against numerous domestic companies in addition to the internal capabilities of some of our customers. In the truck components & assemblies market, we compete primarily against companies including Mid-West Forge, Inc., Spencer Forge and Machine, Inc. and Traxle, that serve as suppliers to many Tier I and smaller companies. In the aerospace & defense electronics market, we compete primarily against companies including Jabil Circuit, Inc., LaBarge, Inc., Primus Technologies Corporation, Sparton Corporation and Teledyne Technologies Incorporated. In the test & measurement services market, we compete primarily against companies including SIMCO Electronics, Transcat, Inc., Davis Inotek Instruments, and a variety of small, local, independent laboratories. We may face new competitors in the future as the outsourcing industry evolves and existing or start-up companies develop capabilities similar to ours.

We believe that the principal competitive factors in our markets include the availability of capacity, technological capability, flexibility, financial strength and timeliness in responding to design and schedule changes, price, quality and delivery. Although we believe that we generally compete favorably with respect to each of these factors, some of our competitors are larger and have greater financial and operating resources than we do. Some of our competitors have greater geographic breadth and range of services than we do. We also face competition from manufacturing operations of our current and potential customers that continually evaluate the relative benefits of internal manufacturing compared to outsourcing. We believe our competitive position to be good, and the barriers to entry to be high in the markets we serve.

## **Suppliers**

For the majority of our business, we purchase raw materials and component parts from suppliers chosen by our customers, at prices negotiated by our customers. When these suppliers increase their prices, cause delays in production schedules or fail to meet our customers' quality standards, our customers have contractually agreed to reimburse us for the costs associated with such price increases and not to charge us for costs caused by such delays or quality issues. Accordingly, our risks are primarily limited to accurate inspections of such materials, timely communications, and the collection of such reimbursements or charges, along with any additional costs incurred by us due to delays in, interruptions of, or non-optimal scheduling of, production schedules. For a smaller portion of our business, we arrange our own suppliers and assume the additional risks of price increases, quality concerns and production delays.

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Raw steel and fabricated steel parts are a major component of our cost of sales and net revenue for the truck components & assemblies business. We purchase the majority of our steel for use in this business at the direction of our customers, with any periodic changes in the price of steel being reflected in the prices we are paid for our services, such that we neither benefit from nor are directly harmed by any future changes in the price of steel.

There can be no assurance that supply interruptions or price increases will not slow production, delay shipments to our customers or increase costs in the future, any of which could adversely affect our financial results. Delays, interruptions, or non-optimal scheduling of production related to interruptions in raw materials supplies can be expected to increase our costs.

## **Research and Development**

Our research and development activities are mainly related to our product lines that serve the aerospace & defense electronics market. Process improvement expenditures related to our outsourced services are not reflected in research and development expense. Accordingly, our research and development expense represents a relatively small percentage of our net revenue. We invested \$2.0 million, \$2.8 million and \$3.7 million in research and development in 2006, 2005 and 2004, respectively. We also utilize our research and development capability to develop processes and technologies for the benefit of our customers.

## **Patents, Trademarks and Licenses**

We own and are licensed under a number of patents and trademarks that we believe are sufficient for our operations. Our business as a whole is not materially dependent upon any one patent, trademark, license or technologically related group of patents or licenses.

We regard our manufacturing processes and certain designs as proprietary trade secrets and confidential information. We rely largely upon a combination of trade secret laws, non-disclosure agreements with customers, suppliers and consultants, and our internal security systems, confidentiality procedures and employee confidentiality agreements to maintain the trade secrecy of our designs and manufacturing processes.

## **Government Regulation**

Our operations are subject to compliance with regulatory requirements of federal, state and local authorities, both in the U.S. and in Mexico, including regulations concerning financial reporting and controls, labor relations, export and import matters, health and safety matters and protection of the environment. While compliance with applicable regulations has not adversely affected our operations in the past, there can be no assurance that we will continue to be in compliance in the future or that these regulations will not change or that the costs of compliance will not be material to us.

We must comply with detailed government procurement and contracting regulations and with U.S. Government security regulations, certain of which carry substantial penalty provisions for nonperformance or misrepresentation in the course of negotiations. Our failure to comply with our government procurement, contracting or security obligations could result in penalties or our suspension or debarment from government contracting, which would have a material adverse effect on our consolidated results of operations.

We are required to maintain U.S. Government security clearances at several of our locations. These clearances could be suspended or revoked if we were found not to be in compliance with applicable security regulations. Any such revocation or suspension would delay our delivery of products to customers. Although we have adopted policies directed at ensuring our compliance with applicable regulations and there have been no suspensions or revocations at any of our facilities, there can be no assurance that the approved status of our facilities will continue without interruption.

We are also subject to comprehensive and changing federal, state and local environmental requirements, both in the U.S. and in Mexico, including those governing discharges to air and water, the handling and disposal of

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solid and hazardous wastes and the remediation of contamination associated with releases of hazardous substances. We use hazardous substances in our operations and, as is the case with manufacturers in general, if a release of hazardous substances occurs on or from our properties, we may be held liable and may be required to pay the cost of remedying the condition. The amount of any resulting liability could be material.

### **Employees**

As of December 31, 2006, we had a total of approximately 2,639 employees, 2,174 engaged in manufacturing and providing our technical services, 46 engaged in sales and marketing, 151 engaged in engineering and 268 engaged in administration. Approximately 1,298 of our employees are covered by collective bargaining agreements with various unions that expire on various dates through 2009. Excluding certain Mexico employees covered under an annually ratified agreement, no other collective bargaining agreements are subject to renewal in the next 12 months. Although we believe overall that our relations with our labor unions are positive, there can be no assurance that present and future issues with our unions will be resolved favorably, that negotiations will be successful or that we will not experience a work stoppage, which could adversely affect our consolidated results of operations.

### **Internet Access**

Copies of our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to these reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available free of charge through our website ([www.sypris.com](http://www.sypris.com)) as soon as reasonably practicable after we electronically file the material with, or furnish it to, the Securities and Exchange Commission.

## **Item 1A. Risk Factors**

### **Risks Related to Our Business and Forward-Looking Statements**

This annual report, and our other oral or written communications, may contain forward-looking statements. These statements may include our expectations or projections about the future of our industries, business strategies, potential acquisitions or financial results and our views about developments beyond our control including domestic or global economic conditions, trends and market forces. These statements are based on management's views and assumptions at the time originally made and we undertake no obligation to update these statements, even if, for example, they remain available on our website after our outlook has changed. There can be no assurance that our expectations, projections or views will come to pass, and you should not place undue reliance on these forward-looking statements.

A number of significant risk factors could materially affect our specific business operations, and cause our performance to differ materially from any future results projected or implied by our prior statements, including those described below. Many of these risk factors are also identified in connection with the more specific descriptions contained throughout this report.

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### *Customers*

#### **Customer contracts could be less profitable than expected.**

We generally bear the risk that our contracts could be unprofitable or less profitable than planned, despite our estimates of revenues and future costs to complete such contracts. For contracts to which we apply the percentage of completion accounting method, revisions to our cost estimates could reduce our operating results in later periods.

A material portion of our business is conducted under multi-year contracts, which generally include fixed prices or periodic price reductions without minimum purchase requirements. Our financial results are at greater risk when we must accept contractual responsibility for raw material or component prices, when we cannot offset price reductions and cost increases with operating efficiencies or other savings, when we must submit contract bid prices before all key design elements are finalized or when we are subjected to other competitive pressures which erode our margins. The profitability of our contracts also can be adversely affected by unexpected start-up costs on new programs, operating inefficiencies, ineffective capital investments, inflationary pressures or inaccurate forecasts of future unit costs.

In the past few years, we have signed long-term supply agreements with Dana and ArvinMeritor and acquired their facilities in Morganton, North Carolina, Kenton, Ohio and Toluca, Mexico, among other manufacturing assets. Although these acquired facilities have well-established product markets, these customers or their products may not continue to be successful, product enhancements may not be made in a timely fashion, our long-term pricing agreements could generate lower margins than anticipated and there can be no assurance that we will successfully integrate these operations. In addition, our failure to identify potential liabilities with respect to certain indemnified environmental and other conditions, or our assertion of related claims, could adversely affect our operating results or our customer relationships.

On the Filing Date, Dana and 40 of its subsidiaries filed for protection under Chapter 11 of the Bankruptcy Code. Dana (or any of our other significant customers who similarly seek bankruptcy protection) could act to terminate all or a portion of its business with us, originate new business with our competitors, terminate or assign our long-term supply agreements. Any loss of revenue from our major customers, including the non-payment or late payment of our invoices, could adversely affect our balance sheet, revenues, profitability and cash flows, debt covenants or access to capital needed for operations.

#### **Changing demands could reduce revenues or increase costs and harm operating results.**

Unexpected changes in our customers' demand levels have harmed our operating results in the past and could do so in the future. Many of our customers will not commit to firm production or delivery schedules. Disagreements over pricing, quality, delivery, capacity, exclusivity, or trade credit terms could disrupt order schedules. Orders also fluctuate due to changing global capacity and demand, new products, changes in market share, reorganizations or bankruptcies, material shortages, labor disputes or other factors that discourage outsourcing. These forces could increase, decrease, accelerate, delay or cancel our delivery schedules.

Inaccurate forecasting of our customers' requirements can disrupt the efficient utilization of our manufacturing capacity, inventories or workforce. If we lose anticipated revenues, we might not succeed in redeploying our substantial capital investment and other fixed costs. If we receive unanticipated orders, these incremental volumes could be unprofitable due to the higher costs of operating above our optimal capacity.

#### **We depend on a few key customers in challenging industries for most of our revenues.**

Our five largest customers in 2006 and 2005 were Dana, ArvinMeritor, Ford, Traxle and Raytheon, collectively accounting for 70% and 67% of net revenue in 2006 and 2005, respectively. Our five largest customers in 2004 were ArvinMeritor, Dana, Honeywell, Raytheon and Visteon, collectively accounting for 67% of net revenue in 2004. The truck components & assemblies industry has experienced credit risk, highly cyclical market demand, labor unrest, rising steel costs, bankruptcy and other obstacles, while the aerospace & defense electronics industry has seen consolidation and uncertain funding.

We depend on the continued growth and financial stability of these customers, our core markets in these industries and general economic conditions. Adverse changes affecting these customers, markets or general conditions could harm our operating results. The truck components market is highly cyclical, due in part to

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regulatory deadlines, and is expected to decline by up to 40% in 2007. We expect these declines to cause a significant drop in our revenues which is anticipated to adversely affect our financial results. However, if we fail to plan effectively, our inventory levels, fixed costs or other key financial results could be more unfavorable than our forecasts.

Rising costs of steel or component parts have increased our inventory and working capital levels and caused delays in payment from, or other difficulties for, our automotive customers. Many of these customers' labor disputes, financial difficulties and restructuring needs have created rising uncertainty and risk, which could increase our costs or impair our business model. The aerospace & defense industry is pressured by cyclicity, technological change, shortening product life cycles, decreasing margins, unpredictable funding levels and government procurement processes. Any of these factors, particularly in our secured electronic communications or missile programs, could impair our business model.

As of February 25, 2007, we had provided approximately \$39.0 million in combined trade credit outstanding to ArvinMeritor, Dana and Ford, each of which currently carries at least one non-investment grade credit rating on its unsecured debt, indicating a high potential risk of default. There can be no assurance that any of our customers will not default on, delay or dispute payment of, or seek to reject our outstanding invoices in bankruptcy or otherwise.

On the Filing Date, our largest customer, Dana, and 40 of its U.S. subsidiaries, filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York. Dana's European, South American, Asia-Pacific, Canadian and Mexican subsidiaries were excluded from the Chapter 11 filing. On May 10, 2006, we entered into the Agreement under which both parties agreed, among other things, that Dana owed us approximately \$22.1 million, subject to reconciliation. Of this amount, the Agreement also provided us with a \$9.2 million progress payment on May 11, 2006, as well as reduced payment terms on a prospective basis. During the third quarter and in conjunction with the reconciliation under the Agreement, we successfully reconciled approximately \$9.9 million of payables to Dana against receivables from Dana. As of December 31, 2006, Dana and the Company had substantially completed the reconciliation process under the Agreement. Accordingly, as of December 31, 2006 (excluding certain gain contingencies), net amounts expected to be collected from pre-petition Dana (Debtor in Possession) approximated \$1.1 million, although Dana has yet to pay such amounts. We also have a \$3.3 million refundable deposit with Dana for a specified business line yet to be transferred to us for which we are pursuing reimbursement.

In addition, on December 6, 2006, an independent arbitrator initially held that Dana had breached its agreements with Sypris by failing to transfer certain volumes of business and by failing to pay the appropriate prices for the volumes that were transferred. As a result, the arbitrator awarded payments to Sypris totaling \$1.8 million plus \$0.1 million per month on an ongoing basis until such breaches are cured. On January 29, 2007, this award became final. We received a partial payment of \$0.9 million on March 7, 2007. We continue to pursue additional offsets, possible gain contingencies, attorneys' fees, interest and other relief through the Bankruptcy Court and other dispute resolution efforts, the outcome of which is uncertain at this time. For the year ended December 31, 2006, we incurred over \$1.5 million of legal and other professional fees for Dana related issues. Such costs are included in selling, general and administrative expense in the consolidated statement of operations.

Dana may be unable to reorganize, reach acceptable terms with its creditors or emerge from Chapter 11. Our supply agreements may be rejected or assigned by Dana, and we may be unable to negotiate acceptable terms with the reorganized Dana. Dana (or any of our other significant customers who similarly seek bankruptcy protection) could seek to terminate business with us or originate new business with our competitors. Any loss of revenue from our major customers, including the non-payment or late payment of our invoices, could adversely affect our balance sheet, revenues, profitability and cash flows, debt covenants or access to capital needed for operations.

**Congressional budgetary constraints or reallocations can reduce our government sales.**

We sell manufacturing services and products to a number of government agencies, which in the aggregate represented approximately 8% and 9% of our net revenue in 2006 and 2005, respectively. We also serve as a contractor for large aerospace & defense companies such as Boeing, Honeywell, Lockheed Martin, Northrop Grumman and Raytheon, typically under federally funded programs. Sales to larger aerospace & defense customers, in the aggregate, represented approximately 7% and 9% of net revenue during 2006 and 2005, respectively.

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Our government contracts have many inherent risks that could adversely impact our financial results. These contracts depend upon the continuing availability of Congressional appropriations. Future levels of governmental spending, including delays, declines or reallocations in the funding of certain programs could adversely affect our financial results, if we are unable to offset these changes with new business or cost reductions.

### ***Suppliers***

#### **Interruptions in the supply of key components could disrupt production.**

Some of our manufacturing services or products require one or more components that are available from a limited number of providers or from sole-source providers. In the past, some of the materials we use, including steel, certain forgings or castings, capacitors and memory and logic devices, have been subject to industry-wide shortages. As a result, suppliers have been forced to allocate available quantities among their customers, and we have not been able to obtain all of the materials desired. Our inability to reliably obtain these or any other materials when and as needed could slow production or assembly, delay shipments to our customers, impair the recovery of our fixed costs and increase the costs of recovering to customers schedules, including overtime, expedited freight, equipment maintenance, operating inefficiencies, higher working capital and the obsolescence risks associated with larger buffer inventories. Each of these factors could reduce operating results.

#### **Shortages or increased costs of utilities could harm our business and our customers.**

We and our customers depend on a constant supply of electricity and natural gas from utility providers for the operation of our respective businesses and facilities. In the past, we have experienced power outages which reduced our ability to deliver products and our customers demand for those products. If we or our customers experience future interruptions in service from these providers, our production and/or delivery of products could be negatively affected. Additionally, due to the heavy consumption of energy in our production process and the businesses of our customers, if the cost of energy significantly increases, our results of operations, and those of our customers, could be negatively impacted.

### ***Execution***

#### **We must operate more efficiently, or our results could decline.**

If we are unable to improve the cost, efficiency and yield of our operations, our costs could increase and our financial results could decline. A number of major obstacles could include: inflationary pressures; changes in anticipated product mix and the associated variances in our profit margins; efforts to increase our manufacturing capacity and launch new programs; efforts to migrate, restructure or move business operations from one location to another; the need to identify and eliminate our root causes of scrap; our ability to achieve expected annual savings or other synergies from past and future business combinations; inventory risks due to shifts in market demand; obsolescence; price erosion of raw material or component parts; shrinkage, or other factors affecting our inventory valuations; or inability to successfully manage growth, contraction or competitive pressures in our primary markets.

Our management or systems could be inadequate to support our existing or future operations. Growth in our business could require us to invest in additional equipment to improve our efficiency. We may have limited experience or expertise in installing or operating such equipment, which could negatively impact our ability to deliver products on time or with acceptable costs. In addition, a material portion of our manufacturing equipment requires significant maintenance to operate effectively and we may experience maintenance and repair issues. If our efforts to relocate equipment between facilities are unsuccessful or require more time than anticipated, the resulting delays could negatively impact our production processes.

#### **Our growth strategies could be ineffective due to the risks of further acquisitions.**

Our growth strategy includes acquiring complementary businesses. We could fail to identify, finance or complete suitable acquisitions on acceptable terms and prices. Acquisition efforts could increase a number of risks, including: diversion of management's attention; difficulties in integrating systems, operations and cultures; potential loss of key employees and customers of the acquired companies; lack of experience operating in the geographic market of the acquired business; an increase in our expenses and working capital requirements; risks of entering into markets or producing products where we have limited or no experience, including difficulties in integrating purchased technologies and products with our technologies and products; our ability to improve productivity and implement cost reductions; our ability to secure collective bargaining agreements with employees; and exposure to unanticipated liabilities.





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Our discovery of, or failure to discover, material issues during due diligence investigations of acquisition targets, either before closing with regard to potential risks of the acquired operations, or, after closing with regard to the timely discovery of breaches of representations or warranties, or of certain indemnified environmental conditions, could seriously harm our business.

### ***Competition***

#### **Increasing competition could limit or reduce our market share.**

We operate in highly competitive environments that include our customers' internal capabilities. We believe that the principal competitive factors in our markets include the availability of manufacturing capacity, technological strength, speed and flexibility in responding to design or schedule changes, price, quality, delivery, cost management and financial strength. Our earnings could decline if our competitors or customers can provide comparable speed and quality at a lower cost, or if we fail to adequately invest in the range and quality of manufacturing services and products our customers require.

Some of our competitors have greater financial and organizational resources, customer bases and brand recognition than we do. As a result, our competitors may respond more quickly to technological changes or customer needs, consume lower fixed and variable unit costs, negotiate reduced component prices, and obtain better terms for financing growth. If we fail to compete in any of these areas, we may lose market share and our business could be seriously harmed. There can be no assurance that we will not experience increased competition or that we will be able to maintain our profitability if our competitive environment changes.

#### **Our technologies could become obsolete, reducing our revenues and profitability.**

The markets for our products and services are characterized by changing technology and continuing process development. The future of our business will depend in large part upon the continuing relevance of our technological capabilities. We could fail to make required capital investments, develop or successfully market services and products that meet changing customer needs, and anticipate or respond to technological changes in a cost-effective and timely manner. We could encounter competition from new or revised technologies that render our technologies and equipment less profitable or obsolete in our chosen markets, and our operating results may suffer.

### ***Access to Capital***

#### **An inability to obtain favorable financing could impair our growth.**

Our future liquidity and capital requirements are difficult to predict because they depend on numerous factors, including the pace at which we grow our business and acquire new facilities. One method we have used to obtain multi-year supply agreements is to buy a customer's non-core manufacturing assets and produce products for them. We may need to raise substantial additional funds in order to grow this business. We cannot be certain that we will be able to obtain additional financing on favorable terms or at all. Additional equity financing could result in dilution to existing holders. If additional financing is obtained in the form of debt, the terms of the debt could place restrictions on our ability to operate or increase the financial risk of our capital structure. Our ability to borrow under our current credit facility is conditioned upon our compliance with various financial covenants. We could lose our access to such financing if we experience adverse changes in our operations, poor financial results, increased risk profiles of our businesses, declines in our credit ratings, any actual or alleged breach of our debt covenants, insurance conditions or similar agreements, or any adverse regulatory developments. The Company has negotiated revised terms and conditions with respect to its revolving credit facility and certain outstanding notes and anticipates that such revised terms will become effective on or before March 31, 2007. However there can be no assurances that these transactions will be closed, and the Company's financial condition or results could be materially harmed if a mutually satisfactory agreement is not achieved.

Any inability to raise additional funds as needed could impair our ability to operate and grow our business. Such financing could be subject to a number of factors, including market conditions, our operating performance and investor sentiment. These factors may make the timing, amount, terms and conditions of additional financing unattractive for us.

### ***Contract Terminations***

#### **Contract terminations or delays could harm our business.**

We often provide manufacturing services and products under contracts that contain detailed specifications, quality standards and other terms. If we are unable to perform in accordance with such terms, our customers might seek to terminate such contracts, or downgrade our past performance rating, an increasingly critical factor in federal procurement competitions. Moreover, many of our contracts are subject to

termination for convenience or upon

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default. These provisions could provide only limited recoveries of certain incurred costs or profits on completed work, and could impose liability for our customers' costs in procuring undelivered items from another source. If any of our significant contracts were to be terminated or not renewed, we would lose substantial revenues and our operating results as well as prospects for future business opportunities could be adversely affected.

We are subject to various audits, reviews and investigations, including private party whistleblower lawsuits, relating to our compliance with federal and state laws. Should our business be charged with wrongdoing, or determined not to be a presently responsible contractor, we could be temporarily suspended or debarred for up to three or more years from receiving new government contracts or government-approved subcontracts.

### ***Labor Relations***

#### **We must attract and retain qualified employees.**

Our future success in a changing business environment, including during rapid changes in the size, complexity or skills required of our workforce, will depend to a large extent upon the efforts and abilities of our executive, managerial and technical employees. The loss of key employees could have a material adverse effect on our operations. Our future success will also require an ability to attract and retain qualified employees. Labor disputes or changes in the cost of providing pension and other employee benefits, including changes in health care costs, investment returns on plan assets, and discount rates used to calculate pension and related liabilities, could lead to increased costs or disruptions of operations in any of our business units.

#### **Disputes with labor unions could disrupt our business plans.**

We currently have collective bargaining agreements covering approximately 1,298 employees, or approximately 49% of total employees, none of which are subject to renewal in the next 12 months. Although we believe that our overall relations with our labor unions are positive, we could experience a work stoppage or other disputes which could disrupt our operations or the operations of our customers and could harm our operating results.

### ***Regulatory***

#### **Environmental, health and safety risks could expose us to potential liability.**

We are subject to a variety of environmental regulations relating to the use, storage, discharge and disposal of hazardous chemicals and substances used in our operations. If we fail to comply with present or future regulations, we could be forced to alter, suspend or discontinue our manufacturing processes, and pay substantial fines or penalties.

Groundwater and other contamination has occurred at certain of our current and former facilities during the operation of those facilities by their former owners, and this contamination may occur at future facilities we operate or acquire. Although we typically receive environmental indemnification agreements from previous owners of these facilities, there is no assurance that the indemnifications of former owners will be adequate to protect us from liability.

Our Marion, Ohio facility is subject to soil and groundwater contamination involving petroleum compounds, semi-volatile and volatile organic compounds, certain metals, PCBs and other contaminants, some of which exceed the state voluntary action program standards applicable to the site. We continue to test and assess this site to determine the extent of this contamination by the prior owners of the facility. Under our purchase agreement for this facility, Dana has agreed to indemnify us for, among other things, environmental conditions that existed on the site as of closing and as to which we notified Dana prior to December 31, 2002. However, such amounts due from Dana, if any, could be subject to compromise or rejection in conjunction with Dana's Chapter 11 filing. If rejected, Sypris could be exposed to the risk of a substantial discount if Dana's indemnification obligation were held to be an unsecured, prepetition claim.

A leased facility we formerly occupied in Tampa, Florida is subject to remediation activities related to groundwater contamination involving methyl chloride and other volatile organic compounds, which occurred prior to our use of the facility, and such contamination extends beyond the boundaries of the facility. The prior operator of the facility has entered into a consent order with the State of Florida and agreed to remediate the contamination, the full scope of which has not yet been determined.



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We previously acquired certain business assets formerly located at a leased facility in Littleton, Colorado, where chlorinated solvents had been disposed of on site by a prior owner of the business at the site, contaminating the groundwater at and around the site. The seller of the assets to us is operating a remediation system on the site approved by the State of Colorado and has entered into a consent order with the EPA providing for additional investigation at the site. In addition, Sypris has been contractually indemnified by prior owners of both facilities.

Our Morganton, North Carolina facility is subject to soil and groundwater contamination involving petroleum compounds, certain metals, and other contaminants, some of which may exceed the State of North Carolina standards applicable to the site. Under our purchase agreement for this facility, Dana has agreed to indemnify us for, among other things, environmental conditions that existed on the site as of closing and as to which we notified Dana prior to December 31, 2005. However, such amounts due from Dana, if any, could be subject to compromise or rejection in conjunction with Dana's Chapter 11 filing. If rejected, Sypris could be exposed to the risk of a substantial discount, if Dana's indemnification obligation were held to be an unsecured, prepetition claim.

Our Toluca, Mexico facility is subject to soil and groundwater contamination involving petroleum compounds and volatile organic compounds, among other concerns. We continue to test and assess this site to determine the extent of any contamination by the prior owners of the facility. Under our purchase agreement for each facility, Dana and Dana Mexico (Dana's Mexican subsidiary, not currently a party to the bankruptcy) have agreed to indemnify us for, among other things, environmental conditions that existed on the site as of closing and as to which we notified Dana prior to June 30, 2006.

Our Kenton, Ohio facility is subject to soil and groundwater contamination involving petroleum compounds, volatile organic compounds, certain metals, PCBs and other contaminants. Under our purchase agreement for this facility, Meritor Heavy Vehicle Systems agreed to indemnify us for, among other things, environmental conditions that existed on the site as of closing and as to which we notified ArvinMeritor prior to May 2, 2006.

### **Adverse regulatory developments or litigation could harm our business.**

Our businesses operate in heavily regulated environments. We must successfully manage the risk of changes in or adverse actions under applicable law or in our regulatory authorizations, licenses and permits, governmental security clearances or other legal rights to operate our businesses, to manage our work force or to import and export goods and services as needed. Our business activities expose us to the risks of litigation with respect to our customers, suppliers, creditors, stockholders or from product liability, environmental or asbestos-related matters. We also face the risk of other adverse regulatory actions, compliance costs or governmental sanctions, as well as the costs and risks related to our ongoing efforts to design and implement effective internal controls.

### ***Other Risks***

#### **We face other factors which could seriously disrupt our operations.**

Many other risk factors beyond our control could seriously disrupt our operations, including: risks relating to war, future terrorist activities, political uncertainties or natural disasters which could shut down our domestic or foreign facilities, disrupt transportation of products or supplies, increase the costs under our self insurance program, or change the timing and availability of funding in our aerospace & defense electronics markets; risks inherent in operating abroad, including foreign currency exchange rates, adverse regulatory developments, and miscommunications or errors due to inaccurate foreign language translations or currency exchange rates; risks relating to natural disasters or other casualties; or our failure to anticipate or to adequately insure against other risks and uncertainties present in our businesses including unknown or unidentified risks.

#### **Item 1B. Unresolved Staff Comments**

None.

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Our principal manufacturing services operations are engaged in electronics manufacturing services for our aerospace & defense customers and industrial manufacturing services for our truck components & assemblies customers. The following chart indicates the significant facilities that we own or lease, the location and size of each such facility and the manufacturing certifications that each facility possesses. The facilities listed below (other than the corporate office) are used principally as manufacturing facilities.

| <b>Location</b>                              | <b>Market Served</b>            | <b>Own or Lease (Expiration)</b> | <b>Approximate Square Feet</b> | <b>Certifications</b>  |
|--|---------------------------------|----------------------------------|--------------------------------|--|
| <i>Corporate Office:</i>                     |                                 |                                  |                                |  |
| Louisville, Kentucky                         |                                 | Lease (2014)                     | 21,600                         |  |
| <i>Manufacturing and Service Facilities:</i> |                                 |                                  |                                |  |
| Kenton, Ohio                                 | Truck Components & Assemblies   | Own                              | 540,000                        | QS 9000  |
| Louisville, Kentucky                         | Truck Components & Assemblies   | Own                              | 467,000                        | QS 9000  |
| Marion, Ohio                                 | Truck Components & Assemblies   | Own                              | 255,000                        | QS 9000  |
| Morganton, North Carolina                    | Truck Components & Assemblies   | Own                              | 342,000                        | QS 9000<br>ISO 14001   |
| Orlando, Florida                             | Test & Measurement Services     | Own                              | 62,000                         | AS 9100<br>ISO 9001<br>ISO 17025/Guide 25<br>MIL-STD 750, 883,<br>202 and 810                        |
| San Dimas, California                        | Aerospace & Defense Electronics | Lease (2015)                     | 26,300                         | ISO 9001   |
| Tampa, Florida                               | Aerospace & Defense Electronics | Lease (2016)                     | 318,000                        | ISO 9001<br>AS 9100<br>NASA-STD-8739<br>IPC-A-610, Rev E,<br>Class 3<br>J-STD-001, Rev E,<br>Class 3 |
| Toluca, Mexico                               | Truck Components & Assemblies   | Own                              | 209,700                        | QS 9000  |

In addition, we lease space in 21 other facilities primarily utilized to provide technical services, all of which are located in the U.S. We also own 10 ISO-certified mobile calibration units and one ISO-certified transportable field calibration unit that are utilized to provide test & measurement services at customer locations throughout the U.S., the Caribbean and the South Pacific.

Below is a listing and description of the various manufacturing certifications or specifications that we utilize at our facilities.

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| <b>Certification/Specification</b> | <b>Description</b>   |
|------------------------------------|--|
| AS 9100                            | A quality management system developed by the aerospace industry to measure supplier conformance with basic common acceptable aerospace quality requirements.   |
| IPC-A-610                          | A certification process for electronics assembly manufacturing which describes materials, methods and verification criteria for producing high quality electronic products. Class 3 specifically includes high performance or performance-on-demand products where equipment downtime cannot be tolerated, end-use environment may be uncommonly harsh, and the equipment must function when required. |
| J-STD-001                          | A family of voluntary standards of industry-accepted workmanship criteria for electronics assemblies.  |
| ISO 9001                           | A certification process comprised of 20 quality system requirements to ensure quality in the areas of design, development, production, installation and servicing of products.   |
| ISO 9002                           | A certification process similar to the ISO 9001 requirements, but it applies principally to manufacturing services as opposed to engineering services.   |
| ISO 14001                          | A family of voluntary standards and guidance documents defining specific requirements for an Environmental Management System.  |
| ISO 17025/Guide 25                 | A certification process commonly referred to as A2LA, which sets out general provisions that a laboratory must address to carry out specific calibrations or tests and provides laboratories with direction for the development of a fundamental quality management system.  |
| MIL                                | A specification that signifies specific functions or processes that are conducted in compliance with military specifications, such as a quality program, high-reliability soldering, calibration and metrology, and environmental testing.   |
| NASA-STD-8739                      | A specification for space programs designated by the National Aeronautics and Space Administration.  |
| QS 9000                            | A certification process developed by the nation's major automakers that focuses on continuous improvement, defect reduction, variation reduction and elimination of waste.   |

**Item 3. Legal Proceedings**

We are involved from time to time in litigation and other legal or environmental proceedings incidental to our business. There are currently no material pending legal proceedings to which we are a party, excluding the Dana Bankruptcy proceedings under which we are the plaintiff as described under Item 1. Business Recent Developments. Ongoing environmental proceedings include the following:

Our Marion, Ohio facility is subject to soil and groundwater contamination involving petroleum compounds, semi-volatile and volatile organic compounds, certain metals, PCBs and other contaminants, some of which exceed the State of Ohio voluntary action program standards applicable to the site. Under our purchase agreement for this facility, Dana has agreed to indemnify us for, among other things, environmental conditions that existed on the site as of closing and as to which we notified Dana prior to December 31, 2002. Such amounts due from Dana, if any, could be subject to compromise or rejection in conjunction with Dana's Chapter 11 filing.

A leased facility we formerly occupied in Tampa, Florida is currently subject to remediation activities related to groundwater contamination involving methylene chloride and other volatile organic

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compounds which occurred prior to our use of the facility. The contamination extends beyond the boundaries of the facility. In December 1986, Honeywell, a prior operator of the facility, entered into a consent order with the Florida Department of Environmental Regulation under which Honeywell agreed to remediate the contamination, the full scope of which has not yet been determined. We purchased the assets of a business formerly located on this leased site and operated that business from 1993 until December 1994. Philips Electronics, the seller of those assets, has agreed to indemnify us with respect to environmental matters arising from groundwater contamination at the site prior to our use of the facility. On November 3, 2004, Sypris Electronics was served as a co-defendant with Honeywell International, Inc. and Phillips Electronics America Corporation in an environmental lawsuit filed in the Circuit Court of Thirteenth Judicial Circuit Hillsborough County, Florida by Helen Jones and other surrounding landowners, alleging various damages caused by such contamination. Philips Electronics has agreed to pay for our defense costs and a motion to dismiss Sypris Electronics has been filed.

In December 1992, we acquired certain business assets formerly located at a leased facility in Littleton, Colorado. Certain chlorinated solvents disposed of on the site by Honeywell, a previous owner of the business, have contaminated the groundwater at and around the site. Alliant Techsystems, from which we acquired the business assets, operates a remediation system approved by the State of Colorado and has also entered into a consent order with the EPA providing for additional investigation at the site. Alliant Techsystems has agreed to indemnify us with respect to these matters.

Our Morganton, North Carolina facility is subject to soil and groundwater contamination involving petroleum compounds, certain metals, and other contaminants, some of which exceed the State of North Carolina standards applicable to the site. Under our purchase agreement for this facility, Dana has agreed to indemnify us for, among other things, environmental conditions that existed on the site as of closing and as to which we notified Dana prior to December 31, 2005. Such amounts due from Dana, if any, could be subject to compromise or rejection in conjunction with Dana's Chapter 11 filing.

Our Toluca, Mexico facility is subject to soil and groundwater contamination involving petroleum compounds and volatile organic compounds, among other concerns. We continue to test and assess this site to determine the extent of any contamination by the prior owners of the facility. Under our purchase agreement for this facility, Dana and Dana Mexico have agreed to indemnify us for, among other things, environmental conditions that existed on the site as of closing and as to which we notify Dana prior to June 30, 2006.

Our Kenton, Ohio facility is subject to soil and groundwater contamination involving petroleum compounds, volatile organic compounds, certain metals, PCBs and other contaminants. We continue to test and assess this site to determine the extent of any contamination by the prior owners of the facility. Under our purchase agreement for this facility, Meritor Heavy Vehicle Systems has agreed to indemnify us for, among other things, environmental conditions that existed on the site as of closing and as to which we notified ArvinMeritor prior to May 2, 2006.

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

No matters were submitted to a vote of security holders during the fourth quarter of the year ended December 31, 2006.



**Table of Contents****PART II****Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock is traded on the Nasdaq Global Market under the symbol SYPR. The following table sets forth, for the periods indicated, the high and low closing sale prices per share of our common stock as reported by the Nasdaq Global Market.

|                               | <b>High</b> | <b>Low</b> |
|-------------------------------|-------------|------------|
| Year ended December 31, 2005: |             |            |
| First Quarter                 | \$ 15.57    | \$ 10.61   |
| Second Quarter                | 12.77       | 8.52       |
| Third Quarter                 | 14.30       | 10.74      |
| Fourth Quarter                | 11.15       | 8.88       |
| Year ended December 31, 2006: |             |            |
| First Quarter                 | \$ 11.26    | \$ 9.04    |
| Second Quarter                | 10.10       | 7.83       |
| Third Quarter                 | 9.99        | 6.94       |
| Fourth Quarter                | 8.35        | 6.77       |

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***

Among Sypris Solutions, Inc., The S & P Smallcap 600 Index

And The Russell 2000 Index

\* \$100 invested on 12/31/01 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.  
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[www.researchdatagroup.com/S&P.htm](http://www.researchdatagroup.com/S&P.htm)

As of March 8, 2007, there were 18,901,875 holders of record of our common stock. On September 22, 2002, our Board of Directors declared an initial quarterly cash dividend of \$0.03 per common share outstanding. Cash dividends of \$0.03 per common share have been paid quarterly since the initial dividend was declared in 2002.

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Dividends may be paid on common stock only when, as and if declared by our Board of Directors in its sole discretion. We did not repurchase any of our common stock during the fourth quarter of the fiscal year ended December 31, 2006.

**Item 6. Selected Financial Data**

The following selected financial data should be read in conjunction with the Management's Discussion and Analysis of Financial Condition and Results of Operations and our financial statements and related notes included in Item 8 of this Form 10-K. The selected financial data set forth below as of December 31, 2006 and 2005, and for the three years included in the period ended December 31, 2006 are derived from our audited consolidated financial statements included elsewhere in this Form 10-K, and the data below are qualified by reference to those consolidated financial statements and related notes. The financial statement data at December 31, 2004, 2003 and 2002 and for the years ended December 31, 2003 and 2002 are derived from our audited consolidated financial statements not included in this Form 10-K.

|   | 2006(1)                               | Years Ended December 31,<br>2005 2004(2)(3) 2003(3) |                                    |            | 2002       |
|---|---------------------------------------|---|------------------------------------|------------|------------|
|   | (in thousands, except per share data) |   |                                    |            |            |
| <b>Consolidated Statement of Operations Data:</b> |                                       |   |                                    |            |            |
| Net revenue                                       | \$ 497,664                            | \$ 522,766  | \$ 425,402                         | \$ 276,605 | \$ 273,477 |
| Cost of sales                                     | 456,574                               | 471,428   | 371,963                            | 230,660    | 223,936    |
| Gross profit                                      | 41,090                                | 51,338  | 53,439                             | 45,945     | 49,541     |
| Selling, general and administrative               | 38,592                                | 35,669  | 35,248                             | 26,711     | 27,114     |
| Research and development                          | 1,988                                 | 2,833   | 3,697                              | 4,166      | 3,354      |
| Amortization of intangible assets                 | 645                                   | 614   | 596                                | 194        | 97         |
| Operating (loss) income                           | (135)                                 | 12,222  | 13,898                             | 14,874     | 18,976     |
| Interest expense, net                             | 3,708                                 | 5,979   | 2,100                              | 1,693      | 2,742      |
| Other (income) expense, net                       | (387)                                 | (1,325)   | (138)                              | 230        | (159)      |
| (Loss) income before income taxes                 | (3,456)                               | 7,568   | 11,936                             | 12,951     | 16,393     |
| Income tax (benefit) expense                      | (2,094)                               | 2,247   | 3,637                              | 4,860      | 4,940      |
| Net (loss) income                                 | \$ (1,362)                            | \$ 5,321  | \$ 8,299                           | \$ 8,091   | \$ 11,453  |
| (Loss) earnings per common share::                |                                       |   |                                    |            |            |
| Basic   | \$ (0.08)                             | \$ 0.30   | \$ 0.48                            | \$ 0.57    | \$ 0.87    |
| Diluted   | \$ (0.08)                             | \$ 0.29   | \$ 0.47                            | \$ 0.56    | \$ 0.84    |
| Cash dividends per common share                   | \$ 0.12                               | \$ 0.12   | \$ 0.12                            | \$ 0.12    | \$ 0.06    |
| Shares used in computing per share amounts:       |                                       |   |                                    |            |            |
| Basic   | 18,079                                | 18,016  | 17,119                             | 14,237     | 13,117     |
| Diluted   | 18,079                                | 18,323  | 17,745                             | 14,653     | 13,664     |
|   | 2006(1)                               | 2005  | December 31,<br>2004(2)(3) 2003(3) |            | 2002       |
|   | (in thousands)                        |   |                                    |            |            |
| <b>Consolidated Balance Sheet Data:</b>           |                                       |   |                                    |            |            |
| Cash and cash equivalents                         | \$ 32,400                             | \$ 12,060   | \$ 14,060                          | \$ 12,019  | \$ 12,403  |
| Working capital                                   | 100,717                               | 111,765   | 143,123                            | 81,456     | 78,600     |
| Total assets                                      | 379,033                               | 417,624   | 431,178                            | 264,435    | 224,612    |
| Current portion of long-term debt                 | 5,000                                 |   | 7,000                              | 3,200      | 7,000      |

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|  |         |         |         |         |         |
|--|---------|---------|---------|---------|---------|
| Long-term debt, net of current portion | 55,000  | 80,000  | 110,000 | 53,000  | 30,000  |
| Total stockholders' equity             | 209,886 | 213,734 | 208,939 | 145,392 | 137,690 |

- (1) Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" under the modified prospective method. We also adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," an amendment of FASB Statements No. 87, 88, 106 and 132(R). See Note 1 of our consolidated financial statements.
- (2) On May 3, 2004 and June 30, 2004, respectively, we completed the acquisition of the net assets of ArvinMeritor's Kenton, Ohio facility and Dana's Toluca, Mexico facility and their results of operations and related purchased assets are included from those dates forward.
- (3) On December 31, 2003, we completed the acquisition of the net assets of Dana's Morganton, North Carolina facility and its results of operations and related purchased assets are included from that date forward.

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### **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion of our consolidated results of operations and financial condition should be read together with the other financial information and consolidated financial statements included in this Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from the results anticipated in the forward-looking statements as a result of a variety of factors, including those discussed in Risk Factors and elsewhere in this Form 10-K.

#### **Overview**

We are a diversified provider of outsourced services and specialty products. We perform a wide range of manufacturing, engineering, design, testing and other technical services, typically under multi-year, sole-source contracts with major companies and government agencies in the markets for aerospace & defense electronics, truck components & assemblies, and test & measurement services. Revenue from our three core markets accounted for approximately 96% of our revenue for the year ended December 31, 2006, while revenue from our outsourced services accounted for approximately 86% of our revenue.

We are organized into two business groups, the Industrial Group and the Electronics Group. The Industrial Group is one reportable business segment, while the Electronics Group includes two reportable business segments, Aerospace & Defense and Test & Measurement. The Industrial Group is comprised of Sypris Technologies, Inc. and its subsidiaries, which generates revenue primarily from the sale of manufacturing services to customers in the market for truck components & assemblies and from the sale of products to the energy and chemical markets. The Aerospace & Defense reportable segment is comprised of Sypris Data Systems, Inc. and Sypris Electronics, LLC. Revenue from this group is derived primarily from the sale of manufacturing services, technical services and products to customers in the market for aerospace & defense electronics. The Test & Measurement reportable segment consists solely of Sypris Test & Measurement, Inc., which generates revenue primarily from providing technical services for the calibration, certification and repair of test and measurement equipment in the U.S.

Our objective is to become the leading outsourcing specialist in each of our core markets for aerospace & defense electronics, truck components & assemblies, and test & measurement services. We have focused our efforts on establishing long-term relationships with industry leaders who embrace multi-year contractual relationships as a strategic component of their supply chain management.

#### **Critical Accounting Policies and Estimates**

The preparation of the consolidated financial statements and accompanying notes in conformity with U.S. generally accepted accounting principles requires that we make estimates and assumptions that affect the amounts reported. Changes in facts and circumstances could have a significant impact on the resulting estimated amounts included in our consolidated financial statements. We believe the following critical accounting policies affect our more complex judgments and estimates. We also have other policies that we consider to be key accounting policies, such as our policies for revenue recognition in the Industrial Group, including cost of sales; however, these policies do not meet the definition of critical accounting estimates because they do not generally require us to make estimates or judgments that are difficult or subjective.

*Allowance for Doubtful Accounts.* We establish reserves for uncollectible accounts receivable based on overall receivable aging levels, a specific evaluation of accounts for customers with known financial difficulties and evaluation of customer chargebacks, if any. These reserves and corresponding write-offs could significantly increase if our customers experience deteriorating financial results or in the event we receive a significant chargeback, which is deemed uncollectible.

*Impairments.* Goodwill is tested at least annually for impairment by calculating the estimated fair value of each business with which goodwill is associated. The estimated fair value is based on a discounted cash flow analysis that requires judgment in our evaluation of the business and establishing an appropriate discount rate and terminal value to apply in the calculations. In selecting these and other assumptions for each business, we consider historical performance, forecasted operating results, general market conditions and industry considerations specific to the business. It is possible that the assumptions underlying the impairment analysis will change in such a manner that impairment charges may occur. We likely would compute a materially different fair value for a business if different assumptions were used or if circumstances were to change.

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At December 31, 2006, net assets of our Test & Measurement segment were \$12.8 million, including goodwill of \$6.9 million. Our Test & Measurement segment reported an operating loss in 2006 of \$0.1 million, primarily as a result of decreased component screening and product sales. As restructuring efforts continue to pay back and calibration revenues continue to grow, operating income improvement is expected in 2007. If continued improvement in our Test & Measurement operations is not achieved and profitability deteriorates, we may be required to record an impairment charge to goodwill for the Test & Measurement segment.

The recoverability of long-lived assets is evaluated if impairment indicators exist. Indicators of impairment include historical financial performance, operating trends and our future operating plans. If impairment indicators exist, we evaluate the recoverability of long-lived assets based on forecasted undiscounted cash flows. If an impairment has occurred, the long-lived asset is written down to its estimated fair value on a discounted basis. The estimation of future cash flows requires management's judgment concerning historical performance, forecasted operating results, general market conditions and industry considerations specific to the assets. There are inherent uncertainties related to these factors and management's judgments in applying these factors to the analysis of long-lived asset impairment. It is possible that the assumptions underlying the impairment analysis will change in such a manner that impairment charges may occur. We likely would compute a materially different estimate of future cash flows if different assumptions were used or if circumstances were to change.

*Long-term Contracts* A large part of our Aerospace & Defense segment business is derived from long-term contracts for development, production and service activities which we account for consistent with the American Institute of Certified Public Accountants (AICPA) audit and accounting guide, Audits of Federal Government Contractors, the AICPA's Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, and other relevant revenue recognition accounting literature, as applicable. We consider the nature of these contracts and the types of products and services provided when we determine the proper accounting for a particular contract.

Primarily, we record long-term, fixed-price contracts on a percentage of completion basis using units-of-delivery to measure progress toward completing the contract and recognizing net revenue. Revenue is recognized on these contracts when units are shipped or delivered to the customer, as applicable, with unit revenue based upon unit prices as set forth in the applicable contracts. The costs attributed to contract revenue are based upon the estimated average costs of all units to be shipped. For example, we use this method of revenue recognition on our encryption programs. In less frequent circumstances, we enter into milestone specific, fixed-price contracts for which net revenue is recorded when we achieve performance milestones. Revenue recognized under such milestones is limited to net revenue that we would recognize under the cost-to-cost method. Under the cost-to-cost method of accounting, revenue is recognized based on the ratio of costs incurred to our estimate of total costs at completion. For example, we use this methodology for our CEC, Common Card and KI-17 programs. As we incur costs under cost-reimbursement-type contracts, we record net revenue. Cost-reimbursement-type contracts include time and materials and other level-of-effort-type contracts. An example of this type of revenue recognition includes the JWARN program.

As a general rule, we recognize net revenue and profits earlier in a production cycle when we use the cost-to-cost and milestone methods of percentage of completion accounting than when we use the units-of-delivery method. In addition, our profits and margins may vary materially depending on the types of long-term government contracts undertaken, the costs incurred in their performance, the achievement of other performance objectives, and the stage of performance at which the right to receive fees is finally determined.

Contract accounting requires judgment relative to assessing risks, estimating contract revenues and costs, and making assumptions for schedule and technical issues. Due to the size and nature of many of our contracts, the estimation of total revenue and cost at completion is complicated and subject to many variables. Contract costs include material, labor and subcontracting costs, as well as an allocation of indirect costs. Assumptions have to be made regarding the length of time to complete the contract because costs also include expected increases in wages and prices for materials. For contract change orders, claims or similar items, we apply judgment in estimating the amounts and assessing the potential for realization. These amounts are only included in contract value when they can be reliably estimated and realization is considered probable.

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The majority of our Aerospace & Defense segment net revenue is driven by pricing based on costs incurred to produce products or perform services under contracts with the U.S. Government, and therefore not necessarily on market-based factors. Cost-based pricing is determined under the Federal Acquisition Regulations (FAR). The FAR provides guidance on the types of costs that are allowable in establishing prices for goods and services under U.S. Government contracts. For example, costs such as those related to charitable contributions, advertising, interest expense, and public relations are unallowable, and therefore not recoverable through net revenue.

Approximately 12%, 16% and 18% of total net revenue was recognized under the percentage of completion method based on units of delivery during 2006, 2005 and 2004, respectively. Approximately 3%, 2% and 3% of total net revenue was recognized under the percentage of completion method based on milestones or cost-to-cost during 2006, 2005 and 2004, respectively. Therefore, the amounts we record in our consolidated financial statements using contract accounting methods and cost accounting standards are material. Because of the significance of the judgments and estimation processes, it is likely that materially different amounts could be recorded if we used different assumptions or if the underlying circumstances were to change. When adjustments in estimated contract revenues or costs are required, any changes from prior estimates are generally included in earnings in the current period. We closely monitor compliance with and the consistent application of our critical accounting policies related to contract accounting. In addition to less formal monthly reviews, management in the Aerospace & Defense segment formally assess the status of contracts on a quarterly basis through extensive estimate at completion reviews which include multiple levels of program personnel. Costs incurred and allocated to contracts with the U.S. Government are reviewed for compliance with regulatory standards by our personnel, and are subject to audit by the Defense Contract Audit Agency.

*Pension Plan Funded Status* Pension assets and liabilities are complex estimation processes based on third party actuarially determined estimates, which rely on management estimates of the discount rate and rate of return on plan assets. Changes in these rates could significantly impact the actuarially determined amounts recorded in the statement of financial position.

*Reserve for Excess, Obsolete and Scrap Inventory* We record inventory at the lower of cost, determined under the first-in, first-out method, or market and do reserve for excess, obsolete or scrap inventory. These reserves are primarily based upon management's assessment of the salability of the inventory, historical usage of raw materials, historical demand for finished goods, and estimated future usage and demand. An improper assessment of salability or improper estimate of future usage or demand, or significant changes in usage or demand could result in significant changes in the reserves and a positive or a negative impact on our consolidated results of operations in the period the change occurs.

*Stock-based Compensation* We account for stock-based compensation in accordance with the fair value recognition provisions using the Black-Scholes option-pricing method, which requires the input of several subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them (expected term), the estimated volatility of our common stock price over the expected term and the number of options that will ultimately not complete their vesting requirements (forfeitures). Changes in the subjective assumptions can materially affect the fair value estimate of stock-based compensation and, consequently, the related expense recognized on the consolidated statement of operations.

**Results of Operations**

The tables presented below, which compare our consolidated results of operations from one year to another, present the results for each year, the change in those results from one year to another in both dollars and percentage change and the results for each year as a percentage of net revenue. The first two data columns in each table show the absolute results for each year presented. The columns entitled *Year Over Year Change* and *Year Over Year Percentage Change* show the change in results, both in dollars and percentages. These two columns show favorable changes as positive and unfavorable changes as negative. For example, when our net revenue increases from one year to the next, that change is shown as a positive number in both columns. Conversely, when expenses increase from one year to the next, that change is shown as a negative number in both columns. The last two columns in each table show the results for each period as a percentage of net revenue. In these two columns, the cost of sales and gross profit for each are given as a percentage of that segment's net revenue. These amounts are shown in italics. In addition, as used in these tables, *NM* means *not meaningful*.

**Table of Contents****Year Ended December 31, 2006 Compared to Year Ended December 31, 2005**

|                                     | Years Ended<br>December 31, |            | Year Over<br>Year<br>Change<br>Favorable                | Year Over<br>Year<br>Percentage<br>Change<br>Favorable | Results as Percentage of<br>Net Revenue for the<br>Years Ended<br>December 31, |       |
|-------------------------------------|-----------------------------|------------|---|--|--|-------|
|                                     | 2006                        | 2005       | (Unfavorable)<br>(in thousands, except percentage data) | (Unfavorable)  | 2006   | 2005  |
| <b>Net revenue:</b>                 |                             |            |   |  |  |       |
| Industrial Group                    | \$ 364,570                  | \$ 359,602 | \$ 4,968  | 1.4%   | 73.2%  | 68.8% |
| Aerospace & Defense                 | 87,491                      | 115,863    | (28,372)  | (24.5)   | 17.6   | 22.2  |
| Test & Measurement                  | 45,603                      | 47,301     | (1,698)   | (3.6)  | 9.2  | 9.0   |
| Electronics Group                   | 133,094                     | 163,164    | (30,070)  | (18.4)   | 26.8   | 31.2  |
| Total net revenue                   | 497,664                     | 522,766    | (25,102)  | (4.8)  | 100.0  | 100.0 |
| <b>Cost of sales:</b>               |                             |            |   |  |  |       |
| Industrial Group                    | 346,894                     | 336,686    | (10,208)  | (3.0)  | 95.2   | 93.6  |
| Aerospace & Defense                 | 73,832                      | 98,367     | 24,535  | 24.9   | 84.4   | 84.9  |
| Test & Measurement                  | 35,848                      | 36,375     | 527   | 1.4  | 78.6   | 76.9  |
| Electronics Group                   | 109,680                     | 134,742    | 25,062  | 18.6   | 82.4   | 82.6  |
| Total cost of sales                 | 456,574                     | 471,428    | 14,854  | 3.2  | 91.7   | 90.2  |
| <b>Gross profit:</b>                |                             |            |   |  |  |       |
| Industrial Group                    | 17,676                      | 22,916     | (5,240)   | (22.9)   | 4.8  | 6.4   |
| Aerospace & Defense                 | 13,659                      | 17,496     | (3,837)   | (21.9)   | 15.6   | 15.1  |
| Test & Measurement                  | 9,755                       | 10,926     | (1,171)   | (10.7)   | 21.4   | 23.1  |
| Electronics Group                   | 23,414                      | 28,422     | (5,008)   | (17.6)   | 17.6   | 17.4  |
| Total gross profit                  | 41,090                      | 51,338     | (10,248)  | (20.0)   | 8.3  | 9.8   |
| Selling, general and administrative | 38,592                      | 35,669     | (2,923)   | (8.2)  | 7.8  | 6.8   |
| Research and development            | 1,988                       | 2,833      | 845   | 29.8   | 0.4  | 0.6   |
| Amortization of intangible assets   | 645                         | 614        | (31)  | (5.0)  | 0.1  | 0.1   |
| Operating (loss) income             | (135)                       | 12,222     | (12,357)  | NM   | 0.0  | 2.3   |
| Interest expense, net               | 3,708                       | 5,979      | 2,271   | 38.0   | 0.8  | 1.1   |
| Other income, net                   | (387)                       | (1,325)    | (938)   | (70.8)   | (0.1)  | (0.2) |
| (Loss) income before income taxes   | (3,456)                     | 7,568      | (11,024)  | NM   | (0.7)  | 1.4   |
| Income taxes                        | (2,094)                     | 2,247      | 4,341   | NM   | (0.4)  | 0.4   |
| Net (loss) income                   | \$ (1,362)                  | \$ 5,321   | \$ (6,683)  | NM%  | (0.3)%   | 1.0%  |

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*Backlog.* Excluding the backlog from our Industrial Group, which ceased to be tracked starting January 1, 2006, our backlog decreased \$2.4 million to \$99.5 million at December 31, 2006, on \$131.3 million in net orders in 2006 compared to \$146.4 million in 2005. We expect to convert approximately 92% of the backlog at December 31, 2006 to revenue during 2007.

Backlog for our Aerospace & Defense segment decreased \$4.2 million to \$94.0 million at December 31, 2006, on \$83.5 million in net orders in 2006 compared to \$99.9 million in 2005. Backlog for our Test & Measurement segment increased \$1.8 million to \$5.5 million at December 31, 2006 on \$47.7 million in net orders in 2006 compared to \$46.5 million in 2005. We expect to convert approximately 92% of the Aerospace & Defense backlog and approximately 100% of the Test & Measurement backlog at December 31, 2006 to revenue during 2007.

*Net Revenue.* The Industrial Group derives its revenue from manufacturing services and product sales. Net revenue in the Industrial Group for the year increased \$5.0 million to \$364.6 million primarily due to \$12.2 million in additional volume, \$7.7 million of material pricing pass-through and \$0.5 million of price increases which were offset by the cessation of two business lines. We expect revenues to continue to decline in 2007 in line with the forecasted dip in demand for heavy and light-duty truck markets.



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The Aerospace & Defense segment derives its revenue from product sales and technical outsourced services. Aerospace & Defense segment net revenue decreased \$28.4 million to \$87.5 million due to a \$32.6 million decline in volume as a result of one encryption product completing its life cycle during 2006, while the launch of the next generation product was delayed into 2007, as well as maturing manufacturing service programs and declines in data storage product sales. All such decreases were partially offset by \$4.1 million of pricing increases over the prior year, primarily driven by a manufacturing service program.

The Test & Measurement segment derives its revenue from technical services including calibration and component screening, and product sales. Technical services revenue accounted for approximately 87% and 84% of total Test & Measurement revenue in 2006 and 2005, respectively. Test & Measurement segment net revenue decreased \$1.7 million due to a \$1.5 million sales decline in a military program product, with the remainder due to decreased technical services sales.

*Gross Profit.* The Industrial Group's gross profit decreased \$5.2 million in 2006 primarily due to \$2.6 million of production inefficiencies which combined with inflationary increases in salary and fringe benefits, utility costs, supplies expenses and material revaluation impacts on scrap expense of \$2.4 million, \$1.4 million, \$0.3 million and \$0.2 million, respectively which were partially offset by increased volume associated with higher revenue. Gross profit as a percentage of revenue decreased to 4.8% for 2006 from 6.4% in 2005 as a result of the aforementioned production inefficiencies, higher energy costs and salary and fringe benefits along with the impact of declining overhead absorption rates resulting from inventory reduction initiatives.

The Aerospace & Defense segment's gross profit decreased \$3.8 million in 2006 primarily due to the decline in volume of one encryption product which completed its life cycle during 2006, while the launch of the next generation product was delayed until the middle of 2007. Gross margin for the Aerospace & Defense segment was 15.6% in 2006 as compared to 15.1% in 2005. The increase in gross margin percentage resulted primarily from a more favorable mix of product sales with higher gross margins versus manufacturing services.

The Test & Measurement segment's gross profit decreased \$1.2 million in 2006 primarily due to an unfavorable shift in sales mix from product sales and component screening services with higher margins for technical services sales.

*Selling, General and Administrative.* Selling, general and administrative expense increased \$2.9 million in 2006 and increased as a percentage of net revenue to 7.8% in 2006 from 6.8% in 2005. The increase was primarily driven by a \$1.4 million increase in legal fees as a result of Dana's Chapter 11 filing in 2006, a \$0.8 million increase in stock compensation expense as required under SFAS No. 123R, a \$0.6 million increase in administrative costs in the Industrial Group related to a full year of additional infrastructure to support the new contracts in the Industrial Group, and a \$0.5 million increase in allowances for bad debts for the Aerospace & Defense segment, all of which were partially offset by a decrease for the Test & Measurement segment primarily resulting from reduced headcount and severance costs in the prior period which did not recur.

*Research and Development.* Research and development costs decreased \$0.8 million in 2006 due to a \$1.4 million reduction in two of our data systems product development projects, which was partially offset by new intellectual property investments under a manufacturing service program and initial investments in a new product offering within our Aerospace & Defense segment.

*Amortization of Intangible Assets.* Amortization of intangible assets remained consistent with the prior year period.

*Interest Expense, Net.* Interest expense decreased in 2006 due to a decrease in our weighted average debt outstanding. Our weighted average debt outstanding decreased to \$65.1 million during 2006 from \$115.9 million during 2005, resulting primarily from multiple working capital management initiatives. The weighted average interest rate increased to 5.5% in 2006 from 5.2% in 2005. Our effective interest rate is expected to increase in 2007 due to higher interest rates on borrowings under our credit agreement, partially offset by a continuation of working capital reduction initiatives which reduced debt by \$20.0 million and increased cash and cash equivalents by \$20.3 in 2006.

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*Other Income, Net.* Other income, net decreased \$0.9 million in 2006 due primarily to lower foreign currency remeasurement gains of U.S. Dollar denominated accounts of our foreign subsidiaries.

*Income Taxes.* Our effective income tax rate was 60.6% in 2006 as compared to 29.7% for 2005. The change primarily relates to the mix of foreign earnings and domestic losses. The change from prior year also reflects the impact of a change in the Mexican statutory tax rate to 29% for 2006 from 30% in 2005. In 2006 and 2005, tax expense was reduced \$0.4 million and \$0.2 million, respectively as a result of the resolution of various domestic federal and state tax liabilities which proved to be less than original estimates.

**Year Ended December 31, 2005 Compared to Year Ended December 31, 2004**

|  | Years Ended,<br>December 31, |            | Year Over<br>Year Change<br>Favorable | Year Over<br>Year<br>Change<br>Favorable | Results as Percentage of<br>Net Revenue for the<br>Years Ended<br>December 31, |       |
|--|------------------------------|------------|---------------------------------------|--|--|-------|
|  | 2005                         | 2004       | (Unfavorable)                         | (Unfavorable)                            | 2005   | 2004  |
| (in thousands, except percentage data) |                              |            |                                       |  |  |       |
| <b>Net revenue:</b>                    |                              |            |                                       |  |  |       |
| Industrial Group                       | \$ 359,602                   | \$ 260,410 | \$ 99,192                             | 38.1%                                    | 68.8%  | 61.2% |
| Aerospace & Defense                    | 115,863                      | 119,179    | (3,316)                               | (2.8)                                    | 22.2   | 28.0  |
| Test & Measurement                     | 47,301                       | 45,813     | 1,488                                 | 3.2                                      | 9.0  | 10.8  |
| Electronics Group                      | 163,164                      | 164,992    | (1,828)                               | (1.1)                                    | 31.2   | 38.8  |
| Total net revenue                      | 522,766                      | 425,402    | 97,364                                | 22.9                                     | 100.0  | 100.0 |
| <b>Cost of sales:</b>                  |                              |            |                                       |  |  |       |
| Industrial Group                       | 336,686                      | 235,406    | (101,280)                             | (43.0)                                   | 93.6   | 90.4  |
| Aerospace & Defense                    | 98,367                       | 99,895     | 1,528                                 | 1.5                                      | 84.9   | 83.8  |
| Test & Measurement                     | 36,375                       | 36,662     | 287                                   | 0.8                                      | 76.9   | 80.0  |
| Electronics Group                      | 134,742                      | 136,557    | 1,815                                 | 1.3                                      | 82.6   | 82.8  |
| Total cost of sales                    | 471,428                      | 371,963    | (99,465)                              | (26.7)                                   | 90.2   | 87.4  |
| <b>Gross profit:</b>                   |                              |            |                                       |  |  |       |
| Industrial Group                       | 22,916                       | 25,004     | (2,088)                               | (8.4)                                    | 6.4  | 9.6   |
| Aerospace & Defense                    | 17,496                       | 19,284     | (1,788)                               | (9.3)                                    | 15.1   | 16.2  |
| Test & Measurement                     | 10,926                       | 9,151      | 1,775                                 | 19.4                                     | 23.1   | 20.0  |
| Electronics Group                      | 28,422                       | 28,435     | (13)                                  | NM                                       | 17.4   | 17.2  |
| Total gross profit                     | 51,338                       | 53,439     | (2,101)                               | (3.9)                                    | 9.8  | 12.6  |
| Selling, general and administrative    | 35,669                       | 35,248     | (421)                                 | (1.2)                                    | 6.8  | 8.3   |
| Research and development               | 2,833                        | 3,697      | 864                                   | 23.4                                     | 0.6  | 0.9   |
| Amortization of intangible assets      | 614                          | 596        | (18)                                  | (3.0)                                    | 0.1  | 0.1   |
| Operating income                       | 12,222                       | 13,898     | (1,676)                               | (12.1)                                   | 2.3  | 3.3   |
| Interest expense, net                  | 5,979                        | 2,100      | (3,879)                               | (184.7)                                  | 1.1  | 0.5   |

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|                            |          |          |            |         |       |      |
|----------------------------|----------|----------|------------|---------|-------|------|
| Other income, net          | (1,325)  | (138)    | 1,187      | 860.1   | (0.2) |      |
| Income before income taxes | 7,568    | 11,936   | (4,368)    | (36.6)  | 1.4   | 2.8  |
| Income taxes               | 2,247    | 3,637    | 1,390      | 38.2    | 0.4   | 0.9  |
| Net income                 | \$ 5,321 | \$ 8,299 | \$ (2,978) | (35.9)% | 1.0%  | 1.9% |

*Backlog.* Our backlog increased \$2.4 million to \$252.3 million at December 31, 2005, on \$525.2 million in net orders in 2005 compared to \$476.4 million in 2004. Backlog for our Industrial Group increased \$18.9 million to \$150.4 million at December 31, 2005, on \$378.9 million in net orders in 2005 compared to \$318.7 million in 2004. Backlog for our Aerospace & Defense segment decreased \$15.7 million to \$98.2 million at December 31, 2005, on \$99.9 million in net orders in 2005 compared to \$113.3 million in 2004. Backlog for our Test & Measurement segment decreased \$0.7 million to \$3.7 million at December 31, 2005 on \$46.5 million in net orders in 2005 compared to \$44.4 million in 2004.

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*Net Revenue.* Net revenue in the Industrial Group for the year increased due to higher volume resulting from the new ArvinMeritor and Dana contracts that started in May and June of 2004, respectively. These new contracts with ArvinMeritor for trailer axle beams and various drive train components and with Dana for steer axles, drive axle shafts and drive train components for the light, medium and heavy-duty truck markets generated outsourced services revenue of \$213.2 million in 2005, as compared to \$142.5 million in 2004. Excluding the new contracts, the Industrial Group's net revenue increased \$28.5 million, or 24.2%, in 2005, primarily due to record demand for medium and heavy-duty trucks as a result of pre-buy activity ahead of a change in domestic emission requirements.

The Aerospace & Defense segment derives its revenue from manufacturing services, other outsourced services and product sales. Manufacturing services revenue accounted for approximately 81% and 75% of total Aerospace & Defense segment revenue in 2005 and 2004, respectively. Manufacturing services revenue increased \$3.8 million in 2005 primarily due to increased volume on two military programs and revenue from new customers for initial shipments on new contracts. Net revenue from technical outsourced services decreased \$3.2 million in 2005 primarily due to the completion of an engineering program in 2004. Net revenue from product sales decreased \$3.9 million primarily due to decreased demand for legacy data storage products.

The Test & Measurement segment derives its revenue from technical services and product sales. Technical services revenue accounted for approximately 84% and 87% of total Test & Measurement revenue in 2005 and 2004, respectively. Products sales increased \$1.4 million in 2005, primarily due to increased shipments on a military program, while revenue from technical services was consistent with the prior year.

*Gross Profit.* The Industrial Group's gross profit decreased \$2.1 million in 2005 associated with start-up programs and capacity constraints in addition to increased energy costs. Gross profit as a percentage of revenue decreased to 6.4% for 2005 from 9.6% in 2004, primarily due to costs associated with the increase in manufacturing capacity, launch of new programs, overtime to meet customer shipment schedules and increased natural gas costs. The factors impacting gross profit in the fourth quarter included higher natural gas and overtime along with the impact of declining overhead absorption rates resulting from inventory reduction initiatives.

The Aerospace & Defense segment's gross profit decreased \$1.8 million in 2005 primarily due to lower data storage product sales and technical outsourced revenue. Lower overhead absorption attributable to decreased product revenue reduced gross profit by \$1.2 million for 2005. Technical outsourced services gross profit decreased by \$0.6 from 2004 primarily due to lower revenue. Gross margin for the Aerospace & Defense segment was 15.1% in 2005 as compared to 16.2% in 2004. The decrease in gross margin resulted primarily from the lower volume and related margins for product sales, which was partially offset by higher volume for manufacturing services.

The Test & Measurement segment's gross profit increased \$1.8 million in 2005 primarily due to the increased product sales combined with lower personnel costs resulting from headcount reductions in the first half of 2005.

*Selling, General and Administrative.* Selling, general and administrative expense increased \$0.4 million in 2005 and decreased as a percentage of net revenue to 6.8% in 2005 from 8.3% in 2004. The Industrial Group's selling, general and administrative expense accounted for \$0.3 million of the increase, primarily due to higher administrative costs related to additional infrastructure to support the new contracts in the Industrial Group and the overall growth of the business. The Test & Measurement segment also increased selling expense to drive increased revenue, which was offset by reductions in selling, general and administrative expense in the Aerospace & Defense segment resulting from reduced headcount.

*Research and Development.* Research and development costs decreased \$0.9 million in 2005 due to the successful completion and launch of one of our data systems product development projects within our Aerospace & Defense segment in the last half of 2005.

*Amortization of Intangible Assets.* Amortization of intangible assets increased in 2005 primarily due to certain identifiable intangible assets acquired in connection with the ArvinMeritor and Dana contracts that started in May and June of 2004, respectively.

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*Interest Expense, Net.* Interest expense increased in 2005 due to an increase in our weighted average debt outstanding and higher interest rates. Our weighted average debt outstanding increased to \$115.9 million during 2005 from \$51.5 million during 2004. The increase in debt primarily related to the Industrial Group's acquisitions and capital expenditures to increase capacity and automation. The weighted average interest rate increased to 5.2% in 2005 from 4.8% in 2004.

*Other Income, Net.* Other income, net increased \$1.2 million in 2005 due primarily to foreign currency remeasurement gains of U.S. Dollar denominated accounts of our foreign subsidiaries.

*Income Taxes.* Our effective income tax rate was 29.7% in 2005 as compared to 30.5% for 2004. The decrease primarily relates to the full year impact of our Mexico operations acquired on June 30, 2004, for which the 2005 statutory tax rate is 30.0%. In 2005 and 2004, tax expense was reduced by \$0.2 million and \$0.4 million, respectively, as a result of the resolution of various domestic federal and state tax liabilities which proved to be less than original estimates.

**Table of Contents****Quarterly Results**

The following table presents our unaudited condensed consolidated statements of operations data for each of the eight quarters in the two-year period ended December 31, 2006. We have prepared this data on the same basis as our audited consolidated financial statements and, in our opinion, have included all normal recurring adjustments necessary for a fair presentation of this information. You should read these unaudited quarterly results in conjunction with our consolidated financial statements and related notes included elsewhere in this annual report. The consolidated results of operations for any quarter are not necessarily indicative of the results to be expected for any subsequent period.

|                                     | 2006                                  |           |           |           | 2005      |           |           |           |
|-------------------------------------|---------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
|                                     | First                                 | Second    | Third     | Fourth    | First     | Second    | Third     | Fourth    |
|                                     | (in thousands, except per share data) |           |           |           |           |           |           |           |
| <b>Net revenue:</b>                 |                                       |           |           |           |           |           |           |           |
| Industrial Group                    | \$ 92,499                             | \$ 98,454 | \$ 93,021 | \$ 80,596 | \$ 88,690 | \$ 89,673 | \$ 94,504 | \$ 86,735 |
| Aerospace & Defense                 | 26,011                                | 21,917    | 21,166    | 18,397    | 23,996    | 24,095    | 33,866    | 33,906    |
| Test & Measurement                  | 11,487                                | 11,862    | 11,768    | 10,486    | 11,555    | 11,834    | 12,441    | 11,471    |
| Electronics Group                   | 37,498                                | 33,779    | 32,934    | 28,883    | 35,551    | 35,929    | 46,307    | 45,377    |
| Total net revenue                   | 129,997                               | 132,233   | 125,955   | 109,479   | 124,241   | 125,602   | 140,811   | 132,112   |
| <b>Cost of sales:</b>               |                                       |           |           |           |           |           |           |           |
| Industrial Group                    | 86,550                                | 93,963    | 87,871    | 78,510    | 82,293    | 82,132    | 87,161    | 85,100    |
| Aerospace & Defense                 | 22,056                                | 18,570    | 18,559    | 14,647    | 21,605    | 20,726    | 28,498    | 27,538    |
| Test & Measurement                  | 8,772                                 | 9,266     | 9,289     | 8,521     | 8,984     | 8,856     | 9,546     | 8,989     |
| Electronics Group                   | 30,828                                | 27,836    | 27,848    | 23,168    | 30,589    | 29,582    | 38,044    | 36,527    |
| Total cost of sales                 | 117,378                               | 121,799   | 115,719   | 101,678   | 112,882   | 111,714   | 125,205   | 121,627   |
| <b>Gross profit:</b>                |                                       |           |           |           |           |           |           |           |
| Industrial Group                    | 5,949                                 | 4,491     | 5,150     | 2,086     | 6,397     | 7,541     | 7,343     | 1,635     |
| Aerospace & Defense                 | 3,955                                 | 3,347     | 2,607     | 3,750     | 2,391     | 3,369     | 5,368     | 6,368     |
| Test & Measurement                  | 2,715                                 | 2,596     | 2,479     | 1,965     | 2,571     | 2,978     | 2,895     | 2,482     |
| Electronics Group                   | 6,670                                 | 5,943     | 5,086     | 5,715     | 4,962     | 6,347     | 8,263     | 8,850     |
| Total gross profit                  | 12,619                                | 10,434    | 10,236    | 7,801     | 11,359    | 13,888    | 15,606    | 10,485    |
| Selling, general and administrative | 9,919                                 | 9,632     | 10,175    | 8,866     | 8,553     | 9,113     | 8,492     | 9,511     |
| Research and development            | 334                                   | 371       | 427       | 856       | 673       | 944       | 767       | 449       |
| Amortization of intangible assets   | 159                                   | 158       | 163       | 165       | 138       | 175       | 161       | 140       |
| Operating income (loss)             | 2,207                                 | 273       | (529)     | (2,086)   | 1,995     | 3,656     | 6,186     | 385       |
| Interest expense, net               | 1,159                                 | 1,083     | 820       | 646       | 1,261     | 1,508     | 1,797     | 1,413     |
| Other (income) expense, net         | (250)                                 | (8)       | 12        | (141)     | (181)     | (586)     | (89)      | (469)     |
| Income (loss) before income taxes   | 1,298                                 | (802)     | (1,361)   | (2,591)   | 915       | 2,734     | 4,478     | (559)     |
| Income tax expense (benefit)        | 441                                   | (358)     | (559)     | (1,618)   | 325       | 753       | 1,477     | (308)     |
| Net income (loss)                   | \$ 857                                | \$ (444)  | \$ (802)  | \$ (973)  | \$ 590    | \$ 1,981  | \$ 3,001  | \$ (251)  |

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Earnings (loss) per common share:

|                                 |    |      |    |        |    |        |    |        |    |      |    |      |    |      |    |        |
|---------------------------------|----|------|----|--------|----|--------|----|--------|----|------|----|------|----|------|----|--------|
| Basic                           | \$ | 0.05 | \$ | (0.02) | \$ | (0.04) | \$ | (0.05) | \$ | 0.03 | \$ | 0.11 | \$ | 0.17 | \$ | (0.01) |
| Diluted                         | \$ | 0.05 | \$ | (0.02) | \$ | (0.04) | \$ | (0.05) | \$ | 0.03 | \$ | 0.11 | \$ | 0.16 | \$ | (0.01) |
| Cash dividends per common share | \$ | 0.03 | \$ | 0.03   | \$ | 0.03   | \$ | 0.03   | \$ | 0.03 | \$ | 0.03 | \$ | 0.03 | \$ | 0.03   |

Shares used in computing earnings

(loss) per common share:

|         |        |        |        |        |        |        |        |        |
|---------|--------|--------|--------|--------|--------|--------|--------|--------|
| Basic   | 18,042 | 18,065 | 18,094 | 18,105 | 17,964 | 18,028 | 18,036 | 18,037 |
| Diluted | 18,289 | 18,065 | 18,094 | 18,105 | 18,296 | 18,261 | 18,423 | 18,037 |

**Table of Contents****Liquidity, Capital Resources and Financial Condition**

Net cash provided by operating activities decreased \$19.8 million to \$52.8 million in 2006. The cash provided by operating activities in 2006 includes a net decrease in working capital investment primarily due to a decrease in accounts receivable and inventories of \$35.1 and \$5.1 million, respectively. The reduction in working capital in 2006 was primarily driven by the continued execution of our working capital management program along with improved payment terms negotiated in 2006 with various significant customers.

Net cash used in investing activities was \$10.6 million in 2006 as compared to \$36.2 million in 2005. Capital expenditures decreased to \$10.3 million in 2006 from \$36.3 million in 2005. Capital expenditures in 2006 for our Industrial Group were \$5.2 million principally comprised of forging, machining, and centralized tooling equipment, while capital expenditures for our Aerospace & Defense and Test & Measurement segments were \$2.2 million and \$2.8 million, respectively, principally comprised of manufacturing, assembly and test equipment. Capital expenditures in 2005 for the Industrial Group were \$28.4 million, while capital expenditures in 2005 for our Aerospace & Defense and Test & Measurement segments were \$2.9 million and \$4.4 million, respectively. The reduction of capital expenditures in the Industrial Group for 2006 is the result of our expected gradual return to normal levels of capital expenditures, after our initial investments in new plants, forging technology and automation. Capital expenditures decreased in 2006 for the Aerospace & Defense segment as several programs neared completion and new programs required less new capital investment than in prior years.

Net cash used in financing activities was \$21.9 million in 2006 as compared to \$38.3 million in 2005. In 2006, we made net repayments totaling \$20.0 million on our revolving credit facility as a result of cash flow from operations under our various working capital management initiatives.

We had total borrowings under our revolving credit facility of \$5.0 million at December 31, 2006, and an unrestricted cash balance of \$32.4 million. Approximately \$7.7 million of the unrestricted cash balance relates to our Mexican subsidiaries. At the end of 2006, maximum borrowings permitted under the revolving credit facility were \$100.0 million, subject to a \$15.0 million limit for letters of credit of which \$1.7 million were issued. The credit agreement included an option to increase the amount of available credit to \$125.0 million from \$100.0 million, subject to the lead bank's approval. In March 2007, we agreed to terms with our bank group to amend the revolving credit agreement to limit total borrowings at \$50.0 million, with \$50.0 million of additional borrowings available upon lead bank approval, extend the Credit Agreement through October 2009, revise certain financial covenants providing more flexibility in our financing structure and add a security interest in our accounts receivable, inventory and equipment. Under the agreed to terms, other terms of the Credit Agreement remain substantially unchanged. Borrowings under the revolving credit facility may be used to finance working capital requirements, acquisitions and for general corporate purposes, including capital expenditures. Most acquisitions require the approval of our bank group. We intend to use such borrowing capacity to ratably repay \$25 million of the outstanding senior notes. We also agreed to terms to amend our senior notes in March 2007 to enable the aforementioned repayment of \$25 million of the outstanding senior notes, revise certain financial covenants, modify the June 30, 2014 principle payment to June 30, 2012, update our fixed interest rates and among other things, add a perfected security interest in our accounts receivable, inventory and equipment. Under the agreed to terms, other terms of the senior notes remain substantially unchanged.

Our principal commitments at December 31, 2006 consisted of repayments of borrowings under the credit agreement and senior notes, pension obligations and obligations under operating leases for certain of our real property and equipment. Estimated pension contributions for 2007 are expected to range from \$0.3 million to \$0.5 million. We also had purchase commitments totaling approximately \$32.4 million at December 31, 2006, primarily for inventory and manufacturing equipment. The following table provides the payment dates of our debt and contractual lease obligations at December 31, 2006, excluding current liabilities except for the current portion of long-term debt and prior to the 2007 amendments of our senior notes and credit agreement (amounts in thousands):

|                           | 2007      | 2008     | 2009      | 2010     | 2011      | 2012 &<br>Thereafter |
|---------------------------|-----------|----------|-----------|----------|-----------|----------------------|
| Revolving credit facility | \$ 5,000  | \$       | \$        | \$       | \$        | \$                   |
| Senior notes              |           |          | 7,500     |          | 27,500    | 20,000               |
| Operating leases          | 8,311     | 7,559    | 6,297     | 2,813    | 2,620     | 8,812                |
| Total                     | \$ 13,311 | \$ 7,559 | \$ 13,797 | \$ 2,813 | \$ 30,120 | \$ 28,812            |



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At December 31, 2006 we also had approximately \$16.2 million of federal net operating loss carryforwards available to offset future federal taxable income. Such carryforwards will increase future cash flows, if utilized, and reflect income tax losses incurred. Approximately, \$5.7million and \$10.5 million of the carryforwards will expire on December 31, 2024 and 2026, respectively.

We believe that sufficient resources will be available to satisfy our cash requirements for at least the next twelve months. Cash requirements for periods beyond the next twelve months depend on our profitability, our ability to manage working capital requirements and our rate of growth. If we make significant acquisitions, if our largest customers experience financial difficulty, or if working capital and capital expenditure requirements exceed expected levels during the next twelve months or in subsequent periods, we may require additional external sources of capital. There can be no assurance that any additional required financing will be available through bank borrowings, debt or equity financings or otherwise, or that if such financing is available, it will be available on terms acceptable to us. If adequate funds are not available on acceptable terms, our business, consolidated results of operations and financial condition could be adversely affected.

### **Recent Accounting Pronouncements**

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. Specifically, FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. We are required to adopt the provisions of FIN 48 on January 1, 2007. The impact of our reassessment of our tax positions in accordance with the requirements of FIN 48 is expected to be immaterial; however, the Company is awaiting additional guidance expected to be issued in March 2007.

On December 31, 2006, we adopted the recognition and disclosure provisions Statement of Financial Accounting Standard (SFAS) No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R), which required us to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of our pension plan in the December 31, 2006 statement of financial position, with a corresponding adjustment to accumulated other comprehensive income, net of tax. The adjustment to accumulated other comprehensive income at adoption represents the net unrecognized actuarial losses and unrecognized prior service costs, all of which were previously netted against the plan's funded status in our statement of financial position pursuant to the provisions of SFAS No. 87. These amounts will be subsequently recognized as net periodic pension cost pursuant to our historical accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension cost in the same periods will be recognized a component of other comprehensive income. Those amounts, noted below, will be subsequently recognized as a component of net periodic pension cost pursuant to our historical accounting policy for amortizing such amounts.

The incremental effects of adopting the provisions of SFAS No. 158 on our statement of financial position at December 31, 2006 are presented in the following table. The adoption of SFAS No. 158 had no effect on our consolidated statement of operations for the year ended December 31, 2006, or for any prior period presented, and it will not effect our operating results in future periods. Had we not been required to adopt SFAS No. 158 at December 31, 2006, we would have recognized an additional minimum liability pursuant to the provisions of SFAS No. 87. The effect of recognizing the additional minimum liability is included in table below in the column labeled Prior to Application of Statement 158.

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|                                      | December 31, 2006                       |  |          |
|--------------------------------------|---|--|----------|
|                                      | Prior to<br>Adopting<br>SFAS<br>No. 158 | Effect of<br>Adopting<br>SFAS<br>No. 158<br>(in thousands) | Reported |
| Other assets (pension)               | \$ 5,071                                | \$ (3,212)   | \$ 1,859 |
| Other liabilities (pension)          | (3,989)                                 | (148)  | (4,137)  |
| Other liabilities (deferred taxes)   | 1,446                                   | 1,307  | 2,753    |
| Accumulated other comprehensive loss | (3,735)                                 | (3,360)  | (7,095)  |

Included in accumulated other comprehensive income at December 31, 2006 are the following amounts that have not yet been recognized in net periodic pension cost: unrecognized prior service credits of \$0.4 million (\$0.3 million, net of tax) and unrecognized actuarial losses of \$7.5 million (\$4.6 million net of tax).

In December 2004, the FASB issued FASB Statement No. 123 (revised 2004), *Share-Based Payment*. SFAS No. 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and amends FASB Statement No. 95, *Statement of Cash Flows*. Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized as expense based on their fair values. Pro forma disclosure is no longer an alternative. We adopted SFAS No. 123(R) on January 1, 2006, using the modified prospective method and, accordingly, the financial statements for prior periods do not reflect any restated amounts. In accordance with Statement 123(R), we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

As a result, selling general and administrative expense, net loss, basic loss per common share and diluted loss per common share for the year ended December 31, 2006 includes \$1.0 million, \$0.6 million, \$0.04 and \$0.04, respectively related to non-cash compensation expense. Non-cash compensation expense included in selling general and administrative expense, net loss, basic earnings per common share and diluted earnings per common share for 2005 were \$0.2 million, \$0.1 million, \$0.01 and \$0.01, respectively. We had no non-cash compensation for the year ended December 31, 2004. No stock-based compensation was capitalized into inventory, or property plant and equipment during 2006 or 2005. In conjunction with the adoption of SFAS No. 123(R), we selected the straight-line amortization method for graded vesting options granted subsequent to January 1, 2006. Prior to that date, we used an accelerated method previously required for graded vesting awards.

As permitted by SFAS No. 123, we historically accounted for stock option grants in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Had we adopted SFAS No. 123(R) in prior periods, the impact would have approximated the impact of SFAS No. 123 pro forma disclosure below, excluding the impact of the underwater option accelerations in 2005. Our pro forma information is as follows (in thousands except per share data):

|  | Years ended December 31, |          |
|--|--------------------------|----------|
|  | 2005                     | 2004     |
| Net income   | \$ 5,321                 | \$ 8,299 |
| Pro forma stock-based compensation expense, net of tax | 2,597                    | 1,277    |
| Pro forma net income                                   | \$ 2,724                 | \$ 7,022 |
| Pro forma earnings per common share:                   |                          |          |
| Basic  | \$ 0.15                  | \$ 0.41  |
| Diluted  | \$ 0.15                  | \$ 0.40  |

As of December 31, 2006, there was \$2.4 million of total unrecognized compensation cost, after estimated forfeitures, related to unvested share-based compensation granted under our plans. That cost is expected to be recognized over a weighted-average period of 2.3 years. On March 1, 2005, April 25, 2005 and December 28, 2005, the Board of Directors approved resolutions to accelerate the vesting for underwater options as of March 11, 2005, April 25, 2005 and December 30, 2005, respectively in order to reduce future compensation expense related to outstanding options. Substantially all other options terms remained unchanged. After amendment of the underlying option agreements, compensation expense to be recognized in the statement of operations, subsequent to the adoption of SFAS No. 123(R) was reduced by approximately \$1.6 million, net of tax.



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In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. SFAS No. 151 clarifies that abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are required to be recognized as current period charges. The provisions of SFAS No. 151 are effective for fiscal years beginning after June 15, 2005. We adopted SFAS No. 151 on January 1, 2006. The impact on our consolidated financial position and results of operations was not material.

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to financial market risks, including changes in interest rates and foreign currency exchange rates. All borrowings under our credit agreement bear interest at a variable rate based on the prime rate, the London Interbank Offered Rate (LIBOR), or certain alternative short-term rates, plus a margin (1.25 % at December 31, 2006) based upon our leverage ratio. A change in interest rates of 100 basis points would not significantly change interest expense on an annualized basis, based upon our debt outstanding at December 31, 2006. A change in interest rates of 100 basis points would change the fair value of our Senior Notes by \$2.4 million. Fluctuations in foreign currency exchange rates have historically impacted our earnings only to the extent of remeasurement gains related to U.S. Dollar denominated accounts of our foreign subsidiary, because the vast majority of our transactions are denominated in U.S. dollars. A one percent change in foreign currency exchange rates would result in remeasurement gain or loss of approximately \$0.7 million on an annualized basis, based upon the U.S. Dollar denominated accounts of our foreign subsidiary at December 31, 2006. Inflation has not been a significant factor in our operations in any of the periods presented; however, there can be no assurances that the growth in our Industrial Group's business combined with significant increases in the costs of steel will not adversely affect our working capital requirements and our associated interest costs, which could also increase the sensitivity of our results to changes in interest rates.

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**Item 8. Financial Statements and Supplementary Data**

**SYPRIS SOLUTIONS, INC.**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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| <u>Consolidated Statements of Operations</u>  | 38 |
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| <u>Notes to Consolidated Financial Statements</u>   | 42 |

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**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The management of Sypris Solutions, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control system was designed to provide reasonable assurance to Sypris management and its Board of Directors regarding the preparation and fair presentation of published consolidated financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can only provide reasonable assurance with respect to the accuracy of consolidated financial statement preparation and presentation.

Under the supervision and with participation of our management, including the Chief Executive Officer and Chief Financial Officer, we assessed the effectiveness of Sypris Solutions, Inc.'s internal control over financial reporting as of December 31, 2006. In making our assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control – Integrated Framework. Based on our assessment, we concluded that as of December 31, 2006, Sypris' internal control over financial reporting is effective based on these criteria.

Ernst & Young LLP, our independent auditors and a registered public accounting firm, has issued an attestation report on our assessment of Sypris Solutions, Inc.'s internal control over financial reporting.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL  
CONTROL OVER FINANCIAL REPORTING**

Board of Directors and Stockholders

Sypris Solutions, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Sypris Solutions, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Sypris Solutions, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, management's assessment that Sypris Solutions, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Sypris Solutions, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2006 consolidated financial statements of Sypris Solutions, Inc. and our report dated February 14, 2007, except for Note 9, as to which the date is March 12, 2007, expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Louisville, Kentucky

February 14, 2007

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders

Sypris Solutions, Inc.

We have audited the accompanying consolidated balance sheets of Sypris Solutions, Inc. (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sypris Solutions, Inc. at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, the Company changed its method of accounting for stock-based compensation to conform to Statement of Financial Accounting Standards No. 123(R), Share-Based Payment. As further discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standard No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Sypris Solutions, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 14, 2007 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Louisville, Kentucky

February 14, 2007, except for Note 9, as

to which the date is March 12, 2007



**Table of Contents****SYPRIS SOLUTIONS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except for per share data)**

|  | <b>Years ended December 31,</b> |             |             |
|--|---------------------------------|-------------|-------------|
|  | <b>2006</b>                     | <b>2005</b> | <b>2004</b> |
| Net revenue:   |                                 |             |             |
| Outsourced services  | \$ 429,977                      | \$ 446,232  | \$ 355,639  |
| Products   | 67,687                          | 76,534      | 69,763      |
| Total net revenue  | 497,664                         | 522,766     | 425,402     |
| Cost of sales:   |                                 |             |             |
| Outsourced services  | 407,483                         | 418,148     | 326,266     |
| Products   | 49,091                          | 53,280      | 45,697      |
| Total cost of sales  | 456,574                         | 471,428     | 371,963     |
| Gross profit   | 41,090                          | 51,338      | 53,439      |
| Selling, general and administrative                        | 38,592                          | 35,669      | 35,248      |
| Research and development                                   | 1,988                           | 2,833       | 3,697       |
| Amortization of intangible assets                          | 645                             | 614         | 596         |
| Operating (loss) income                                    | (135)                           | 12,222      | 13,898      |
| Interest expense, net                                      | 3,708                           | 5,979       | 2,100       |
| Other (income) expense, net                                | (387)                           | (1,325)     | (138)       |
| (Loss) income before income taxes                          | (3,456)                         | 7,568       | 11,936      |
| Income tax (benefit) expense                               | (2,094)                         | 2,247       | 3,637       |
| Net (loss) income  | \$ (1,362)                      | \$ 5,321    | \$ 8,299    |
| (Loss) earnings per common share:                          |                                 |             |             |
| Basic  | \$ (0.08)                       | \$ 0.30     | \$ 0.48     |
| Diluted  | \$ (0.08)                       | \$ 0.29     | \$ 0.47     |
| Cash dividends per common share                            | \$ 0.12                         | \$ 0.12     | \$ 0.12     |
| Shares used in computing (loss) earnings per common share: |                                 |             |             |
| Basic  | 18,079                          | 18,016      | 17,119      |
| Diluted  | 18,079                          | 18,323      | 17,745      |

The accompanying notes are an integral part of the consolidated financial statements.

**Table of Contents****SYPRIS SOLUTIONS, INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands, except for share data)

|  | December 31, |            |
|--|--------------|------------|
|  | 2006         | 2005       |
| <b>ASSETS</b>  |              |            |
| Current assets:  |              |            |
| Cash and cash equivalents  | \$ 32,400    | \$ 12,060  |
| Restricted cash  | 1,002        |            |
| Accounts receivable, net   | 59,876       | 95,432     |
| Inventory, net   | 74,146       | 79,724     |
| Other current assets   | 34,014       | 26,020     |
| Total current assets   | 201,438      | 213,236    |
| Property, plant and equipment, net   | 155,341      | 176,719    |
| Goodwill   | 14,277       | 14,277     |
| Other assets   | 7,977        | 13,392     |
| Total assets   | \$ 379,033   | \$ 417,624 |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |              |            |
| Current liabilities:   |              |            |
| Accounts payable   | \$ 76,291    | \$ 76,567  |
| Accrued liabilities  | 19,430       | 24,904     |
| Current portion of long-term debt  | 5,000        |            |
| Total current liabilities  | 100,721      | 101,471    |
| Long-term debt   | 55,000       | 80,000     |
| Other liabilities  | 13,426       | 22,419     |
| Total liabilities  | 169,147      | 203,890    |
| Commitments and contingencies  |              |            |
| Stockholders' equity:  |              |            |
| Preferred stock, par value \$0.01 per share, 975,150 shares authorized; no shares issued   |              |            |
| Series A preferred stock, par value \$0.01 per share, 24,850 shares authorized; no shares issued   |              |            |
| Common stock, non-voting, par value \$0.01 per share, 10,000,000 shares authorized; no shares issued   |              |            |
| Common stock, par value \$0.01 per share, 30,000,000 shares authorized; 18,342,243 shares issued and 18,338,484 outstanding in 2006 and 18,165,658 shares issued and outstanding in 2005 | 183          | 182        |
| Additional paid-in capital   | 143,537      | 142,111    |
| Retained earnings  | 69,816       | 73,375     |
| Accumulated other comprehensive loss   | (3,634)      | (1,934)    |
| Treasury stock, 3,759 shares   | (16)         |            |
| Total stockholders' equity   | 209,886      | 213,734    |
| Total liabilities and stockholders' equity   | \$ 379,033   | \$ 417,624 |

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The accompanying notes are an integral part of the consolidated financial statements.

**Table of Contents****SYPRIS SOLUTIONS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

|   | <b>Years ended December 31,</b> |                  |                  |
|---|---------------------------------|------------------|------------------|
|   | <b>2006</b>                     | <b>2005</b>      | <b>2004</b>      |
| <b>Cash flows from operating activities:</b>  |                                 |                  |                  |
| Net (loss) income   | \$ (1,362)                      | \$ 5,321         | \$ 8,299         |
| <b>Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:</b> |                                 |                  |                  |
| Depreciation and amortization   | 28,782                          | 25,909           | 19,066           |
| Deferred income taxes   | (5,079)                         | (1,091)          | 3,692            |
| Provision for excess and obsolete inventory   | 836                             | 739              | 1,520            |
| Provision for doubtful accounts   | 437                             | 607              | 1,842            |
| Noncash compensation expense  | 1,034                           | 219              |                  |
| Other noncash charges   | 142                             | 123              | 252              |
| Contributions to pension plans  | (1,122)                         | (79)             | (929)            |
| <b>Changes in operating assets and liabilities, net of acquisitions:</b>                                  |                                 |                  |                  |
| Accounts receivable   | 35,112                          | 8,595            | (60,995)         |
| Inventory   | 5,123                           | 11,555           | (27,004)         |
| Other current assets  | (7,113)                         | 3,363            | (9,971)          |
| Accounts payable  | 35                              | 15,119           | 33,947           |
| Accrued and other liabilities   | (4,019)                         | 2,208            | 2,871            |
| <b>Net cash provided by (used in) operating activities</b>  | <b>52,806</b>                   | <b>72,588</b>    | <b>(27,410)</b>  |
| <b>Cash flows from investing activities:</b>  |                                 |                  |                  |
| Capital expenditures  | (10,326)                        | (36,264)         | (55,900)         |
| Proceeds from sale of assets  | 92                              | 649              | 47               |
| Purchase of net assets of acquired entities   |                                 |                  | (29,648)         |
| Changes in nonoperating assets and liabilities  | (335)                           | (625)            | (640)            |
| <b>Net cash used in investing activities</b>  | <b>(10,569)</b>                 | <b>(36,240)</b>  | <b>(86,141)</b>  |
| <b>Cash flows from financing activities:</b>  |                                 |                  |                  |
| Net (decrease) increase in debt under revolving credit agreements   | (20,000)                        | (37,000)         | 5,800            |
| Proceeds from issuance of senior notes  |                                 |                  | 55,000           |
| Cash dividends paid   | (2,193)                         | (2,164)          | (2,023)          |
| Proceeds from issuance of common stock, net   | 296                             | 816              | 56,815           |
| <b>Net cash (used in) provided by financing activities</b>  | <b>(21,897)</b>                 | <b>(38,348)</b>  | <b>115,592</b>   |
| <b>Net increase (decrease) in cash and cash equivalents</b>   | <b>20,340</b>                   | <b>(2,000)</b>   | <b>2,041</b>     |
| <b>Cash and cash equivalents at beginning of year</b>   | <b>12,060</b>                   | <b>14,060</b>    | <b>12,019</b>    |
| <b>Cash and cash equivalents at end of year</b>   | <b>\$ 32,400</b>                | <b>\$ 12,060</b> | <b>\$ 14,060</b> |

The accompanying notes are an integral part of the consolidated financial statements.

**Table of Contents****SYPRIS SOLUTIONS, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(in thousands, except for share data)

|  | Common Stock |        | Additional         | Retained  | Accumulated                                | Treasury |
|--|--------------|--------|--------------------|-----------|--|----------|
|  | Shares       | Amount | Paid-In<br>Capital | Earnings  | Other<br>Comprehensive<br>Income<br>(Loss) | Stock    |
| January 1, 2004 balance                                      | 14,283,323   | \$ 143 | \$ 83,541          | \$ 64,054 | \$ (2,346)                                 | \$       |
| Net income   |              |        |                    | 8,299     |  |          |
| Adjustment in minimum pension liability, net of tax of \$405 |              |        |                    |           | (637)                                      |          |
| Foreign currency translation gain                            |              |        |                    |           | 618  |          |
| Comprehensive income (loss)                                  |              |        |                    | 8,299     | (19)                                       |          |
| Cash dividends, \$0.12 per common share                      |              |        |                    | (2,126)   |  |          |
| Issuance of common shares                                    | 3,450,000    | 35     | 55,220             |           |  |          |
| Issuance of shares under Employee Stock Purchase Plan        | 48,537       |        | 499                |           |  |          |
| Exercise of stock options                                    | 138,640      | 1      | 1,086              |           |  |          |
| Stock option tax benefit                                     |              |        | 552                |           |  |          |
| December 31, 2004 balance                                    | 17,920,500   | 179    | 140,898            | 70,227    | (2,365)                                    |          |
| Net income   |              |        |                    | 5,321     |  |          |
| Adjustment in minimum pension liability, net of tax of \$132 |              |        |                    |           | (208)                                      |          |
| Foreign currency translation gain                            |              |        |                    |           | 639  |          |
| Comprehensive income   |              |        |                    | 5,321     | 431  |          |
| Cash dividends, \$0.12 per common share                      |              |        |                    | (2,173)   |  |          |
| Restricted common stock grant                                | 127,500      | 2      | (2)                |           |  |          |
| Noncash compensation   |              |        | 219                |           |  |          |
| Issuance of shares under Employee Stock Purchase Plan        | 36,177       |        | 350                |           |  |          |
| Exercise of stock options                                    | 81,481       | 1      | 465                |           |  |          |
| Stock option tax benefit                                     |              |        | 181                |           |  |          |
| December 31, 2005 balance                                    | 18,165,658   | 182    | 142,111            | 73,375    | (1,934)                                    |          |
| Net loss   |              |        |                    | (1,362)   |  |          |
| Adjustment in minimum pension liability, net of tax of \$578 |              |        |                    |           | 823  |          |
| Foreign currency translation loss                            |              |        |                    |           | (549)                                      |          |
| Comprehensive (loss) income                                  |              |        |                    | (1,362)   | 274  |          |
| Adoption of SFAS No. 158, net of \$1,386 of tax              |              |        |                    |           | (1,974)                                    |          |
| Cash dividends, \$0.12 per common share                      |              |        |                    | (2,197)   |  |          |
| Restricted common stock grant                                | 112,000      | 1      |                    |           |  |          |
| Noncash compensation   |              |        | 1,034              |           |  |          |
| Exercise of stock options                                    | 64,585       |        | 311                |           |  |          |
| Treasury stock   | (3,759)      |        |                    |           |  | (16)     |
| Stock option tax benefit                                     |              |        | 81                 |           |  |          |

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|                           |            |    |     |    |         |    |        |    |         |    |      |
|---------------------------|------------|----|-----|----|---------|----|--------|----|---------|----|------|
| December 31, 2006 balance | 18,338,484 | \$ | 183 | \$ | 143,537 | \$ | 69,816 | \$ | (3,634) | \$ | (16) |
|---------------------------|------------|----|-----|----|---------|----|--------|----|---------|----|------|

The accompanying notes are an integral part of the consolidated financial statements.

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**SYPRIS SOLUTIONS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Organization and Significant Accounting Policies**

*Consolidation Policy*

The accompanying consolidated financial statements include the accounts of Sypris Solutions, Inc. and its wholly-owned subsidiaries (collectively, Sypris or the Company) and have been prepared by the Company in accordance with the rules and regulations of the Securities and Exchange Commission. The Company's operations are domiciled in the United States (U.S.) and Mexico and serve a wide variety of domestic and international customers. All significant intercompany accounts and transactions have been eliminated.

*Nature of Business*

Sypris is a diversified provider of outsourced services and specialty products. The Company performs a wide range of manufacturing, engineering, design, testing, and other technical services, typically under multi-year, sole-source contracts with corporations and government agencies in the markets for truck components & assemblies, aerospace & defense electronics, and test & measurement services. The Company provides such services through its Industrial and Electronics Groups (Note 18).

*Use of Estimates*

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Specifically, due to the size and nature of the Company's aerospace and defense related programs, the estimation of total contract related revenues and cost at completion is subject to a wide range of variables. As contracts may require performance over several accounting periods, formal detailed cost-to-complete estimates are performed and updated monthly. Management's estimates of costs-to-complete change due to internal and external factors, such as labor rate and efficiency variances, revised estimates of warranty costs, estimated future material prices and customer specification and testing requirement changes. Actual results could differ from those estimates.

*Cash Equivalents and Restricted Cash*

Cash equivalents include all highly liquid investments with a maturity of three months or less when purchased, while restricted cash consists of amounts funded to the Company by a Landlord under a new lease agreement signed in 2006. Under the terms of the lease, the funds are required to be expended on leasehold improvements.

*Inventory*

Inventory is stated at the lower of cost or estimated net realizable value. Costs for raw materials, work in process and finished goods, excluding contract inventory included in the Electronics Group, is determined under the first-in, first-out method (see Note 2). Indirect inventories, which include perishable tooling, repair parts and other materials consumed in the manufacturing process but not incorporated into finished products are classified as raw materials.

Costs on long-term contracts and programs in progress represent recoverable costs incurred for production or contract-specific materials and equipment, allocable operating overhead, advances to suppliers and where appropriate, pre-contract engineering and design expenses. Pursuant to contract provisions, agencies of the U.S. Government and certain other customers have title to, or a security interest in, inventories related to such contracts as a result of advances, performance based payments and progress payments. Such advances and payments are reflected as an offset against the related inventory balances. General administrative expenses related to commercial products and services provided essentially under commercial terms and conditions are expensed as incurred.

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**SYPRIS SOLUTIONS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

The Company's reserve for excess and obsolete inventory is primarily based upon forecasted demand for its product sales, and any change to the reserve arising from forecast revisions is reflected in cost of sales in the period the revision is made.

*Property, Plant and Equipment*

Property, plant and equipment is stated at cost. Depreciation of property, plant and equipment is generally computed using the straight-line method over their estimated economic lives. For land improvements, buildings and building improvements, the estimated economic life is generally 40 years. Estimated economic lives range from three to fifteen years for machinery, equipment, furniture and fixtures. Leasehold improvements are amortized over the shorter of their economic life or the respective lease term using the straight-line method. Expenditures for maintenance, repairs and renewals of minor items are expensed as incurred. Major rebuilds and improvements are capitalized.

Interest cost is capitalized for qualifying assets during the period in which the asset is being installed and prepared for its intended use. Capitalized interest cost is amortized on the same basis as the related depreciation.

*Long-lived Assets*

When indicators of impairment exist, the Company evaluates long-lived assets for impairment and assesses their recoverability based upon anticipated undiscounted future cash flows. If facts and circumstances indicate that the carrying value of an asset or groups of assets, as applicable, is impaired, the long-lived asset or groups of long-lived assets are written down to their estimated fair value.

*Goodwill*

Goodwill is tested at least annually for impairment by calculating the estimated fair value of each business with which goodwill is associated. The estimated fair value is determined based on a discounted cash flow basis, which is compared to the carrying value of each applicable business. The Company tested goodwill of \$14,277,000 for impairment as of December 31, 2006 and 2005, determining that no impairment loss was necessary. As of December 31, 2006 and 2005, the carrying value of goodwill for the Industrial Group, Aerospace & Defense and the Test & Measurement segments was \$440,000, \$6,900,000 and \$6,937,000, respectively.

*Net Revenue and Cost of Sales*

Net revenue of products and services provided essentially under commercial terms and conditions are recorded upon delivery and passage of title, or when services are rendered. Related shipping and handling costs, if any, are included in costs of sales. Net revenue under service-type contracts is recorded as costs are incurred. Applicable estimated profits are included in earnings in the proportion that incurred costs bear to total estimated costs.

Net revenue under long-term, fixed-price contracts with aerospace & defense companies and agencies of the U.S. Government is recognized using the percentage of completion method, primarily using units-of-delivery as the basis to measure progress toward completing the contract and recognizing revenue. Estimated contract profits are taken into earnings in proportion to recorded sales. Sales under certain long-term fixed-price contracts that specifically provide for milestones are recorded as revenue upon achievement of performance milestones, limited to revenue recognized using the cost-to-cost method of accounting where sales and profits are recorded based on the ratio of costs incurred to estimated total costs at completion. Amounts representing contract change orders or claims are included in revenue when such costs are reliably estimated and realization is probable. When adjustments in contract value or estimated costs are determined, any changes from prior estimates are reflected in earnings in the current period. Anticipated losses on contracts are charged to earnings when determined to be probable.



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**SYPRIS SOLUTIONS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

Revenue recognized under the percentage of completion method of accounting totaled approximately \$72,815,000, \$94,419,000 and \$90,018,000 for the years ended December 31, 2006, 2005 and 2004, respectively. In 2006, 2005 and 2004, approximately 80%, 91% and 85%, respectively, of such amount was accounted for based on units of delivery and approximately 20%, 9% and 15%, respectively, was accounted for based on milestones or cost-to-cost.

*Product Warranty Costs*

The provision for estimated warranty costs is recorded at the time of sale and periodically adjusted to reflect actual experience. The accrued liability for warranty costs is included in the caption "Accrued liabilities" in the accompanying consolidated balance sheets.

*Concentrations of Credit Risk*

Financial instruments which potentially expose the Company to concentrations of credit risk consist of accounts receivable. The Company's customer base consists of a number of customers in diverse industries across geographic areas, primarily in North America and Mexico, various departments or agencies of the U.S. Government, and aerospace & defense companies under contract with the U.S. Government. The Company performs periodic credit evaluations of its customers' financial condition and does not require collateral on its commercial accounts receivable. Credit losses are provided for in the consolidated financial statements and consistently have been within management's expectations. Approximately 67% and 72% of accounts receivable outstanding at December 31, 2006 and 2005, respectively are due from the Company's four largest customers. More specifically, Dana Corporation (Dana) and ArvinMeritor, Inc. (ArvinMeritor) comprise 29% and 30%, respectively of December 31, 2006 outstanding accounts receivables. Similar amounts at December 31, 2005 were 34% and 27%, respectively.

The Industrial Group's largest customers for the year ended December 31, 2006 were Dana and ArvinMeritor, which represented approximately 41% and 19%, respectively, of the Company's total net revenue. Dana and ArvinMeritor were the Company's largest customers for the year ended December 31, 2005 which represented approximately 39% and 15%, respectively, of the Company's total net revenue. Dana and ArvinMeritor were the Company's largest customers for the year ended December 31, 2004, which represented approximately 36% and 15%, respectively, of the Company's total net revenue. The Company recognized revenue from contracts with the U.S. Government and its agencies approximating 8%, 9% and 9% of net revenue for the years ended December 31, 2006, 2005 and 2004, respectively. No other single customer accounted for more than 10% of the Company's total net revenue for the years ended December 31, 2006, 2005 or 2004.

*Foreign Currency Translation*

The functional currency for the Company's Mexican subsidiary is the Mexican peso. Assets and liabilities are translated at period end exchange rate, and income and expense items are translated at the period end weighted average exchange rate. The resulting translation adjustments are recorded in comprehensive income (loss) as a separate component of stockholders' equity. Remeasurement gains or losses for U.S. dollar denominated accounts of the Company's Mexican subsidiary are included in other income, net.

*Collective Bargaining Agreements*

Approximately 1,298 or 49% of the Company's employees, all of which are in the Industrial Group, are covered by collective bargaining agreements. Certain Mexico employees are covered by an annually ratified collective bargaining agreement and represent approximately 334 or 13% of the Company's workforce.

*Adoption of Recently Issued Accounting Standards*

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes," an interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in



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income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. Specifically, FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 were effective for the Company on January 1, 2007. The impact of the Company's reassessment of its tax positions in accordance with the requirements of FIN 48 is expected to be immaterial; however, the Company is awaiting additional guidance expected to be issued in March 2007.

On September 29, 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R). On December 31, 2006, the Company adopted the recognition and disclosure provisions of SFAS No. 158, which required the Company to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plan in the December 31, 2006 statement of financial position, with a corresponding adjustment to accumulated other comprehensive income, net of tax. The adjustment to accumulated other comprehensive income at adoption represents the net unrecognized actuarial losses and unrecognized prior service costs, all of which were previously netted against the plan's funded status in the Company's statement of financial position pursuant to the provisions of SFAS No. 87. These amounts, noted below, will be subsequently recognized as net periodic pension cost pursuant to the Company's historical accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension cost in the same periods will be recognized a component of other comprehensive income. Those amounts will be subsequently recognized as a component of net periodic pension cost pursuant to the Company's historical accounting policy for amortizing such amounts.

The incremental effects of adopting the provisions of SFAS No. 158 on the Company's statement of financial position at December 31, 2006 are presented in the following table. The adoption of SFAS No. 158 had no effect on the Company's consolidated statement of operations for the year ended December 31, 2006, or for any prior period presented, and it will not effect the Company's operating results in future periods. Had the Company not been required to adopt SFAS No. 158 at December 31, 2006, it would have recognized an additional minimum liability pursuant to the provisions of SFAS No. 87. The effect of recognizing the additional minimum liability is included in table below in the column labeled Prior to Application of SFAS No. 158.

|  | December 31, 2006 |                |          |
|--|-------------------|----------------|----------|
|  | Prior to          | Effect of      |          |
|  | Adopting          | Adopting       |          |
|  | SFAS              | Reported       |          |
|  | No. 158           | SFAS           | Balance  |
|  |                   | (in thousands) |          |
| Other assets (pension)                 | \$ 5,071          | \$ (3,212)     | \$ 1,859 |
| Other liabilities (pension)            | (3,989)           | (148)          | (4,137)  |
| Other liabilities (deferred taxes)     | 1,446             | 1,307          | 2,753    |
| Accumulated other comprehensive income | (3,735)           | (3,360)        | (7,095)  |

Accumulated other comprehensive loss at December 31, 2006 includes the following amounts that have not yet been recognized in net periodic pension cost: unrecognized prior service credits of \$443,000 (\$271,000 net of tax) and unrecognized actuarial losses \$7,538,000 (\$4,606,000 net of tax). The prior service credit and actuarial loss included in accumulated other comprehensive loss and expected to be recognized in net periodic pension cost during the fiscal year-ended December 31, 2007 is \$51,000 (\$31,000 net of tax) and \$255,000 (\$156,000 net of tax), respectively.

In December 2004, the FASB issued FASB Statement No. 123 (revised 2004), Share-Based Payment. SFAS No. 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and



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amends FASB Statement No. 95, *Statement of Cash Flows*. Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized as expense based on their fair values. Pro forma disclosure is no longer an alternative. The Company adopted SFAS No. 123(R) on January 1, 2006, using the modified prospective method and, accordingly, the financial statements for prior periods do not reflect any restated amounts. In accordance with Statement 123(R), the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

As a result, selling general and administrative expense, net loss, basic loss per common share and diluted loss per common share for the year ended December 31, 2006 includes \$1,034,000, \$646,000, \$0.04 and \$0.04, respectively related to non-cash compensation expense. Non-cash compensation expense included in selling general and administrative expense, net loss, basic earnings per common share and diluted earnings per common share for 2005 were \$219,000, \$134,000, \$0.01 and \$0.01, respectively. The Company had no non-cash compensation for the year ended December 31, 2004. No stock-based compensation was capitalized into inventory, or property plant and equipment during 2006 or 2005. In conjunction with the adoption of SFAS No. 123(R), the Company selected the straight-line amortization method for graded vesting options granted subsequent to January 1, 2006. Prior to that date, the Company used an accelerated method previously required for graded vesting awards.

As permitted by SFAS No. 123, the Company historically accounted for stock option grants in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Had the Company adopted SFAS No. 123(R) in prior periods, the impact would have approximated the impact of SFAS No. 123 pro forma disclosure below, excluding the impact of the underwater option accelerations in 2005. The Company's pro forma information is as follows (in thousands except per share data):

|  | <b>Years ended December 31,</b> |                 |
|--|---------------------------------|-----------------|
|  | <b>2005</b>                     | <b>2004</b>     |
| Net income   | \$ 5,321                        | \$ 8,299        |
| Pro forma stock-based compensation expense, net of tax | 2,597                           | 1,277           |
| <b>Pro forma net income</b>                            | <b>\$ 2,724</b>                 | <b>\$ 7,022</b> |
| Pro forma earnings per common share:                   |                                 |                 |
| Basic  | \$ 0.15                         | \$ 0.41         |
| Diluted  | \$ 0.15                         | \$ 0.40         |

On March 1, 2005, April 25, 2005 and December 28, 2005, the Board of Directors approved resolutions to accelerate the vesting for underwater options as of March 11, 2005, April 25, 2005 and December 30, 2005, respectively in order to reduce future compensation expense related to outstanding options. Substantially all other options terms remained unchanged. After amendment of the underlying option agreements, compensation expense to be recognized in the statement of operations, subsequent to the adoption of SFAS No. 123(R) was reduced by approximately \$1,573,000, net of tax.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4. SFAS No. 151 clarifies that abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are required to be recognized as current period charges. The provisions of SFAS No. 151 are effective for fiscal years beginning after June 15, 2005. The Company adopted SFAS No. 151 on January 1, 2006. The impact on the Company's consolidated financial position and results of operations was not material.

*Reclassifications*

Certain amounts in the Company's 2005 consolidated financial statements have been reclassified to conform to the 2006 presentation.



**Table of Contents****SYPRIS SOLUTIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****(2) Major Customer Chapter 11 Filing**

On March 3, 2006 (Filing Date), the Company's largest customer, Dana Corporation (Dana), and 40 of its U.S. subsidiaries, filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York. Dana's European, South American, Asia-Pacific, Canadian and Mexican subsidiaries were excluded from the Chapter 11 filing. On May 10, 2006, the Company reached an agreement with Dana (Agreement) under which both parties agreed, among other things, that Dana owed the Company approximately \$22,100,000, subject to reconciliation. Of this amount, the Agreement also provided the Company with a \$9,200,000 progress payment on May 11, 2006, as well as reduced payment terms on a prospective basis. During the third quarter and in conjunction with the reconciliation under the Agreement, the Company successfully reconciled approximately \$9,900,000 of payables to Dana against receivables from Dana. As of December 31, 2006, Dana and the Company had substantially completed the reconciliation process under the Agreement. Accordingly, as of December 31, 2006 (excluding certain gain contingencies), net amounts expected to be collected from pre-petition Dana (Debtor in Possession) approximated \$1,100,000, although Dana has yet to pay such amounts. The Company also had a \$3,300,000 million refundable deposit with Dana at December 31, 2006 for a specified business line yet to be transferred to us for which the Company is pursuing reimbursement.

In addition, on December 6, 2006, an independent arbitrator initially held that Dana had breached certain of its agreements with Sypris by failing to transfer certain volumes of business and by failing to pay the appropriate prices for the volumes that were transferred. As a result, the arbitrator awarded payments to Sypris totaling \$1,818,212 plus \$146,258 per month on an ongoing basis until such breaches are cured. On January 29, 2007, this award became final. The arbitration ruling was subject to a 30 day clarification period and was not included in the 2006 statement of financial position. The financial statement impact award is expected to be recognized in 2007 upon resolution of the aforementioned contingencies.

The Company continues to pursue additional offsets, possible gain contingencies, attorneys' fees, interest and other relief through the Bankruptcy Court and other dispute resolution efforts, the outcome of which is uncertain at this time. For the year ended December 31, 2006, the Company incurred over \$1,511,000 of legal and other professional fees for Dana related issues. Such costs are included in selling, general and administrative expense in the consolidated statement of operations.

**(3) Accounts Receivable**

Accounts receivable consists of the following:

|                                 | December 31,   |           |
|---------------------------------|----------------|-----------|
|                                 | 2006           | 2005      |
|                                 | (in thousands) |           |
| Commercial                      | \$ 60,529      | \$ 89,342 |
| U.S. Government                 | 849            | 7,988     |
|                                 | 61,378         | 97,330    |
| Allowance for doubtful accounts | (1,502)        | (1,898)   |
|                                 | \$ 59,876      | \$ 95,432 |

Accounts receivable from the U.S. Government includes amounts due under long-term contracts, all of which are billed at December 31, 2006 and 2005, of \$746,000 and \$7,118,000 respectively.





**Table of Contents****SYPRIS SOLUTIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****(4) Inventory**

Inventory consists of the following:

|   | December 31,     |                  |
|---|------------------|------------------|
|   | 2006             | 2005             |
|   | (in thousands)   |                  |
| Raw materials, including perishable tooling of \$1,276 and \$2,301 in 2006 and 2005, respectively           | \$ 28,885        | \$ 35,440        |
| Work in process   | 12,576           | 16,275           |
| Finished goods  | 10,129           | 14,525           |
| Costs relating to long-term contracts and programs, net of amounts attributed to revenue recognized to date | 40,451           | 34,690           |
| Progress payments related to long-term contracts and programs   | (11,107)         | (14,864)         |
| Reserve for excess and obsolete inventory   | (6,788)          | (6,342)          |
|   | <b>\$ 74,146</b> | <b>\$ 79,724</b> |

**(5) Other Current Assets**

Other current assets consist of the following:

|                         | December 31,     |                  |
|-------------------------|------------------|------------------|
|                         | 2006             | 2005             |
|                         | (in thousands)   |                  |
| Deferred contract costs | \$ 18,813        | \$ 10,890        |
| Other                   | 15,201           | 15,130           |
|                         | <b>\$ 34,014</b> | <b>\$ 26,020</b> |

Included in other current assets are prepaid expenses, income taxes refundable, and other items, none of which exceed 5% of total current assets.

**(6) Property, Plant and Equipment**

Property, plant and equipment consist of the following:

|  | December 31,   |          |
|--|----------------|----------|
|  | 2006           | 2005     |
|  | (in thousands) |          |
| Land and land improvements                   | \$ 5,408       | \$ 5,448 |
| Buildings and building improvements          | 37,304         | 37,194   |
| Machinery, equipment, furniture and fixtures | 252,174        | 244,606  |

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|                          |            |            |
|--------------------------|------------|------------|
| Construction in progress | 4,408      | 9,633      |
|                          | 299,294    | 296,881    |
| Accumulated depreciation | (143,953)  | (120,162)  |
|                          | \$ 155,341 | \$ 176,719 |

Depreciation expense totaled approximately \$27,819,000, \$25,295,000 and \$18,470,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Approximately \$334,000 and \$488,000 was included in accounts payable for capital expenditures at December 31, 2006 and 2005, respectively.

**Table of Contents****SYPRIS SOLUTIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****(7) Other Assets**

Other assets consist of the following:

|                                       | <b>December 31,</b>   |                  |
|---------------------------------------|-----------------------|------------------|
|                                       | <b>2006</b>           | <b>2005</b>      |
|                                       | <b>(in thousands)</b> |                  |
| <b>Intangible assets:</b>             |                       |                  |
| Gross carrying value:                 |                       |                  |
| Industrial Group                      | \$ 3,407              | \$ 3,407         |
| Aerospace & Defense                   | 920                   | 795              |
| Test & Measurement                    | 720                   | 720              |
| Electronics Group                     | 1,640                 | 1,515            |
| <b>Total gross carrying value</b>     | <b>5,047</b>          | <b>4,922</b>     |
| Accumulated amortization:             |                       |                  |
| Industrial Group                      | (1,398)               | (1,011)          |
| Aerospace & Defense                   | (424)                 | (361)            |
| Test & Measurement                    | (699)                 | (499)            |
| Electronics Group                     | (1,123)               | (860)            |
| <b>Total accumulated amortization</b> | <b>(2,521)</b>        | <b>(1,871)</b>   |
| Intangible assets, net                | 2,526                 | 3,051            |
| Prepaid benefit cost                  | 2,015                 | 5,181            |
| Other                                 | 3,436                 | 5,160            |
|                                       | <b>\$ 7,977</b>       | <b>\$ 13,392</b> |

Intangible assets consist primarily of long-term supply agreements in the Industrial Group and non-compete and royalty agreements in both segments of the Electronics Group. The weighted average amortization period for intangible assets was 8 years at December 31, 2006 and 2005, respectively. Other includes unamortized loan costs for the Credit Agreement and Senior Notes of approximately \$512,000 and \$451,000, respectively, at December 31, 2006. Similar amounts for 2005 were \$698,000 and \$419,000, respectively. Amortization expense is expected to approximate \$600,000 annually over the next five years.

**(8) Accrued Liabilities**

Accrued liabilities consist of the following:

**December 31,**  
**2006                      2005**

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|  | (in thousands) |           |
|--|----------------|-----------|
| Salaries, wages, employment taxes and withholdings | \$ 2,248       | \$ 2,329  |
| Employee benefit plans                             | 3,827          | 5,247     |
| Income, property and other taxes                   | 2,437          | 4,599     |
| Unearned revenue                                   | 4,386          | 7,453     |
| Other  | 6,532          | 5,276     |
|  | \$ 19,430      | \$ 24,904 |

Included in other accrued liabilities are accrued operating expenses, accrued warranty expenses, accrued interest and other items, none of which exceed 5% of total current liabilities.

**Table of Contents****SYPRIS SOLUTIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****(9) Long-Term Debt**

Long-term debt consists of the following:

|                           | <b>December 31,</b>   |             |
|---------------------------|-----------------------|-------------|
|                           | <b>2006</b>           | <b>2005</b> |
|                           | <b>(in thousands)</b> |             |
| Revolving credit facility | \$ 5,000              | \$ 25,000   |
| Senior notes              | 55,000                | 55,000      |
|                           | 60,000                | 80,000      |
| Less current portion      | 5,000                 |             |
|                           | \$ 55,000             | \$ 80,000   |

On June 10, 2004 and August 19, 2004, the Company issued a total of \$55,000,000 of senior notes through a private placement transaction (the Senior Notes). The Senior Notes consist of \$7,500,000 of notes due in 2009 bearing interest at 4.73%, \$27,500,000 of notes due in 2011 bearing interest at 5.35% and a \$20,000,000 note due in 2014 bearing interest at 5.78%. The Company agreed to terms to amend the Senior Notes in March 2007 to enable the ratable repayment of \$25 million of the outstanding Senior Notes, revise certain financial covenants, modify the June 30, 2014 principle payment to June 30, 2012, increase our interest rates and among other things, add a perfected security interest in our accounts receivable, inventory and equipment. Under the agreed to terms, other terms of the Senior Notes remain substantially unchanged.

The Company also has a credit agreement with a syndicate of banks (the Credit Agreement) that was entered into in October 1999. At December 31, 2006, the Company had total availability for borrowings and letters of credit under the revolving credit facility of \$95,000,000 unrestricted along with an unrestricted cash balance of \$32,400,000, which provides for total cash and borrowing capacity of \$127,400,000. Approximately \$7,713,000 of the unrestricted cash balance relates to our Mexican subsidiaries. On September 13, 2005, the Company signed a collateral sharing agreement which pledged 65% of the stock in our Mexico subsidiary as collateral under the Credit Agreement. In March 2007, the Company agreed to terms to amend the Credit Agreement to extend the Credit Agreement through October 2009, revise certain financial covenants providing more flexibility in our financing structure, limit total borrowings at \$50.0 million, with \$50.0 million of additional borrowings available upon lead bank approval, and add a security interest in our accounts receivable, inventory and equipment. Under the agreed to terms, other terms of the Credit Agreement remain substantially unchanged. Current maturities of long-term debt represent amounts due under a short-term borrowing arrangement included in the Credit Agreement. Standby letters of credit up to a maximum of \$15,000,000 may be issued under the Credit Agreement of which \$1,720,000 were issued at December 31, 2006. Standby letters of credit at December 31, 2005 were not significant.

Under the amended terms of the amended Credit Agreement, interest rates are determined at the time of borrowing and are based on the London Interbank Offered Rate plus a margin of 1.00% to 3.5%; or the greater of the prime rate or the federal funds rate plus 0.5%, plus a margin up to 0.75%. The Company also pays a fee of 0.20% to 0.50% on the unused portion of the aggregate commitment. The margins applied to the respective interest rates and the commitment fee are adjusted quarterly and are based on the Company's ratio of net funded debt to earnings before interest, taxes, depreciation and amortization.

The Credit Agreement and Senior Notes contain customary affirmative and negative covenants, including financial covenants requiring the maintenance of interest coverage and leverage ratios and minimum levels of net worth. As of December 31, 2006, the Company was in compliance with all covenants.

The weighted average interest rate for outstanding borrowings at December 31, 2006 was 6.5%. The weighted average interest rates for borrowings during the years ended December 31, 2006, 2005 and 2004 were 5.5%, 5.2% and 4.8% respectively. Interest incurred, net of amounts capitalized, during the years ended December 31, 2006, 2005 and 2004 totaled approximately \$4,275,000, \$6,279,000 and \$2,584,000, respectively.



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The Company had no capitalized interest in 2006. Capitalized interest for the years ended December 31, 2005 and 2004 approximated \$328,000 and \$355,000, respectively. Interest paid during the years ended December 31, 2006, 2005 and 2004 totaled approximately \$3,843,000, \$6,541,000 and \$2,328,000, respectively.

**(10) Fair Value of Financial Instruments**

Cash, accounts receivable, accounts payable and accrued liabilities are reflected in the consolidated financial statements at their carrying amount which approximates fair value because of the short-term maturity of those instruments. The carrying value for the Senior Notes exceeded the fair value by approximately \$1,014,000 at December 31, 2006. The carrying amount of debt outstanding at December 31, 2006 and 2005 under the Credit Agreement approximates fair value because borrowings are for terms of less than six months and have rates that reflect currently available terms and conditions for similar debt.

**(11) Employee Benefit Plans**

The Industrial Group sponsors noncontributory defined benefit pension plans (the Pension Plans) covering certain of its employees. The Pension Plans covering salaried and management employees provide pension benefits that are based on the employees' highest five-year average compensation within ten years before retirement. The Pension Plans covering hourly employees and union members generally provide benefits at stated amounts for each year of service. All of the Company's pension plans are frozen to new participants and certain plans are frozen to additional benefit accruals. The Company's funding policy is to make the minimum annual contributions required by the applicable regulations. The Pension Plans' assets are primarily invested in equity securities and fixed income securities.

The following table details the components of pension (income) expense:

|   | Years ended December 31, |         |         |
|---|--------------------------|---------|---------|
|   | 2006                     | 2005    | 2004    |
|   | (in thousands)           |         |         |
| Service cost                                  | \$ 98                    | \$ 105  | \$ 124  |
| Interest cost on projected benefit obligation | 2,152                    | 2,202   | 2,272   |
| Net amortizations and deferrals               | 439                      | 503     | 480     |
| Expected return on plan assets                | (2,791)                  | (2,722) | (2,589) |
|   | \$ (102)                 | \$ 88   | \$ 287  |

**Table of Contents****SYPRIS SOLUTIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

The following are summaries of the changes in the benefit obligations and plan assets and of the funded status of the Pension Plans:

|  | <b>December 31,</b>   |                   |
|--|-----------------------|-------------------|
|  | <b>2006</b>           | <b>2005</b>       |
|  | <b>(in thousands)</b> |                   |
| <b>Change in benefit obligation:</b>   |                       |                   |
| Benefit obligation at beginning of year  | \$ 40,407             | \$ 39,991         |
| Service cost   | 98                    | 105               |
| Interest cost  | 2,152                 | 2,202             |
| Actuarial loss   | 546                   | 140               |
| Benefits paid  | (2,092)               | (2,031)           |
| <b>Benefit obligation at end of year</b>   | <b>\$ 41,111</b>      | <b>\$ 40,407</b>  |
| <b>Change in plan assets:</b>  |                       |                   |
| Fair value of plan assets at beginning of year                                     | \$ 34,383             | \$ 34,232         |
| Actual return on plan assets   | 5,420                 | 2,172             |
| Company contributions  | 1,122                 | 10                |
| Benefits paid  | (2,092)               | (2,031)           |
| <b>Fair value of plan assets at end of year</b>                                    | <b>\$ 38,833</b>      | <b>\$ 34,383</b>  |
| <b>Underfunded status of the plans</b>   | <b>\$ (2,278)</b>     | <b>\$ (6,024)</b> |
| <b>Balance sheet assets (liabilities):</b>   |                       |                   |
| Other assets   | \$ 1,859              | \$ 4,968          |
| Other liabilities  | (4,137)               | (6,511)           |
| Accumulated other comprehensive loss   | 7,095                 | 5,136             |
| <b>Net amount recognized</b>   | <b>\$ 4,817</b>       | <b>\$ 3,593</b>   |
| <b>Pension plans with accumulated benefit obligation in excess of plan assets:</b> |                       |                   |
| Projected benefit obligation   | \$ 25,599             | \$ 24,996         |
| Accumulated benefit obligation   | 25,452                | 24,867            |
| Fair value of plan assets  | 21,462                | 18,356            |
| <b>Projected benefit obligation and net periodic pension cost assumptions:</b>     |                       |                   |
| Discount rate  | 5.50%                 | 5.60%             |
| Rate of compensation increase  | 4.00                  | 4.00              |
| Expected long-term rate of return on plan assets                                   | 8.25                  | 8.25              |
| <b>Weighted average asset allocation:</b>  |                       |                   |
| Equity securities  | 65%                   | 67%               |
| Debt securities  | 35                    | 33                |
| <b>Total</b>   | <b>100%</b>           | <b>100%</b>       |



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Reconciliation of the funded status of the plans for the year ended December 31, 2005 is as follows:

|                                 |            |
|---------------------------------|------------|
| Underfunded status of the plans | \$ (6,024) |
| Unrecognized actuarial loss     | 9,515      |
| Unrecognized prior service cost | 102        |
| Net asset recognized            | \$ 3,593   |

The Company uses November 30 as the measurement date for the Pension Plans. Total estimated contributions expected to be paid to the plans during 2007 ranges from \$300,000 to \$500,000. The expected long-term rates of return on plan assets for determining net periodic pension cost for 2006 and 2005 were chosen by the

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Company from a best estimate range determined by applying anticipated long-term returns and long-term volatility for various assets categories to the target asset allocation of the plan. The target asset allocation of plan assets is equity securities ranging 55-65% and fixed income securities ranging 35-45% of total investments. At December 31, 2005, the equity percentage temporarily exceeded the range due to equity security returns.

At December 31, 2006, the benefits expected to be paid in each of the next five fiscal years, and in aggregate for the five fiscal years thereafter are as follows (in thousands):

|            |                  |
|------------|------------------|
| 2007       | \$ 2,550         |
| 2008       | 2,689            |
| 2009       | 2,809            |
| 2010       | 2,902            |
| 2011       | 2,984            |
| Thereafter | 15,697           |
|            | <b>\$ 29,631</b> |

The Company sponsors a defined contribution plan (the Defined Contribution Plan) for substantially all employees of the Company. The Defined Contribution Plan is intended to meet the requirements of Section 401(k) of the Internal Revenue Code. The Defined Contribution Plan allows the Company to match participant contributions and provide discretionary contributions. Contributions to the Defined Contribution Plan in 2006, 2005 and 2004 totaled approximately \$2,142,000, \$2,543,000 and \$3,238,000, respectively.

The Company has self-insured medical plans (the Medical Plans) covering substantially all employees. The number of employees participating in the Medical Plans was approximately 1,700, 1,853 and 1,850 at December 31, 2006, 2005 and 2004, respectively. The Medical Plans limit the Company's annual obligations to fund claims to specified amounts per participant. The Company is adequately insured for amounts in excess of these limits. Employees are responsible for payment of a portion of the premiums. During 2006, 2005 and 2004, the Company charged approximately \$14,245,000, \$10,694,000 and \$10,640,000, respectively, to operations related to medical claims incurred and estimated, reinsurance premiums, and administrative costs for the Medical Plans.

**(12) Commitments and Contingencies**

The Company leases certain of its real property and certain equipment, vehicles and computer hardware under operating leases with terms ranging from month-to-month to ten years and which contain various renewal and rent escalation clauses. Future minimum annual lease commitments under operating leases that have initial or remaining noncancelable lease terms in excess of one year as of December 31, 2006 are as follows (in thousands):

|                     |                  |
|---------------------|------------------|
| 2007                | \$ 8,311         |
| 2008                | 7,559            |
| 2009                | 6,297            |
| 2010                | 2,813            |
| 2011                | 2,620            |
| 2012 and thereafter | 8,812            |
|                     | <b>\$ 36,412</b> |

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Rent expense for the years ended December 31, 2006, 2005 and 2004 totaled approximately \$8,362,000 \$8,377,000 and \$7,427,000, respectively.

The Company entered into agreements for the sale and leaseback of certain specific manufacturing and testing equipment during 2001. The terms of the operating leases range from five to nine years and the Company has the option to purchase the equipment at the expiration of the respective lease term at a fixed price based upon the equipment's estimated residual value. Lease payments on these operating leases are guaranteed by the Company.

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**SYPRIS SOLUTIONS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

Proceeds from the sale and leaseback transactions during 2001 were approximately \$5,420,000 and the transactions resulted in a deferred loss of approximately \$787,000. Deferred losses on sales and leaseback transactions are amortized on a straight-line basis over the term of the respective leases. Cumulative deferred losses, including deferred losses incurred prior to 2001, net of amortization, was approximately \$396,000 and \$542,000 as of December 31, 2006 and 2005, respectively, which is included in other assets. Future minimum annual lease commitments related to these leases are included in the above schedule. As of December 31, 2006, the Company had outstanding purchase commitments of approximately \$32,440,000 primarily for the acquisition of inventory and manufacturing equipment.

The Company bears insurance risk as a member of a group captive insurance entity for certain general liability, automobile and workers compensation insurance programs, a self insured worker's compensation program and a self-insured employee health program. The Company records estimated liabilities for its insurance programs based on information provided by the third-party plan administrators, historical claims experience, expected costs of claims incurred but not paid, and expected costs to settle unpaid claims. The Company monitors its estimated insurance-related liabilities on a quarterly basis. As facts change, it may become necessary to make adjustments that could be material to the Company's consolidated results of operations and financial condition. The Company believes that its present insurance coverage and level of accrued liabilities are adequate.

The Company is involved in certain litigation and contract issues arising in the normal course of business. While the outcome of these matters cannot, at this time, be predicted in light of the uncertainties inherent therein, management does not expect that these matters will have a material adverse effect on the consolidated financial position or results of operations of the Company. For example, the Company has purchased certain plants with various potential environmental issues under purchase agreements which include indemnification provisions for, among other things, environmental conditions that existed on the sites at closing.

**(13) Stock Option and Purchase Plans**

The Company's stock compensation program provides for the grant of performance-based stock options (Target Options), restricted shares, and stock options. A total of 3,000,000 shares of common stock were reserved for issuance under the 2004 equity plan. The aggregate number of shares available for future grant as of December 31, 2006 and 2005 was 2,033,271 and 2,386,607, respectively.

The terms and conditions of the Target Options grants provide for the determination of the exercise price and the beginning of the vesting period to occur when the fair market value of the Company's common stock achieves certain targeted price levels. The Company has not granted Target Options since the first quarter of 2003.

On August 1, 2005, the Company first issued restricted shares under the 2004 Equity Plan, including certain shares subject to performance requirements (Performance Restricted Stock). The 2004 Equity Plan provides for restrictions which lapse after one, two, three or four years for certain grants or for certain other shares, one-third of the restriction is removed after three, five and seven years, respectively. During the restricted period, which is commensurate with each vesting period, the recipients receive dividends and voting rights for the shares. Generally, if a recipient leaves the Company before the end of the restricted period or if performance requirements, if any, are not met, the shares will be forfeited.

The Company has certain stock compensation plans under which options to purchase common stock may be granted to officers, key employees and non-employee directors. Options may be granted at not less than the market price on the date of grant. Stock option grants under the 2004 Equity Plan include both six and ten year lives along with graded vesting over three, four and five years of service.

Fair value for restricted shares is equal to the stock price on the date of grant. The fair values of Target Options were determined by a third party valuation firm using a Monte-Carlo Simulation Model, while the fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option-pricing method. The Company uses historical Company and industry data to estimate the expected price volatility, the expected option



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life, the expected forfeiture rate and the expected dividend yield. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. The following weighted average assumptions were used to estimate the fair value of options granted using the Black-Scholes option-pricing model:

|                          | Years ended December 31, |       |       |
|--------------------------|--------------------------|-------|-------|
|                          | 2006                     | 2005  | 2004  |
| Expected life (years)    | 5.3                      | 5.8   | 6.8   |
| Expected volatility      | 48.0%                    | 53.0% | 55.5% |
| Risk-free interest rates | 4.81%                    | 4.12% | 3.76% |
| Expected dividend yield  | 1.26%                    | 1.06% | 0.70% |

Target Options to purchase 17,500 shares of common stock were forfeited during 2006. Target Options for which the targeted price level has not been achieved of 269,500 and 287,000 shares at December 31, 2006 and 2005, respectively, are excluded from disclosures of options outstanding.

A summary of the restricted stock activity is as follows (excluding performance restricted stock):

|                                       | Number of<br>Shares | Weighted<br>Average      |
|---------------------------------------|---------------------|--------------------------|
|                                       |                     | Grant Date<br>Fair Value |
| Nonvested shares at January 1, 2006   | 107,500             | 12.98                    |
| Granted                               | 92,000              | 10.34                    |
| Forfeited                             | (1,500)             | 10.36                    |
| Vested                                | (6,000)             | 13.30                    |
| Nonvested shares at December 31, 2006 | 192,000             | \$ 11.72                 |

The total fair value of shares vested during 2006 was \$42,000. No shares vested during 2005 or 2004. In conjunction with the vesting of restricted shares and payment of taxes thereon, the Company received into treasury 2,259 restricted shares at \$7.06 per share, the closing market price on the date the restricted stock vested. Such repurchased shares are presented as treasury stock in the stockholders' equity section of the consolidated balance sheet. At December 31 2006 and 2005, the Company also had 40,000 and 20,000 shares, respectively of outstanding Performance Restricted Stock.

The following table summarizes option activity for the year ended December 31, 2006:

| Number<br>of<br>Shares | Weighted-<br>average<br>Exercise Price | Weighted-<br>average<br>Remaining | Aggregate<br>Intrinsic<br>Value |
|------------------------|--|-----------------------------------|---------------------------------|
|------------------------|--|-----------------------------------|---------------------------------|

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|                                  |           | <b>Per Share</b> | <b>Term</b> |            |
|----------------------------------|-----------|------------------|-------------|------------|
| Outstanding at January 1, 2006   | 2,288,945 | \$ 9.98          |             |            |
| Granted                          | 257,836   | 9.66             |             |            |
| Forfeited                        | (44,700)  | 9.41             |             |            |
| Expired                          | (61,335)  | 10.41            |             |            |
| Exercised                        | (137,429) | 7.68             |             |            |
| Outstanding at December 31, 2006 | 2,303,317 | \$ 10.08         | 4.04        | \$ 297,728 |
| Exercisable at December 31, 2006 | 1,873,838 | \$ 10.38         | 3.95        | \$ 258,361 |

The weighted average grant date fair value based on the Black-Scholes option pricing model for options granted in the year ended December 31, 2006, 2005 and 2004 was \$4.13, \$5.65 and \$8.87 per share, respectively. The total intrinsic value of options exercised was \$284,000, \$476,000 and \$1,471,000 during the years ended December 31, 2006, 2005 and 2004, respectively.

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**SYPRIS SOLUTIONS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED**

As of December 31, 2006, there was \$2,427,000 of total unrecognized compensation cost, after estimated forfeitures, related to unvested share-based compensation granted under our plans. That cost is expected to be recognized over a weighted-average period of 2.3 years. The total fair value of option shares vested was \$1,020,000, \$7,958,000 and \$1,396,000 during the years ended December 31, 2006, 2005 and 2004, respectively.

The Company stock purchase plan was terminated effective January 31, 2005 and previously provided substantially all employees who satisfied the eligibility requirements the opportunity to purchase shares of the Company's common stock on a compensation deduction basis. The purchase price was the lower of 85% of the fair market value of the common stock on the first or last business day of the purchase period. Payroll deductions could not exceed \$6,000 for any six-month cycle. During 2005 and 2004, a total of 36,177 and 48,357 shares, respectively, were issued under the plan.

**(14) Stockholders' Equity**

On March 17, 2004, the Company completed a public stock offering of 3,000,000 shares of its common stock, and, on April 8, 2004, an additional 450,000 shares were issued through the exercise of an over-allotment option. The shares were sold at \$17.00 per share and generated proceeds, after underwriting discounts and expenses, of approximately \$55,255,000. Proceeds from the offering were primarily used to repay debt.

The Company has a stockholder rights plan, under which each stockholder owns one right for each outstanding share of common stock owned. Each right entitles the holder to purchase one one-thousandth of a share of a new series of preferred stock at an exercise price of \$63.00. The rights trade along with, and not separately from, the shares of common stock unless they become exercisable. If any person or group acquires or makes a tender offer for 15% or more of the common stock of the Company (except in transactions approved by the Company's Board of Directors in advance) the rights become exercisable, and they will separate, become tradable, and entitle stockholders, other than such person or group, to acquire, at the exercise price, preferred stock with a market value equal to twice the exercise price. If the Company is acquired in a merger or other business combination with such person or group, or if 50% of its earning power or assets are sold to such person or group, each right will entitle its holder, other than such person or group, to acquire, at the exercise price, shares of the acquiring company's common stock with a market value of twice the exercise price. The rights will expire on October 23, 2011, unless redeemed or exchanged earlier by the Company, and will be represented by existing common stock certificates until they become exercisable.

As of December 31, 2006, 24,850 shares of the Company's preferred stock were designated as Series A Preferred Stock in connection with the adoption of the stockholder rights plan. There are no shares of Series A Preferred Stock currently outstanding. The holders of Series A Preferred Stock will have voting rights, be entitled to receive dividends based on a defined formula and have certain rights in the event of the Company's dissolution. The shares of Series A Preferred Stock shall not be redeemable. However, the Company may purchase shares of Series A Preferred Stock in the open market or pursuant to an offer to a holder or holders.

Cumulative losses recorded in other comprehensive loss for adjustments in the minimum pension liability, net of tax, totaled \$4,342,000, \$3,191,000 and \$2,983,000 at December 31, 2006, 2005 and 2004, respectively. Other comprehensive loss also included cumulative foreign currency translation gains of \$708,000, \$1,257,000, \$618,000 at December 31, 2006, 2005 and 2004, respectively. For the year ended December 31, 2006 and 2005, other income, net includes foreign currency remeasurement gains of \$102,000 and \$871,000, respectively. Foreign currency remeasurement gains for the year ended December 31, 2004 were not significant.



**Table of Contents****SYPRIS SOLUTIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED****(15) Income Taxes**

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Accordingly, deferred income taxes have been provided for temporary differences between the recognition of revenue and expenses for financial and income tax reporting purposes and between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements.

The components of (loss) income before taxes are as follows:

|          | Years ended December 31, |          |           |
|----------|--------------------------|----------|-----------|
|          | 2006                     | 2005     | 2004      |
|          | (in thousands)           |          |           |
| Domestic | \$ (11,560)              | \$ 579   | \$ 8,423  |
| Foreign  | 8,104                    | 6,989    | 3,513     |
|          | \$ (3,456)               | \$ 7,568 | \$ 11,936 |

The components of income tax (benefit) expense are as follows:

|   | Years ended December 31, |          |          |
|---|--------------------------|----------|----------|
|   | 2006                     | 2005     | 2004     |
|   | (in thousands)           |          |          |
| Current:                                    |                          |          |          |
| Federal                                     | \$ (214)                 | \$ 661   | \$ (350) |
| State                                       | 320                      | 23       | 33       |
| Foreign                                     | 2,879                    | 2,654    | 262      |
| Total current income tax expense (benefit)  | 2,985                    | 3,338    | (55)     |
| Deferred:                                   |                          |          |          |
| Federal                                     | (3,830)                  | (519)    | 2,424    |
| State                                       | (720)                    | 6        | 519      |
| Foreign                                     | (529)                    | (578)    | 749      |
| Total deferred income tax (benefit) expense | (5,079)                  | (1,091)  | 3,692    |
|   | \$ (2,094)               | \$ 2,247 | \$ 3,637 |

The Company files a consolidated federal income tax return which includes all domestic subsidiaries. Income taxes paid during 2006, 2005 and 2004 totaled approximately \$546,000, \$465,000 and \$4,188,000, respectively. The Company received approximately \$1,365,000, \$4,266,000 and \$2,555,000 in federal income tax refunds during 2006, 2005 and 2004, respectively. At December 31, 2006, the Company had approximately \$16,235,000 of federal net operating loss carryforwards available to offset federal taxable income. Approximately, \$5,735,000 and \$10,500,000 of the carryforwards will expire on December 31, 2024 and 2026, respectively. At December 31, 2006, the Company had approximately \$9,446,000 of state net operating loss carryforwards available to offset future state taxable income. Such carryforwards reflect income tax losses incurred (in thousands) which will expire on December 31 of the following years:

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|      |          |
|------|----------|
| 2009 | \$ 1,401 |
| 2010 | 560      |
| 2011 | 5,999    |
| 2017 | 464      |
| 2025 | 1,022    |
|      | \$ 9,446 |

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The following is a reconciliation of income tax (benefit) expense to that computed by applying the federal statutory rate to (loss) income before income taxes:

|  | Years ended December 31, |          |          |
|--|--------------------------|----------|----------|
|  | 2006                     | 2005     | 2004     |
|  | (in thousands)           |          |          |
| Federal tax at the statutory rate              | \$ (1,209)               | \$ 2,573 | \$ 4,058 |
| Current year permanent differences             | 156                      | 150      | 112      |
| State income taxes, net of federal tax benefit | (137)                    | 23       | 432      |
| Change in estimate of tax contingencies        | (402)                    | (200)    | (434)    |
| Change in estimate of blended tax rate         |                          | 144      | 249      |
| Research tax credits                           | 100                      | (100)    | (464)    |
| Effect of tax rates of foreign subsidiaries    | (486)                    | (300)    | (183)    |
| Other  | (116)                    | (43)     | (133)    |
|  | \$ (2,094)               | \$ 2,247 | \$ 3,637 |

Deferred income tax assets and liabilities are as follows:

|  | December 31,      |                   |
|--|-------------------|-------------------|
|  | 2006              | 2005              |
|  | (in thousands)    |                   |
| Deferred tax assets:                               |                   |                   |
| Compensation and benefit accruals                  | \$ 1,094          | \$ 873            |
| Inventory valuation                                | 2,990             | 2,477             |
| Federal and State net operating loss carryforwards | 6,835             | 1,991             |
| Accounts receivable allowance                      | 584               | 739               |
| Foreign inventory valuation and other provisions   | 339               |                   |
| AMT credits  | 232               | 584               |
| Other  | 309               |                   |
| <b>Total deferred tax assets</b>                   | <b>12,383</b>     | <b>6,664</b>      |
| Deferred tax liabilities:                          |                   |                   |
| Depreciation                                       | (15,544)          | (15,644)          |
| Foreign inventory valuation and other provisions   |                   | (208)             |
| Defined benefit pension plan                       |                   | (187)             |
| Contract provisions                                | (525)             | (33)              |
| Other  | (209)             | (4)               |
| <b>Total deferred tax liabilities</b>              | <b>(16,278)</b>   | <b>(16,076)</b>   |
| <b>Net deferred tax liability</b>                  | <b>\$ (3,895)</b> | <b>\$ (9,412)</b> |

Management believes it is more likely than not that the Company's future earnings will be sufficient to ensure the realization of deferred tax assets for federal and state purposes. The Company had \$1,300,000 of reserves recorded for various uncertain tax positions at December 31,

2006.

The American Jobs Creation Act of 2004 (the Act), which was signed into law on October 22, 2004, introduces a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (Repatriation Provision), provided certain criteria are met. The FASB issued Staff Position No. FAS 109-2 in December 2004, which requires the recording of tax expense if and when an entity decides to repatriate foreign earnings subject to the Act. The Company has considered the implications of the Act on the repatriation of certain foreign earnings, which reduces the Federal income tax rate on dividends from non-U.S. subsidiaries. The Company did not repatriate earnings under the Act in fiscal 2006 or 2005 because it intends to indefinitely reinvest foreign earnings outside the U.S., and has not provided an estimate for any U.S. or additional foreign taxes on undistributed

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earnings of foreign subsidiaries (\$13,180,000 at December 31, 2006) that might be payable if these earnings were repatriated. However, the Company believes that U.S. foreign tax credits would, for the most part, eliminate any additional U.S. tax.

**(16) (Loss) Earnings Per Common Share**

Basic (loss) earnings per common share is calculated by dividing net (loss) income available to common stockholders by the weighted average number of common shares outstanding during the year. Diluted (loss) earnings per common share is calculated by using the weighted average number of common shares outstanding adjusted to include the potentially dilutive effect of outstanding stock options.

The following table presents information necessary to calculate (loss) earnings per common share:

|  | Years ended December 31,                  |          |          |
|--|---|----------|----------|
|  | 2006                                      | 2005     | 2004     |
|  | (in thousands, except for per share data) |          |          |
| <b>Shares outstanding:</b>   |   |          |          |
| Weighted average shares outstanding                                  | 18,079                                    | 18,016   | 17,119   |
| Effect of dilutive employee stock options                            |   | 307      | 626      |
| Adjusted weighted average shares outstanding and assumed conversions | 18,079                                    | 18,323   | 17,745   |
| Net (loss) income applicable to common stock                         | \$ (1,362)                                | \$ 5,321 | \$ 8,299 |
| <b>(Loss) earnings per common share:</b>                             |   |          |          |
| Basic  | \$ (0.08)                                 | \$ 0.30  | \$ 0.48  |
| Diluted  | \$ (0.08)                                 | \$ 0.29  | \$ 0.47  |

Weighted average anti-dilutive options outstanding excluded from diluted earnings per common share were 508,000 and 122,000 at December 31, 2005 and 2004, respectively.

**(17) Segment Information**

The Company is organized into two business groups, the Industrial Group and the Electronics Group. The Industrial Group is one reportable business segment, while the Electronics Group includes two reportable business segments, Aerospace & Defense and Test & Measurement. The segments are each managed separately because of the distinctions between the products, services, markets, customers, technologies, and workforce skills of the segments. The Industrial Group provides manufacturing services for a variety of customers that outsource forged and finished steel components and subassemblies. The Industrial Group also manufactures high-pressure closures and other fabricated products. The Aerospace & Defense reportable segment provides manufacturing and technical services as an outsourced service provider and manufactures complex data storage systems. The Test & Measurement reportable segment provides a wide range of technical services for a diversified customer base as an outsourced service provider and manufactures magnetic instruments, current sensors, and other electronic products. Revenue derived from outsourced services for the Industrial Group accounted for 70%, 67% and 59% of total net revenue in 2006, 2005 and 2004, respectively. Revenue derived from outsourced services for the Aerospace & Defense reportable segment accounted for 8%, 11% and 15% of total net revenue in 2006, 2005 and 2004, respectively. Revenue derived from outsourced services for the Test & Measurement reportable segment accounted for 8%, 8% and 10% of total net revenue in 2006, 2005 and 2004, respectively. There was no intersegment net revenue recognized for any year presented.



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The following table presents financial information for the reportable segments of the Company:

|   | Years ended December 31, |            |            |
|---|--------------------------|------------|------------|
|   | 2006                     | 2005       | 2004       |
|   | (in thousands)           |            |            |
| <b>Net revenue from unaffiliated customers:</b> |                          |            |            |
| Industrial Group                                | \$ 364,570               | \$ 359,602 | \$ 260,410 |
| Aerospace & Defense                             | 87,491                   | 115,863    | 119,179    |
| Test & Measurement                              | 45,603                   | 47,301     | 45,813     |
| Electronics Group                               | 133,094                  | 163,164    | 164,992    |
|   | \$ 497,664               | \$ 522,766 | \$ 425,402 |
| <b>Gross profit:</b>                            |                          |            |            |
| Industrial Group                                | \$ 17,676                | \$ 22,916  | \$ 25,004  |
| Aerospace & Defense                             | 13,659                   | 17,496     | 19,284     |
| Test & Measurement                              | 9,755                    | 10,926     | 9,151      |
| Electronics Group                               | 23,414                   | 28,422     | 28,435     |
|   | \$ 41,090                | \$ 51,338  | \$ 53,439  |
| <b>Operating (loss) income:</b>                 |                          |            |            |
| Industrial Group                                | \$ 7,849                 | \$ 14,014  | \$ 16,404  |
| Aerospace & Defense                             | 489                      | 4,305      | 3,597      |
| Test & Measurement                              | (94)                     | 354        | (431)      |
| Electronics Group                               | 395                      | 4,659      | 3,166      |
| General, corporate and other                    | (8,379)                  | (6,451)    | (5,672)    |
|   | \$ (135)                 | \$ 12,222  | \$ 13,898  |
| <b>Total assets:</b>                            |                          |            |            |
| Industrial Group                                | \$ 227,358               | \$ 278,967 | \$ 270,228 |
| Aerospace & Defense                             | 89,433                   | 83,443     | 101,344    |
| Test & Measurement                              | 30,772                   | 33,631     | 33,537     |
| Electronics Group                               | 120,205                  | 117,074    | 134,881    |
| General, corporate and other                    | 31,470                   | 21,583     | 26,069     |
|   | \$ 379,033               | \$ 417,624 | \$ 431,178 |
| <b>Depreciation and amortization:</b>           |                          |            |            |

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|                              |           |           |           |
|------------------------------|-----------|-----------|-----------|
| Industrial Group             | \$ 18,639 | \$ 16,045 | \$ 10,151 |
| Aerospace & Defense          | 5,096     | 5,642     | 5,061     |
| Test & Measurement           | 4,422     | 3,963     | 3,553     |
| Electronics Group            | 9,518     | 9,605     | 8,614     |
| General, corporate and other | 625       | 259       | 301       |
|                              | \$ 28,782 | \$ 25,909 | \$ 19,066 |



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|                              | Years ended December 31, |           |           |
|------------------------------|--------------------------|-----------|-----------|
|                              | 2006                     | 2005      | 2004      |
|                              | (in thousands)           |           |           |
| Capital expenditures:        |                          |           |           |
| Industrial Group             | \$ 5,167                 | \$ 28,391 | \$ 42,634 |
| Aerospace & Defense          | 2,233                    | 2,889     | 8,399     |
| Test & Measurement           | 2,764                    | 4,366     | 4,601     |
| Electronics Group            | 4,997                    | 7,255     | 13,000    |
| General, corporate and other | 162                      | 618       | 266       |
|                              | \$ 10,326                | \$ 36,264 | \$ 55,900 |

The Company's export sales from the U.S. totaled \$44,963,000, \$47,622,000 and \$37,318,000 in 2006, 2005 and 2004, respectively. Approximately \$86,166,000, \$68,671,000 and \$26,481,000 of net revenue in 2006, 2005 and 2004, respectively, and \$29,774,000 and \$32,304,000 of long lived assets at December 31, 2006 and 2005, respectively, relate to the Company's international operations.

**(18) Quarterly Financial Information (Unaudited)**

The following is an analysis of certain items in the consolidated statements of operations by quarter for the years ended December 31, 2006 and 2005:

|  | 2006                                      |            |            |            | 2005       |            |            |            |
|--|---|------------|------------|------------|------------|------------|------------|------------|
|  | First                                     | Second     | Third      | Fourth     | First      | Second     | Third      | Fourth     |
|  | (in thousands, except for per share data) |            |            |            |            |            |            |            |
| Net revenue                              | \$ 129,997                                | \$ 132,233 | \$ 125,955 | \$ 109,479 | \$ 124,241 | \$ 125,602 | \$ 140,811 | \$ 132,112 |
| Gross profit                             | 12,619                                    | 10,434     | 10,236     | 7,801      | 11,359     | 13,888     | 15,606     | 10,485     |
| Operating income (loss)                  | 2,207                                     | 273        | (529)      | (2,086)    | 1,995      | 3,656      | 6,186      | 385        |
| Net income (loss)                        | 857                                       | (444)      | (802)      | (973)      | 590        | 1,981      | 3,001      | (251)      |
| Earnings (loss) per common share:        |   |            |            |            |            |            |            |            |
| Basic                                    | \$ 0.05                                   | \$ (0.02)  | \$ (0.04)  | \$ (0.05)  | \$ 0.03    | \$ 0.11    | \$ 0.17    | \$ (0.01)  |
| Diluted                                  | \$ 0.05                                   | \$ (0.02)  | \$ (0.04)  | \$ (0.05)  | \$ 0.03    | \$ 0.11    | \$ 0.16    | \$ (0.01)  |
| Cash dividends declared per common share | \$ 0.03                                   | \$ 0.03    | \$ 0.03    | \$ 0.03    | \$ 0.03    | \$ 0.03    | \$ 0.03    | \$ 0.03    |

**(19) Subsequent Events**

On January 12, 2007, the Company granted a total of \$569,000 in cash payments and 258,000 restricted stock awards under a key employee retention program. The cash payment is subject to pro-rata repayment provisions in the event of employee termination prior to January 1, 2008, while the restricted shares are subject to two or four year vesting.

On January 29, 2007, the Company received final judgment pertaining to the December 2006 arbitration ruling which resulted in the recognition of a \$1,818,212 gain contingency in the first quarter of 2007. The arbitration award also requires a monthly payment by Dana to the Company for \$146,258 for each month the arbitration issues remain unresolved.

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**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

As of the end of the period covered by this annual report, an evaluation was performed under the supervision and with the participation of the Company's management, including the President and Chief Executive Officer (the CEO) and the Chief Financial Officer (the CFO), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective.

**Management's Report on Internal Control over Financial Reporting**

The management of Sypris Solutions, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Management's report on internal control over financial reporting is included in Part II, Item 8 of this Form 10-K. Additionally, Ernst & Young LLP, our independent auditors and a registered public accounting firm, has issued an attestation report on our assessment of Sypris Solutions, Inc.'s internal control over financial reporting, which is included in Part II, Item 8 of this Form 10K.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information**

None.

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**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance**

The information required herein is incorporated by reference from sections of the Company's Proxy Statement titled Section 16(a) Beneficial Ownership Reporting Compliance, Governance of the Company Committees of the Board of Directors, Governance of the Company Audit and Finance Committee, Proposal One, Election of Directors, and Executive Officers, which Proxy Statement will be filed with the Securities and Exchange Commission pursuant to instruction G(3) of the General Instructions to Form 10-K.

The Company has adopted a Code of Business Conduct that applies to all of its directors, officers (including its chief executive officer, chief financial officer, chief accounting officer and any person performing similar functions) and employees. The Company has made the Code of Business Conduct available on its website at [www.sypris.com](http://www.sypris.com).

**Item 11. Executive Compensation**

The information required herein is incorporated by reference from sections of the Company's Proxy Statement titled Governance of the Company Compensation of Directors, Governance of the Company Compensation Committee Interlocks and Insider Participation, Summary Compensation Table, Grants of Plan-based Awards, Outstanding Equity Awards at Fiscal Year-End, Option Exercises and Stock Vested, Pension Benefits, Nonqualified Deferred Compensation, Director Compensation, Compensation Discussion and Analyses and Compensation Committee Report which Proxy Statement will be filed with the Securities and Exchange Commission pursuant to instruction G(3) of the General Instructions to Form 10-K.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required herein is incorporated by reference from the sections of the Company's Proxy Statement titled Stock Ownership of Certain Beneficial Owners and Equity Compensation Plan Information which Proxy Statement will be filed with the Securities and Exchange Commission pursuant to instruction G(3) of the General Instructions to Form 10-K.

**Item 13. Certain Relationships and Related Transactions and Director Independence**

The information required herein is incorporated by reference from the sections of the Company's Proxy Statement titled Governance of the Company Certain Relationships and Related Transactions, Governance of the Company Certain Employees, and Governance of the Company Independence which Proxy Statement will be filed with the Securities and Exchange Commission pursuant to instruction G(3) of the General Instructions to Form 10-K.

**Item 14. Principal Accountant Fees and Services**

The information required herein is incorporated by reference from the section of the Company's Proxy Statement titled Relationship with Independent Public Accountants, which Proxy Statement will be filed with the Securities and Exchange Commission pursuant to instruction G(3) of the General Instructions to Form 10-K.

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**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a) The following documents are filed as part of this Report:

1. Financial Statements

The financial statements as set forth under Item 8 of this report on Form 10-K are included.

2. Financial Statement Schedules

Schedule II Valuation and Qualifying Accounts

All other consolidated financial statement schedules have been omitted because the required information is shown in the consolidated financial statements or notes thereto or they are not applicable.

3. Exhibits

| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 3.1                   | Certificate of Incorporation of the Company (incorporated by reference to Exhibit 3.1 to the Company's Form 10-Q for the quarterly period ended June 30, 2004 filed on August 3, 2004 (Commission File No. 000-24020)).  |
| 3.2                   | Bylaws of the Company (incorporated by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-8 filed May 9, 2002 (No. 333-87880)).  |
| 4.1                   | Specimen common stock certificate (incorporated by reference to Exhibit 4.1 to the Company's Form 10-K for the fiscal year ended December 31, 1998 filed on March 5, 1999).  |
| 4.2                   | Rights Agreement dated as of October 23, 2001 between the Company and LaSalle Bank National Association, as Rights Agent, including as Exhibit A the Form of Certificate of Designation and as Exhibit B the Form of Right Certificate (incorporated by reference to Exhibit 4.1 to the Company's Form 8-K filed on October 23, 2001 (Commission File No. 000-24020)).                           |
| 10.1                  | Purchase and Sale Agreement among Honeywell Inc., Defense Communications Products Corporation (prior name of Group Technologies Corporation) and Group Financial Partners, Inc. dated May 21, 1989 (incorporated by reference to Exhibit 10.18 to the Company's Registration Statement on Form S-1 filed May 18, 1994 (Registration No. 33-76326)).  |
| 10.2                  | Purchase and Sale Agreement among Alliant Techsystems Inc., MAC Acquisition I, Inc. and Group Technologies Corporation dated December 31, 1992 (incorporated by reference to Exhibit 10.16 to the Company's Registration Statement on Form S-1 filed May 18, 1994 (Registration No. 33-76326)).  |
| 10.3                  | Purchase and Sale Agreement among Philips Electronic North America Corporation and Group Technologies Corporation dated June 25, 1993 (incorporated by reference to Exhibit 10.17 to the Company's Registration Statement on Form S-1 filed May 18, 1994 (Registration No. 33-76326)).   |
| 10.4                  | Asset Purchase Agreement dated April 6, 2001 by and between Tube Turns Technologies, Inc. and Dana Corporation as amended by a First Amendment dated May 4, 2001 and as amended by a Second Amendment on May 15, 2001 (incorporated by reference to Exhibit 2.1 to the Company's Form 10-Q for the quarterly period ended June 30, 2001 filed on July 30, 2001 (Commission File No. 000-24020)). |

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- 10.5 Asset Purchase Agreement between Sypris Technologies, Inc. and Dana Corporation dated December 8, 2003 (incorporated by reference to Exhibit 10.7 to the Company's Form 10-K for the fiscal year ended December 31, 2003 filed on February 12, 2004 (Commission File No. 000-24020)).

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| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 10.6                  | 1999 Amended and Restated Loan Agreement between Bank One, Kentucky, NA, Sypris Solutions, Inc., Bell Technologies, Inc., Tube Turns Technologies, Inc., Group Technologies Corporation and Metrum-Datatape, Inc. dated October 27, 1999 (incorporated by reference to Exhibit 10.1 to the Company's Form 10-K for the fiscal year ended December 31, 1999 filed on February 25, 2000 (Commission File No. 000-24020)).   |
| 10.6.1                | 2000A Amendment to Loan Documents between Bank One, Kentucky, NA, Sypris Solutions, Inc., Bell Technologies, Inc., Tube Turns Technologies, Inc., Group Technologies Corporation and Metrum-Datatape, Inc. dated November 9, 2000 (incorporated by reference to Exhibit 10.6.1 to the Company's Form 10-K for the fiscal year ended December 31, 2000 filed on March 2, 2001 (Commission File No. 000-24020)).  |
| 10.6.2                | 2001A Amendment to Loan Documents between Bank One, Kentucky, NA, Sypris Solutions, Inc., Bell Technologies, Inc., Tube Turns Technologies, Inc., Group Technologies Corporation and Metrum-Datatape, Inc. dated February 15, 2001 (incorporated by reference to Exhibit 10.6.2 to the Company's Form 10-Q for the quarterly period ended April 1, 2001 filed on April 30, 2001 (Commission File No. 000-24020)).   |
| 10.6.3                | 2002A Amendment to Loan Documents between Bank One, Kentucky, NA, Sypris Solutions, Inc., Sypris Test & Measurement, Inc., Sypris Technologies, Inc., Sypris Electronics, LLC, Sypris Data Systems, Inc. and Sypris Technologies Marion, LLC dated December 21, 2001 (incorporated by reference to Exhibit 10.6.3 to the Company's Form 10-K for the fiscal year ended December 31, 2001 filed on January 31, 2002 (Commission File No. 000-24020)).                                |
| 10.6.4                | 2002B Amendment to Loan Documents between Bank One, Kentucky, NA, Sypris Solutions, Inc., Sypris Test & Measurement, Inc., Sypris Technologies, Inc., Sypris Electronics, LLC, Sypris Data Systems, Inc. and Sypris Technologies Marion, LLC dated July 3, 2002 (incorporated by reference to Exhibit 10.25 to the Company's Form 10-Q for the quarterly period ended June 30, 2002 filed on July 29, 2002 (Commission File No. 000-24020)).  |
| 10.6.5                | 2003A Amendment to Loan Documents between Bank One, Kentucky, NA, Sypris Solutions, Inc., Sypris Test & Measurement, Inc., Sypris Technologies, Inc., Sypris Electronics, LLC, Sypris Data Systems, Inc. and Sypris Technologies Marion, LLC dated October 16, 2003 (incorporated by reference to Exhibit 99.1 to the Company's Form 10-Q for the quarterly period ended September 28, 2003 filed on October 29, 2003 (Commission File No. 000-24020)).                             |
| 10.6.6                | 2005A Amendment to Loan Documents between JP Morgan Chase Bank, NA, Sypris Solutions, Inc., Sypris Test & Measurement, Inc., Sypris Technologies, Inc., Sypris Electronics, LLC, Sypris Data Systems, Inc., Sypris Technologies Marion, LLC and Sypris Technologies Kenton, Inc. dated March 10, 2005 (incorporated by reference to Exhibit 10.6.6 to the Company's Form 10-K for the fiscal year ended December 31, 2004 filed on March 11, 2005 (Commission File No. 000-24020)). |
| 10.6.7                | 2005B Amendment to Loan Documents between JP Morgan Chase Bank, NA, Sypris Solutions, Inc., Sypris Test & Measurement, Inc., Sypris Technologies, Inc., Sypris Electronics, LLC, Sypris Data Systems, Inc., Sypris Technologies Marion, LLC and Sypris Technologies Kenton, Inc. dated May 10, 2005 (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q filed on August 5, 2005 (Commission File No. 000-24020)).   |
| 10.6.8                | 2005C Amendment to Loan Documents between JP Morgan Chase Bank, NA, Sypris Solutions, Inc., Sypris Test & Measurement, Inc., Sypris Technologies, Inc., Sypris Electronics, LLC, Sypris Data Systems, Inc., Sypris Technologies Marion, LLC and Sypris Technologies Kenton, Inc. dated August 3, 2005 (incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q filed on August 5, 2005 (Commission File No. 000-24020)).   |

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| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 10.6.9                | 2006A Amendment to Loan Documents between JP Morgan Chase Bank, NA, Sypris Solutions, Inc., Sypris Test & Measurement, Inc., Sypris Technologies, Inc., Sypris Electronics, LLC, Sypris Data Systems, Inc., Sypris Technologies Marion, LLC and Sypris Technologies Kenton, Inc. dated February 28, 2006 (incorporated by reference to Exhibit 10.6.9 to the Company's Form 10-K for the fiscal year ended December 31, 2005 filed on March 15, 2006 (Commission File No. 000-24020)).  |
| 10.7                  | Note Purchase Agreement between The Guardian Life Insurance Company of America, Connecticut General Life Insurance Company, Life Insurance Company of North America, Jefferson Pilot Financial Insurance Company, Jefferson-Pilot Life Insurance Company, Jefferson Pilot LifeAmerica Insurance Company, and Sypris Solutions, Inc. dated as of June 10, 2004 (incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q for the quarterly period ended June 30, 2004 filed on August 3, 2004 (Commission File No. 000-24020)).  |
| 10.7.1                | First Amendment to Note Purchase Agreement between The Guardian Life Insurance Company of America, Connecticut General Life Insurance Company, Life Insurance Company of North America, Jefferson Pilot Financial Insurance Company, Jefferson-Pilot Life Insurance Company, Jefferson Pilot LifeAmerica Insurance Company, and Sypris Solutions, Inc. dated as of August 3, 2005 (incorporated by reference to Exhibit 10.3 to the Company's Form 10-Q filed on August 5, 2005 (Commission File No. 000-24020)).   |
| 10.7.2                | Second Amendment to Note Purchase Agreement between The Guardian Life Insurance Company of America, Connecticut General Life Insurance Company, Life Insurance Company of North America, Jefferson Pilot Financial Insurance Company, Jefferson-Pilot Life Insurance Company, Jefferson Pilot LifeAmerica Insurance Company, and Sypris Solutions, Inc. dated as of March 13, 2006 (incorporated by reference to Exhibit 10.7.2 to the Company's Form 10-K for the fiscal year ended December 31, 2005 filed on March 15, 2006 (Commission File No. 000-24020)).  |
| 10.8                  | Lease between John Hancock Mutual Life Insurance Company and Honeywell, Inc. dated April 27, 1979; related Notice of Assignment from John Hancock Mutual Life Insurance Company to Sweetwell Industrial Associates, L.P., dated July 10, 1986; related Assignment and Assumption of Lease between Honeywell, Inc. and Defense Communications Products Corporation (prior name of Group Technologies Corporation) dated May 21, 1989; and related Amendment I to Lease Agreement between Sweetwell Industries Associates, L.P. and Group Technologies Corporation dated October 25, 1991, regarding Tampa industrial park property (incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on Form S-1 filed May 18, 1994 (Registration No. 33-76326)). |
| 10.8.1                | Agreement related to Fourth Renewal of Lease between Sweetwell Industries Associates, L.P. and Group Technologies Corporation dated November 1, 2000, regarding Tampa industrial park property (incorporated by reference to Exhibit 10.8.1 to the Company's Form 10-K for the fiscal year ended December 31, 2000 filed on March 2, 2001 (Commission File No. 000-24020)).   |
| 10.8.2                | Agreement related to Fifth Renewal of Lease between Sweetwell Industries Associates, L.P. and Group Technologies Corporation dated October 12, 2006, regarding Tampa industrial park property.  |
| 10.9                  | Lease between Metrum-Datatape, Inc. (assignee of Metrum, Inc.) and Alliant Techsystems, Inc. dated March 29, 1993 and amended July 29, 1993, May 2, 1994, November 14, 1995, December 4, 1996 and February 12, 1998 regarding 4800 East Dry Creek Road Property (incorporated by reference to Exhibit 10.25 to the Company's Form 10-Q for the quarterly period ended June 28, 1998 filed on August 4, 1998 (Commission File No. 000-24020)).   |
| 10.10                 | Lease between Sypris Data Systems, Inc. and Via Verde Venture, LLC. dated September 24, 2003 regarding 160 East Via Verde, San Dimas, California (incorporated by reference to Exhibit 10.11 to the Company's Form 10-K for the fiscal year ended December 31, 2003 filed on February 12, 2004 (Commission File No. 000-24020)).  |
| 10.11*                | Sypris Solutions, Inc. 1994 Stock Option Plan for Key Employees as Amended and Restated effective February 26, 2002 (incorporated by reference to Exhibit 4.5 to the Company's Form S-8 filed on May 9, 2002 (Registration No. 333-87880)).   |

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| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 10.12*                | Sypris Solutions, Inc. Share Performance Program For Stock Option Grants dated July 1, 1998 (incorporated by reference to Exhibit 10.28 to the Company's Form 10-Q for the quarterly period ended June 28, 1998 filed on August 4, 1998 (Commission File No. 000-24020)).   |
| 10.13*                | Sypris Solutions, Inc. Independent Directors' Stock Option Plan as Amended and Restated effective February 26, 2002 (incorporated by reference to Exhibit 4.5 to the Company's Form S-8 filed on May 9, 2002 (Registration No. 333-87882)).   |
| 10.14*                | Sypris Solutions, Inc., Directors Compensation Program As Amended and Restated Effective February 24, 2004 and as amended December 15, 2004, (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on December 21, 2004 (Commission File No. 000-24020)).  |
| 10.15*                | Sypris Solutions, Inc. Directors Compensation Program adopted on September 1, 1995 Amended and Restated on March 1, 2005 (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on March 3, 2005 (Commission File No. 000-24020)).  |
| 10.16*                | Sypris Solutions, Inc. Directors Compensation Program adopted on September 1, 1995 Amended and Restated on February 20, 2007.   |
| 10.17*                | Sypris Solutions, Inc. Executive Bonus Plan, effective as of January 1, 2003 (incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q for the quarterly period ended March 30, 2003 filed on April 30, 2003 (Commission File No. 000-24020)).  |
| 10.18*                | Sypris Solutions, Inc. Incentive Bonus Plan, effective as of January 1, 2004 (incorporated by reference to Exhibit 10.17 to the Company's Form 10-K for the fiscal year ended December 31, 2004 filed on March 11, 2005 (Commission File No. 000-24020)).   |
| 10.19*                | Sypris Solutions, Inc. Incentive Bonus Plan, effective as of January 1, 2005 (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on March 3, 2005 (Commission File No. 000-24020)).  |
| 10.20*                | 2004 Sypris Equity Plan effective as of April 27, 2004 (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q for the quarterly period ended March 31, 2004 filed on April 30, 2004 (Commission File No. 000-24020)).  |
| 10.21*                | Form of non-qualified stock option award agreement for non-employee directors (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on December 21, 2004 (Commission File No. 000-24020)).   |
| 10.22*                | Form of non-qualified stock option award agreement for grants to executive officers and other key employees (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on December 21, 2004 (Commission File No. 000-24020)).   |
| 10.23*                | Form of performance-based stock option award agreement for grants to executive officers and other key employees (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed on December 21, 2004 (Commission File No. 000-24020)).   |
| 10.24*                | Form of Restricted Stock Award Agreement for grants to executive officers and other key employees (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on March 3, 2005 (Commission File No. 000-24020)).   |
| 10.25*                | Form of Non-Qualified Stock Option Award Agreement for Six-Year Stock Option for grants to executive officers and other key employees (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed on March 3, 2005 (Commission File No. 000-24020)).   |
| 10.26*                | Form of Amendment to Stock Option Agreements to Accelerate Vesting Periods for Certain Underwater Options for grants to executive officers and other key employees (incorporated by reference to Exhibit 10.25 to the Company's Form 10-K for the fiscal year ended December 31, 2004 filed on March 11, 2005 (Commission File No. 000-24020)). |



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| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 10.27*                | Employment Agreement by and between Metrum-Datatape, Inc. and G. Darrell Robertson dated February 28, 2000 (incorporated by reference to Exhibit 10.20 to the Company's Form 10-K for the fiscal year ended December 31, 2000 filed on March 2, 2001 (Commission File No. 000-24020)).                         |
| 10.28                 | Underwriting Agreement dated March 20, 2002 among Sypris Solutions, Inc., Needham & Company, Inc. and A.G. Edwards & Sons, Inc. (incorporated by reference to Exhibit 10.20 to the Company's Form 10-Q for the quarterly period ended March 31, 2002 filed on April 29, 2002 (Commission File No. 000-24020)). |
| 10.29                 | Underwriting Agreement dated March 11, 2004 among Sypris Solutions, Inc. and Needham & Company, Inc. (incorporated by reference to Exhibit 10.3 to the Company's Form 10-Q for the quarterly period ended March 31, 2004 filed on April 30, 2004 (Commission File No. 000-24020)).                             |
| 10.30*                | Amendment to Stock Option Agreements to David D. Johnson (incorporated by reference to Exhibit 10.7 to the Company's Form 10-Q filed on May 6, 2005 (Commission File No. 000-24020)).  |
| 10.31*                | Sypris Solutions, Inc. Incentive Bonus Plan (July 1, 2005 – December 31, 2005) (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on June 27, 2005 (Commission File No. 000-24020)).   |
| 10.32*                | Form of Two-Year Restricted Stock Award Agreement for Grants to Executive Officers and Other Key Employees (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on June 27, 2005 (Commission File No. 000-24020)).   |
| 10.33*                | Amended Form of Two-Year Restricted Stock Award Agreement for Grants to Executive Officers and Other Key Employees (incorporated by reference to Exhibit 10.8 to the Company's Form 10-Q filed on August 5, 2005 (Commission File No. 000-24020)).   |
| 10.34*                | Form of 1-3-5 Year Restricted Stock Award Agreement for Grants to Executive Officers and Other Key Employees (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on June 27, 2005 (Commission File No. 000-24020)).   |
| 10.35*                | Amended Form of 1-3-5 Year Restricted Stock Award Agreement for Grants to Executive Officers and Other Key Employees (incorporated by reference to Exhibit 10.9 to the Company's Form 10-Q filed on August 5, 2005 (Commission File No. 000-24020)).   |
| 10.36*                | Long-term Incentive Program and Form of Long-term Incentive Award Agreements for Grants to Executive Officers and Other Key Employees (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed on June 27, 2005 (Commission File No. 000-24020)).  |
| 10.37*                | Amended Executive Long-Term Incentive Program and Alternate Form of Executive Long-Term Incentive Award Agreements for Grants to Executive Officers and Other Key Employees (incorporated by reference to Exhibit 10.10 to the Company's Form 10-Q filed on August 5, 2005 (Commission File No. 000-24020)).   |
| 10.38*                | Form of Amendment to Stock Option Agreements to Accelerate Vesting Periods for Certain Underwater Options for grants to executive officers and other key employees (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on January 6, 2006 (Commission File No. 000-24020)).             |
| 10.39                 | Preliminary Settlement Agreement between Sypris Solutions, Inc. and Dana Corporation (Debtor in Possession) dated May 10, 2006. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on May 10, 2006 (Commission File No. 000-24020)).   |
| 10.40*                | Form of Four-year Restricted Stock Award Agreement for Grants to Executive Officers and Terms of Awards Under the 2007 Special Incentive Executive Award Program. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on January 17, 2007 (Commission File No. 000-24020)).             |
| 10.41*                | Form of Refund Agreement to Award Cash Incentive Grants (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on January 17, 2007 (Commission File No. 000-24020)).   |
| 21                    | Subsidiaries of the Company  |

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| <b>Exhibit<br/>Number</b> | <b>Description</b>  |
|---------------------------|---|
| 23                        | Consent of Ernst & Young LLP  |
| 31.1                      | CEO certification pursuant to Section 302 of Sarbanes - Oxley Act of 2002.  |
| 31.2                      | CFO certification pursuant to Section 302 of Sarbanes - Oxley Act of 2002.  |
| 32                        | CEO and CFO certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes - Oxley Act of 2002. |

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\* Management contract or compensatory plan or arrangement.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 14, 2007.

SYPRIS SOLUTIONS, INC.  
(Registrant)

/s/ Jeffrey T. Gill  
(Jeffrey T. Gill)

President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 14, 2007:

|  |  |
|--|--|
| /s/ Robert E. Gill<br><br>(Robert E. Gill)         | Chairman of the Board  |
| /s/ Jeffrey T. Gill<br><br>(Jeffrey T. Gill)       | President, Chief Executive Officer and Director                          |
| /s/ T. Scott Hatton<br><br>(T. Scott Hatton)       | Vice President and Chief Financial Officer (Principal Financial Officer) |
| /s/ Jeffrey T. Reibel<br><br>(Jeffrey T. Reibel)   | Controller (Principal Accounting Officer)                                |
| /s/ John F. Brinkley<br><br>(John F. Brinkley)     | Director   |
| /s/ William G. Ferko<br><br>(William G. Ferko)     | Director   |
| /s/ R. Scott Gill<br><br>(R. Scott Gill)           | Director   |
| /s/ William L. Healey<br><br>(William L. Healey)   | Director   |
| /s/ Sidney R. Petersen<br><br>(Sidney R. Petersen) | Director   |

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/s/ Robert Sroka

Director

(Robert Sroka)

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## SCHEDULE II

## SYPRIS SOLUTIONS, INC.

## VALUATION AND QUALIFYING ACCOUNTS

|   | Balance<br>at<br>Beginning<br>of<br>Period | Charged to<br>Costs and<br>Expenses | Charged to<br>Other<br>Accounts<br>(in thousands) | Deductions    | Balance at<br>End of<br>Period |
|---|--|-------------------------------------|---|---------------|--------------------------------|
| Allowance for doubtful accounts:                        |  |                                     |   |               |                                |
| Year ended December 31, 2006                            | \$ 1,898                                   | \$ 437                              | \$  | \$ (833)(1)   | \$ 1,502                       |
| Year ended December 31, 2005                            | \$ 1,697                                   | \$ 607                              | \$  | \$ (406)(1)   | \$ 1,898                       |
| Year ended December 31, 2004                            | \$ 594                                     | \$ 1,842                            | \$  | \$ (739)(1)   | \$ 1,697                       |
| Reserve for inactive, obsolete and unsalable inventory: |  |                                     |   |               |                                |
| Year ended December 31, 2006                            | \$ 6,342                                   | \$ 836                              | \$  | \$ (390)(2)   | \$ 6,788                       |
| Year ended December 31, 2005                            | \$ 5,902                                   | \$ 739                              | \$  | \$ (299)(2)   | \$ 6,342                       |
| Year ended December 31, 2004                            | \$ 5,146                                   | \$ 1,520                            | \$ 335(3)   | \$ (1,099)(2) | \$ 5,902                       |

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- (1) Uncollectible accounts written off.  
(2) Inactive, obsolete and unsalable inventory written off.  
(3) Excess and obsolete reserve assumed in acquisition.