INPUT OUTPUT INC
Form 10-Q/A
June 05, 2006

FORM 10-Q/A

(Amendment No. 1)

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

OR

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

COMMISSION FILE NUMBER 1-12691

INPUT/OUTPUT, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

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

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

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

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

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

At October 28, 2005, there were 79,679,577 shares of common stock, par value $0.01 per share, outstanding.

INPUT/OUTPUT, INC. AND SUBSIDIARIES

EXPLANATORY NOTE

This Form 10-Q/A (Amendment No. 1) amends our Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005, as initially filed with the Securities and Exchange Commission (the SEC) on November 9, 2005, and is being filed to reflect the restatement of our consolidated financial statements for the quarterly periods ended September 30, 2005 and 2004, as discussed in Note 1 of the Notes to Unaudited Consolidated Financial Statements contained herein. The restatements were necessitated due to an incorrect application of accounting principles for revenue recognition by the company s GX Technology Corporation subsidiary in connection with license sales of its multi-client seismic survey data. On March 16, 2006, we announced that our previously reported consolidated financial statements as of and for the three and nine months ended September 30, 2005 and 2004 and the year ended December 31, 2004 should no longer be relied upon. Also, we included in our restated balance sheet at September 30, 2005 a deferred tax liability and a corresponding increase in goodwill related to the book and tax differences between the acquired intangible assets of Concept Systems, in addition to its deferred income tax expense impact on our results of operations for the three and nine months ended September 30, 2005. The consolidated financial information contained in this Form 10-Q/A as of and for the three and nine months ended September 30, 2005 and 2004 reflects our restated results of operations for those three and nine month periods. Our consolidated statements of cash flows for the nine months ended September 30, 2005 and 2004 have been restated resulting in changes within cash flows from operating activities, but no changes to net cash used in operating activities. Our consolidated balance sheet at December 31, 2004 has been updated to reflect the restatements and reclassifications as previously reported in our Annual Report on Form 10-K for the year ended December 31, 2005 as filed with the SEC on March 31, 2006. For additional information concerning the restatements, the accounting periods affected and the impact on the company s results of operations and financial condition, see Note 1 of Notes to Unaudited Consolidated Financial Statements and Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations contained in this Form 10-Q/A.

As required by Rule 12b-15 under the Securities Exchange Act of 1934, as amended (the Exchange Act), new certifications of our principal executive officer and principal financial officer are being filed as exhibits to this Form 10-Q/A under Item 6 of Part II. For purposes of this Form 10-Q/A, and in accordance with Rule 12b-15 under the Exchange Act, each item in our Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005 that was affected by this Amendment No. 1 has been amended and replaced in its entirety. No attempt has been made in this Form 10-Q/A to modify or update other disclosures as presented in the original Form 10-Q, except as required to reflect such amendments. This Amendment No. 1 does not reflect events, other than those relating to the restatements, that have occurred after November 9, 2005, the date the Quarterly Report on Form 10-Q was originally filed, except that the information and disclosure contained in Part I, Item 4. Controls and Procedures has been brought current to the date of this filing. Information with respect to events occurring after November 9, 2005 has been or will be set forth, as appropriate, in our subsequent periodic filings, including our Quarterly Reports on Form 10-Q and Form 10-Q/A, and Current Reports on Form 8-K. Any reference to facts and circumstances at a current date refer to such facts and circumstances as of such original filing date.

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INPUT/OUTPUT, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	September 30, 2005 (Restated)	December 31, 2004 (Restated)
	(In thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 15,682	$ 14,935
Restricted cash	2,372	1,592
Accounts receivable, net	88,535	61,598
Current portion of notes receivable, net	11,084	10,784
Unbilled receivables	13,500	7,309
Inventories	82,561	86,659
Prepaid expenses and other current assets	12,621	7,974
Total current assets	226,355	190,851
Notes receivable	7,542	4,143
Non-current deferred income tax asset	1,113	1,113
Property, plant and equipment, net	24,438	46,051
Multi-client data library, net	15,935	10,025
Investments at cost	4,000	3,500
Goodwill	154,890	152,958
Intangible and other assets, net	70,039	77,453
Total assets	$ 504,312	$ 486,094
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and current maturities of long-term debt and lease obligations	$ 4,564	$ 6,564
Accounts payable	24,479	40,856
Accrued expenses	29,351	26,116
Deferred revenue	22,674	15,081
Deferred income tax liability	1,113	1,113
Total current liabilities	82,181	89,730
Long-term debt and lease obligations, net of current maturities	71,418	79,387
Non-current deferred income tax liability	4,567	5,529
Other long-term liabilities	4,887	2,688
Total liabilities	163,053	177,334
Cumulative convertible preferred stock	29,800	
Stockholders equity:		
Common stock, $0.01 par value; authorized 200,000,000 shares; outstanding 79,670,553 shares at September 30, 2005, and 78,561,675 shares at December 31, 2004, net of treasury stock	805	795
Additional paid-in capital	487,112	480,845
Accumulated deficit	(165,598)	(167,151)
Accumulated other comprehensive (loss) income	(149)	2,332
Treasury stock, at cost, 795,582 shares at September 30, 2005, and 784,009 shares at December 31, 2004	(5,920)	(5,844)
Unamortized restricted stock compensation	(4,791)	(2,217)

Total stockholders equity		311,459		308,760
Total liabilities and stockholders equity	$	504,312	$	486,094

See accompanying Notes to Unaudited Consolidated Financial Statements.

INPUT/OUTPUT, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months Ended September 30, 2005 (Restated)	Three Months Ended September 30, 2004 (Restated)	Nine Months Ended September 30, 2005 (Restated)	Nine Months Ended September 30, 2004 (Restated)
	(In thousands, except per share amounts)			
Net sales	$ 79,508	$ 76,761	$ 231,717	$ 175,374
Cost of sales	55,683	62,476	169,053	127,978
Gross profit	23,825	14,285	62,664	47,396
Operating expenses (income):				
Research and development	4,814	5,374	14,148	13,880
Marketing and sales	7,565	7,198	22,575	15,511
General and administrative	6,429	11,530	19,227	22,074
(Gain) loss on sale of assets	(1)	(2,498)	75	(3,394)
Total operating expenses	18,807	21,604	56,025	48,071
Income (loss) from operations	5,018	(7,319)	6,639	(675)
Interest expense	(1,367)	(1,623)	(4,726)	(4,616)
Interest income	218	261	482	1,020
Other income (expense)	(4)	36	61	192
Income (loss) before income taxes	3,865	(8,645)	2,456	(4,079)
Income tax expense (benefit)	650	305	(202)	1,243
Net income (loss)	3,215	(8,950)	2,658	(5,322)
Preferred stock dividends and accretion	488		1,104	
Net income (loss) applicable to common shares	$ 2,727	$ (8,950)	$ 1,554	$ (5,322)
Earnings per share:				
Basic	$ 0.03	$ (0.12)	$ 0.02	$ (0.09)
Diluted	$ 0.03	$ (0.12)	$ 0.02	$ (0.09)
Weighted average number of common shares outstanding:				
Basic	79,313	76,419	78,903	61,924
Diluted	80,646	76,419	79,957	61,924

See accompanying Notes to Unaudited Consolidated Financial Statements.

INPUT/OUTPUT, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine Months Ended September 30, 2005 (Restated)	Nine Months Ended September 30, 2004 (Restated)
	(In thousands)	
Cash flows from operating activities:		
Net income (loss)	$ 2,658	$ (5,322)
Adjustments to reconcile net income (loss) to cash used in operating activities:		
Depreciation and amortization (other than multi-client library)	18,292	11,305
Amortization of multi-client library	5,521	2,731
Amortization of restricted stock and other stock compensation	1,707	435
Reduction of tax reserves	(1,393)	
Deferred income tax	(544)	
Bad debt expense	473	5,708
Loss (gain) on sale of fixed assets	75	(3,394)
Change in operating assets and liabilities:		
Accounts and notes receivable	(31,964)	(32,865)
Unbilled receivables	(6,191)	728
Inventories	10,885	(10,760)
Accounts payable and accrued expenses	(15,086)	17,493
Deferred revenue	7,281	5,956
Other assets and liabilities	(2,980)	733
Net cash used in operating activities	(11,266)	(7,252)
Cash flows from investing activities:		
Purchase of property, plant and equipment	(4,233)	(3,717)
Investment in multi-client data library	(11,431)	(1,083)
Proceeds from the sale of fixed assets	37	4,504
Investment at cost	(500)	
Acquisition of intellectual property rights	(1,850)	
Proceeds from collection of long-term note receivable		5,800
Business acquisition		(176,731)
Cash of acquired businesses		2,193
Liquidation of Energy Virtual Partners, Inc.		117
Net cash used in investing activities	(17,977)	(168,917)
Cash flows from financing activities:		
Net borrowings under revolving line of credit	3,585	
Payments on notes payable, long-term debt and lease obligations	(5,483)	(4,302)
Net proceeds from issuance of common stock		150,066
Net proceeds from preferred stock offering	29,800	
Payment of preferred dividends	(1,104)	
Return of deposit securing a letter of credit	1,500	
Proceeds from employee stock purchases and exercise of stock options	2,314	3,279
Purchases of treasury stock	(224)	(87)
Net cash provided by financing activities	30,388	148,956
Effect of change in foreign currency exchange rates on cash and cash equivalents	(398)	(377)
Net increase (decrease) in cash and cash equivalents	747	(27,590)

Cash and cash equivalents at beginning of period		14,935		59,507
Cash and cash equivalents at end of period	$	15,682	$	31,917

See accompanying Notes to Unaudited Consolidated Financial Statements.

INPUT/OUTPUT, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation and Restatement

The consolidated balance sheet of Input/Output, Inc. and its subsidiaries (collectively referred to as the Company or I/O , unless the context otherwise requires) at December 31, 2004 (restated see below) has been derived from the Company s audited consolidated financial statements at that date. The consolidated balance sheet at September 30, 2005 (restated see below), the consolidated statements of operations for the three and nine months ended September 30, 2005, (restated see below) and 2004 (restated see below), and the consolidated statements of cash flows for the nine months ended September 30, 2005 (restated see below) and 2004 (restated see below) have been prepared by the Company without audit. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for the three and nine months ended September 30, 2005 (restated see below) are not necessarily indicative of the operating results for a full year or of future operations.

These consolidated financial statements have been prepared using accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and applicable rules of Regulation S-X of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements presented in accordance with accounting principles generally accepted in the United States have been omitted. The accompanying consolidated financial statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2005, which reflects the restatement of the consolidated financial statements as of and for the year ended December 31, 2004. Certain amounts previously reported in the consolidated financial statements have been reclassified to conform to the current period s presentation.

Restatement of Consolidated Financial Statements as of and for the Three and Nine Months Ended September 30, 2005

The Company s consolidated balance sheets at September 30, 2005 and December 31, 2004, and the consolidated statements of operations for the three and nine months ended September 30, 2005 and 2004 and the consolidated statements of cash flows for the nine months ended September 30, 2005 and 2004 have been restated, principally as a result of incorrect application of accounting principles for revenue recognition by the Company s subsidiary, GX Technology Corporation (GXT), in connection with license sales of GXT s multi-client seismic survey data. The Company has included in its restated balance sheet at September 30, 2005 and December 31, 2004, a deferred tax liability and a corresponding increase in goodwill related to book and tax differences of the intangible assets of its Concept Systems Holding Limited (Concept Systems) subsidiary, which had been acquired by the Company in 2004, in addition to its deferred income tax expense impact on the Company s results of operations for the three and nine months ended September 30, 2005. Also, the Company s balance sheet at December 31, 2004 has been updated to reflect the restatements and reclassifications as previously reported in the Company s Annual Report on Form 10-K for the year-ended December 31, 2005 as filed with the SEC on March 31, 2006.

GXT was acquired by the Company in June 2004; therefore, GXT s internal control over financial reporting was excluded from management s assessment of the Company s internal control over financial reporting as of December 31, 2004. In the process of assessing GXT s internal controls in connection with the preparation of the 2005 consolidated financial statements the Company determined that GXT s policies and procedures for timing of recognizing revenue generated from licenses of multi-client seismic survey data were not in accordance with generally accepted accounting principles. The Company determined that the revenues from certain GXT multi-client data transactions in 2004 and the first three quarters of 2005 had been recognized by GXT upon the signing of customer letter agreements and delivery of the multi-client data, but prior to the receipt from the customer of a signed final master geophysical data license agreement and accompanying license supplement. As there was not adequate evidence of a final license arrangement, the Company determined that the revenue from these transactions should not have been recognized by GXT until delivery of the data to the customer and the receipt from the customer of a signed final master geophysical data license agreement and accompanying license supplement.

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

	As Previously Reported	Adjustments	As Restated
	(In thousands, except share and per share data)		
Balance Sheet as of September 30, 2005:			
Non-current deferred income tax asset	$	$ 1,113	$ 1,113
Multi-client data library, net	15,205	730	15,935
Goodwill	148,998	5,892	154,890
Intangible and other assets, net	70,482	(443)	70,039
Total assets	497,020	7,292	504,312
Accrued expenses	32,628	(3,277)	29,351
Deferred revenue	14,162	8,512	22,674
Deferred income tax liability		1,113	1,113
Total current liabilities	75,833	6,348	82,181
Non-current deferred income tax liability		4,567	4,567
Total liabilities	152,138	10,915	163,053
Accumulated deficit	(161,636)	(3,962)	(165,598)
Accumulated other comprehensive (loss) income	(488)	339	(149)
Total stockholders equity	315,082	(3,623)	311,459
Total liabilities and stockholders equity	497,020	7,292	504,312
Statement of Operations for the three months ended September 30, 2005:			
Net sales	$ 82,710	$ (3,202)	$ 79,508
Cost of sales	59,644	(3,961)	55,683
Gross profit	23,066	759	23,825
Marketing and sales	7,704	(139)	7,565
Total operating expenses	18,946	(139)	18,807
Income (loss) from operations	4,120	898	5,018
Income (loss) before income taxes	2,967	898	3,865
Income tax expense (benefit)	1,036	(386)	650
Net income (loss)	1,931	1,284	3,215
Net income (loss) applicable to common shares	1,443	1,284	2,727
Basic and diluted net income (loss) per share	0.02	0.01	0.03
Statement of Operations for the nine months ended September 30, 2005:			
Net sales	$ 233,571	$ (1,854)	$ 231,717
Cost of sales	171,940	(2,887)	169,053
Gross profit	61,631	1,033	62,664
Marketing and sales	22,672	(97)	22,575
Total operating expenses	56,122	(97)	56,025
Income (loss) from operations	5,509	1,130	6,639
Income (loss) before income taxes	1,326	1,130	2,456
Income tax expense (benefit)	342	(544)	(202)
Net income (loss)	984	1,674	2,658
Net income (loss) applicable to common shares	(120)	1,674	1,554
Basic and diluted net income (loss) per share	(0.00)	0.02	0.02
Weighted average number of diluted common shares outstanding	78,903	1,054	79,957
Statement of Cash Flows for the nine months ended September 30, 2005:			
Net income (loss)	$ 984	$ 1,674	$ 2,658
Amortization of multi-client library	5,798	(277)	5,521
Deferred income taxes		(544)	(544)

Accounts payable and accrued expenses		(12,379)		(2,707)		(15,086)
Deferred revenue		5,427		1,854		7,281
Balance Sheet as of December 31, 2004:						
Non-current deferred income tax asset	$	480	$	633	$	1,113
Multi-client data library, net		9,572		453		10,025
Goodwill		147,066		5,892		152,958
Total assets		479,116		6,978		486,094
Accrued expenses		26,686		(570)		26,116
Deferred revenue		8,423		6,658		15,081
Deferred income tax liability				1,113		1,113
Total current liabilities		82,529		7,201		89,730
Non-current deferred income tax liability				5,529		5,529
Total liabilities		164,604		12,730		177,334
Accumulated deficit		(161,516)		(5,635)		(167,151)
Accumulated other comprehensive income (loss)		2,449		(117)		2,332
Total stockholders equity		314,512		(5,752)		308,760
Total liabilities and stockholders equity		479,116		6,978		486,094
Statement of Operations for the three months ended September 30, 2004:						
Net sales	$	80,861	$	(4,100)	$	76,761
Cost of sales		62,456		20		62,476
Gross profit		18,405		(4,120)		14,285
Marketing and sales		7,342		(144)		7,198
Total operating expenses		21,748		(144)		21,604
Income (loss) from operations		(3,343)		(3,976)		(7,319)
Income (loss) before income taxes		(4,669)		(3,976)		(8,645)
Net income (loss)		(4,974)		(3,976)		(8,950)
Net income (loss) applicable to common shares		(4,974)		(3,976)		(8,950)
Basic and diluted net income (loss) per share		(0.07)		(0.05)		(0.12)
Statement of Operations for the nine months ended September 30, 2004:						
Net sales	$	179,475	$	(4,101)	$	175,374
Cost of sales		127,958		20		127,978
Gross profit		51,517		(4,121)		47,396
Marketing and sales		15,656		(145)		15,511
Total operating expenses		48,216		(145)		48,071
Income (loss) from operations		3,301		(3,976)		(675)
Income (loss) before income taxes		(102)		(3,977)		(4,079)
Net income (loss)		(1,345)		(3,977)		(5,322)
Net income (loss) applicable to common shares		(1,345)		(3,977)		(5,322)
Basic and diluted net income (loss) per share		(0.02)		(0.07)		(0.09)
Statement of Cash Flows for the nine months ended September 30, 2004:						
Net income (loss)	$	(1,345)	$	(3,977)	$	(5,322)
Amortization of multi-client data library		2,709		22		2,731
Accounts payable and accrued expenses		17,638		(145)		17,493
Deferred revenue		1,856		4,100		5,956

(2) Summary of Significant Accounting Policies and Estimates

Refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2004 for a complete discussion of the Company s significant accounting policies and estimates.

Prior to the first quarter of 2005, the estimated useful life of a multi-client data library once it became available for commercial sale was two years for 2-D projects and three years for 3-D projects. In the first quarter of 2005, the Company determined that the estimated useful economic life of its multi-client data library is four years from the date a multi-client data library becomes available for commercial sale. The Company s method of amortizing the costs of a multi-client data library available for commercial sale is the greater of (i) the percentage of actual revenue to the total estimated revenue multiplied by the estimated total cost of the project or (ii) the straight-line basis over a four-year period. The change in estimate was determined based upon further historical experience of GXT, a wholly owned subsidiary of the Company, in marketing and selling its multi-client data libraries, in addition to a review of industry standards regarding such useful economic lives. The change did not have a material impact to the Company s results of operations during the nine months ended September 30, 2005.

(3) Pro Forma Results of Acquisitions

In June 2004, the Company purchased all the equity interest of GXT, and in February 2004, the Company purchased all the share capital of Concept Systems. The consolidated results of operations of the Company include the results of GXT and Concept Systems from the dates of acquisition. The following summarized unaudited pro forma consolidated income statement information for the nine months ended September 30, 2004, assumes that the GXT and Concept Systems acquisitions had occurred as of the beginning of the period presented. The Company has prepared these unaudited pro forma financial results for comparative purposes only. These unaudited pro forma financial results may not be indicative of the results that would have occurred if the Company had completed the acquisitions as of the beginning of the period presented or the results that will be attained in the future.

The Company has adjusted these pro forma income statements as a result of the final purchase price studies that were completed in the fourth quarter of 2004. As discussed in Note 1 of Notes to Unaudited Consolidated Financial Statements, the Company restated its consolidated financial statements for the year ended December 31, 2004 in connection with the correction of errors regarding the timing of revenue recognition for GXT s multi-client data library license sales. In addition, during the second quarter of 2005 the Company discovered that royalty expenses incurred by GXT related to its multi-client data library had not been properly recorded in the first quarter of 2005. As a result of these errors, the Company restated its financial statements for the three months ended March 31, 2005. The pro forma information for the nine-month period ended September 30, 2004 has been restated to give effect to a correction of the royalty expense of that pre-acquisition period. Amounts presented below are in thousands, except for the per share amounts:

	As Previously Reported Pro forma Nine Months Ended September 30, 2004	Purchase Price and Other Adjustments	As Restated Pro forma Nine Months Ended September 30, 2004
Net sales	$ 213,538	$ (4,101)	$ 209,437
Income from operations	$ 1,716	$ (4,424)	$ (2,708)
Net loss applicable to common shares	$ (1,821)	$ (5,987)	$ (7,808)
Basic and diluted net loss per common share	$ (0.02)	$ (0.08)	$ (0.10)

(4) Stock-Based Compensation

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005 (Restated)	2004 (Restated)	2005 (Restated)	2004 (Restated)
Net income (loss) applicable to common shares	$ 2,727	$ (8,950)	$ 1,554	$ (5,322)
Add: Stock-based employee compensation expense included in reported net income (loss) applicable to common shares	785	324	1,707	435
Deduct: Stock-based employee compensation expense determined under fair value methods for all awards	(1,746)	(1,008)	(4,589)	(2,486)
Pro forma net income (loss) applicable to common shares	$ 1,766	$ (9,634)	$ (1,328)	$ (7,373)
	$ 0.03	$ (0.12)	$ 0.02	$ (0.09)

Basic and diluted net income (loss) per common share as reported								
Pro forma basic and diluted net income (loss) per common share	$	0.02	$	(0.13)	$	(0.02)	$	(0.12)

The fair value of each option was determined using the Black-Scholes option valuation model. The key variables used in valuing the options were as follows: average risk-free interest rate based on 5-year Treasury bonds, an estimated option term of five years, no dividends and expected stock price volatility of 60% during the three and nine months ended September 30, 2005 and 2004.

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

(5) Segment and Product Information

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

A summary of segment information for the three and nine months ended September 30, 2005 and 2004 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005 (Restated)	**2004 (Restated)**	**2005 (Restated)**	**2004 (Restated)**
Net sales:				
Land Imaging Systems	$ 38,809	$ 38,351	$ 106,811	$ 95,626
Marine Imaging Systems	16,338	19,145	43,984	43,699
Data Management Solutions	4,715	4,481	11,566	11,448
Seismic Imaging Solutions	19,646	14,507	69,356	23,685
Corporate and Other		277		916
Total	$ 79,508	$ 76,761	$ 231,717	$ 175,374
Income (loss) from operations:				
Land Imaging Systems	$ 4,257	$ 4,094	$ 12,077	$ 11,702
Marine Imaging Systems	4,090	(2,539)	9,588	2,635
Data Management Solutions	1,470	1,428	1,824	3,538
Seismic Imaging Solutions	1,613	(6,348)	2,663	(3,652)
Corporate and Other	(6,412)	(3,954)	(19,513)	(14,898)
Total	$ 5,018	$ (7,319)	$ 6,639	$ (675)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005 (Restated)	**2004 (Restated)**	**2005 (Restated)**	**2004 (Restated)**
Equipment and system sales	$ 54,258	$ 56,312	$ 145,410	$ 136,473

Multi-client data library sales		9,310		2,606		34,167		6,987
Imaging services		10,154		11,780		34,486		15,960
Other revenues		5,786		6,063		17,654		15,954
Total	$	79,508	$	76,761	$	231,717	$	175,374

(6) Accounts and Notes Receivable

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

	September 30, 2005	December 31, 2004
Accounts receivable, principally trade	$ 91,565	$ 64,751
Less allowance for doubtful accounts	(3,030)	(3,153)
Accounts receivable, net	$ 88,535	$ 61,598

Notes receivable are generally collateralized by the products sold, bear interest at contractual rates ranging from 0.0% to 7.3% per year and are due at various dates through 2008. For non-interest bearing notes with a maturity greater than one year or those notes which the stated rate of interest is considered a below market rate of interest, the Company imputes interest using prevailing market rates at the notes origination. The weighted average effective interest rate at September 30, 2005 was 5.2%. A summary of notes receivable, accrued interest and allowance for doubtful notes is as follows (in thousands):

	September 30, 2005	December 31, 2004
Notes receivable and accrued interest	$ 24,318	$ 20,820
Less allowance for doubtful notes	(5,692)	(5,893)
Notes receivable, net	18,626	14,927
Less current portion of notes receivable, net	11,084	10,784
Long-term notes receivable	$ 7,542	$ 4,143

In 2004, the Company sold its first VectorSeis® Ocean system for seabed data acquisition. A portion of the purchase price was financed by the Company through a series of notes receivable totaling $6.9 million at December 31, 2004. During the second quarter of 2005, the Company advanced to the customer $4.6 million on a non-interest bearing basis. The Company imputed interest on a short-term basis as its expectation was that the advance would be repaid over a short-term period. In July 2005, the Company and the customer entered into an agreement that provides for terms of repayment of the outstanding balances over a three year period. The notes are secured by a lien in the purchased equipment. During the third quarter of 2005, the customer made scheduled payments of $4.8 million, resulting in a total outstanding indebtedness under this arrangement of $10.4 million at September 30, 2005. Under this agreement, the Company also purchased for $1.85 million all intellectual property rights the customer may have regarding the VectorSeis Ocean system as a result of the customer s work on enhancing the system.

(7) Inventories

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

	September 30, 2005	December 31, 2004

Raw materials and subassemblies	$	36,560	$	33,791
Work-in-process		11,434		5,737
Finished goods		44,269		57,953
Reserve for excess and obsolete inventories		(9,702)		(10,822)
Inventories, net	$	82,561	$	86,659

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

(8) Non-Cash Investing and Financing Activities

In June 2005, the owner of the Company s corporate headquarters and manufacturing facility located in Stafford, Texas, sold the facilities to two unrelated parties. See further discussion of certain effects of this transaction on the Company at Note 9 of *Notes to Unaudited Consolidated Financial Statements*.

In February 2004, the Company acquired all of the share capital of Concept Systems. As part of the consideration, the Company issued 1,680,000 shares of its common stock, valued at $10.8 million. Also, in June 2004, the Company acquired all the capital stock of GXT. As part of the purchase consideration for the GXT acquisition, the Company assumed certain outstanding GXT stock options, valued at $14.6 million.

During the nine months ended September 30, 2005, the Company transferred $7.3 million (net book value) of rental equipment to inventory. During the nine months ended September 30, 2004, the Company transferred $6.5 million of inventory at cost, to property, plant, and equipment.

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

A summary of the Company s notes payable, long term debt and lease obligations as of September 30, 2005, is as follows (in thousands):

Obligations		**September 30, 2005**
$25.0 million revolving line of credit	$	3,585
Facility lease obligation		6,246
$60.0 million convertible senior notes		60,000
Equipment capital leases		4,493
Other notes payable		1,658
Total	$	75,982

In May 2005, the Company obtained a $25.0 million revolving line of credit with a maturity date of May 24, 2008. The outstanding balance of indebtedness under this credit facility was $3.6 million at September 30, 2005. Beginning October 1, 2005, the Company can elect to apply either the lender s Base Rate (as defined in the agreement) or the three month LIBOR rate plus 2.25% to 2.75% (depending on the Company s Fixed Charge Coverage Ratio, as defined in the agreement) as interest on outstanding borrowings under the revolving line of credit. Prior to October 1, 2005, the lender s Base Rate applied. The annual interest rate in effect at September 30, 2005 was 6.75%. The Company is obligated to pay a commitment fee of 0.25% per annum on the unused portion of the revolving credit facility. In addition, the Company can issue letters of credit totaling up to $5 million under this facility, which, if issued, reduces the Company s borrowing availability under this revolving line of credit.

A portion of the Company s assets is pledged as collateral for outstanding borrowings under this revolving line of credit. Total borrowings are subject to a borrowing base limitation based on a percentage of eligible accounts receivable and inventories. As of September 30, 2005, the borrowing base calculation permitted total borrowings of $25.0 million, of which $21.4 million remained available. The credit agreement prohibits the Company from paying common stock dividends and limits certain capital expenditures, incurring additional debt, selling significant assets, acquiring other businesses, and merging with other entities without the consent of the lenders. The credit agreement requires compliance with certain financial and non-financial covenants, including quarterly requirements related to a Fixed Charge Coverage Ratio (not less than 1.25 to 1), as defined in the agreement. At September 30, 2005, the Company was in compliance with all of the covenants under the credit agreement.

The credit agreement includes a contingent lockbox arrangement, which is triggered upon an event of default or if the Company s availability under the line of credit falls below $5.0 million. If triggered, all available funds would be used to pay down the outstanding principal balance under the line of credit. The Company currently classifies the outstanding balance under the line of credit as long-term; however, if the contingent lockbox arrangement is triggered, the Company would be required to reflect its outstanding borrowings under this line of credit as short-term.

In 2001, the Company sold its facilities that served as the corporate headquarters and manufacturing facility located in Stafford, Texas for $21.0 million. Simultaneously with the sale, the Company entered into a non-cancelable twelve-year lease with the purchaser of the property. Because the Company retained a continuing involvement in the property that precluded sale-leaseback treatment for financial accounting purposes, the sale-leaseback transaction was accounted for as a financing transaction, and the Company recorded a lease obligation of $21.0 million using an implicit interest rate of 9.1% per annum.

In June 2005, the owner sold the facilities to two parties, which were unrelated to each other as well as unrelated to the seller. In conjunction with the sale of the facilities, the Company entered into two separate lease arrangements for each of the facilities with the new owners. One lease (the Operating Lease), which was classified as an operating lease, has a twelve-year lease term; the other lease (the Lease Obligation), continues to be accounted for as a financing transaction due to the Company s continuing involvement in the property as a lessee, and has a ten-year lease term which the Company does not expect to renew. Both leases have renewal options that allow the Company to extend the leases for up to an additional twenty-year term.

Because the Company subleases more than a minor portion of the property under the Lease Obligation, the Company recorded the commitment as a $6.3 million lease obligation at an implicit interest rate of 9% per annum. The Operating Lease qualified as a sale-leaseback for financial reporting purposes; as a result, in June 2005, $11.8 million under its lease obligations and $8.1 million of long-term assets (primarily fixed assets) were treated as being disposed of, with the Company recording a deferred gain of $3.7 million. The deferred gain will be recognized on the straight-line basis over the twelve-year lease term. Under the previous lease arrangements, the Company had provided a letter of credit to the previous owner, which the Company secured by depositing $1.5 million with the issuing bank. There are no similar requirements under the new lease agreements; therefore, in June 2005, the letter of credit was terminated and the Company reclassified the $1.5 million deposit to cash and cash equivalents.

In December 2003, the Company issued $60.0 million of convertible senior notes, which mature on December 15, 2008. The notes bear interest at an annual rate of 5.5%, payable semi-annually. The notes, which are not redeemable prior to their maturity, are convertible into the Company s common stock at an initial conversion rate of 231.4815 shares per $1,000 principal amount of notes (a conversion price of $4.32 per share), which represents 13,888,890 total common shares. The Company paid $3.5 million in underwriting and professional fees, which have been recorded as deferred financing costs and are being amortized over the term of the notes.

A summary of future principal obligations under the notes payable, long-term debt, the Lease Obligation and equipment capital lease obligations as of September 30, 2005, is as follows (in thousands):

Years Ended December 31,	**Notes Payable, Long-term Debt and Lease Obligation**	**Equipment Capital Lease Obligations**
2005	$ 669	$ 857
2006	1,345	2,580
2007	406	1,185
2008	64,054	219
2009	541	
2010 and thereafter	4,474	
Total	$ 71,489	4,841
Imputed Interest		(348)
Net present value of equipment capital lease obligations		4,493
Current portion of equipment capital lease obligations		2,642
Long-term portion of equipment capital lease obligations		$ 1,851

(10) Cumulative Convertible Preferred Stock

In February 2005, the Company issued 30,000 shares of a newly designated Series D-1 Cumulative Convertible Preferred Stock (Series D-1 Preferred Stock) in a privately-negotiated transaction, at a purchase price of $1,000 per share, for an aggregate of $29.8 million in net proceeds. Dividends, which are contractually obligated to be paid quarterly, may be paid, at the option of the Company, either in cash or by the issuance of the Company s common stock. Dividends are paid at a rate equal to the greater of (i) five percent per annum or (ii) the three month LIBOR rate on the last day of the immediately preceding calendar quarter plus two and one-half percent per annum. The preferred dividend rate was 6.02% at September 30, 2005.

The Series D-1 Preferred Stock may be converted, at the holder s election, into 3,812,428 shares of the Company s common stock, subject to adjustment, at an initial conversion price of $7.869 per share, also subject to adjustment in certain events. Also, commencing on February 17, 2007, or sooner if the 20 day average market price of the Company s common stock is less than $4.45 (Minimum Price) on any date after August 12, 2005, the holder has the right to redeem all or part of the Series D-1 Preferred Stock. The Company may satisfy its redemption obligations either in cash or by the issuance of the Company s common stock, calculated based upon the prevailing market price, but not less than $4.45 per share, of the Company s common stock at the time of redemption. However, if the 20-day average price of the Company s common stock is less than the Minimum Price during that time, the Company may satisfy its redemption obligation by resetting the conversion price to the Minimum Price, and thereafter, all dividends must be paid in cash.

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

The proceeds received from the sale of the Series D-1 Preferred Stock, net of transaction costs, have been classified outside of stockholders equity on the balance sheet below total liabilities. The transaction costs have been deferred and are being accreted through the statement of operations through February 2007. Prior to the conversion, common shares issuable will be assessed for inclusion in the weighted average common shares outstanding for the Company s diluted net income per common share using the if-converted method based on the Company s common share price at the beginning of the applicable period.

(11) Net Income (Loss) per Common Share

Basic net income (loss) per common share is computed by dividing net income (loss) applicable to common shares by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share is determined based on the assumption that outstanding dilutive stock options have been exercised and the aggregate proceeds were used to reacquire common stock using the average price of such common stock for the period. The total number of shares issuable under outstanding anti-dilutive options at September 30, 2005 and 2004 were 5,925,596 and 8,644,210, respectively. The Company has outstanding $60.0 million of convertible senior notes, for which 13,888,890 common shares may be acquired upon their full conversion. The convertible notes are anti-dilutive for all periods presented and have been excluded from the diluted net income per common share. In February 2005, the Company issued the Series D-1 Preferred Stock, which may be converted, at the holder s election, into 3,812,428 total common shares. The Series D-1 Preferred Stock is anti-dilutive for the periods outstanding and has been excluded from the diluted net income per common share.

The following table summarizes the calculation of the weighted average number of common shares and weighted average number of diluted common shares outstanding for purposes of the computation of basic net income (loss) per common share and diluted net income (loss) per common share (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005 (Restated)	2004 (Restated)	2005 (Restated)	2004 (Restated)
Net income (loss) applicable to common shares	$ 2,727	$ (8,950)	$ 1,554	$ (5,322)
Weighted average number of common shares outstanding	79,313	76,419	78,903	61,924
Effect of dilutive stock options	1,333		1,054	
Weighted average number of diluted common shares outstanding	80,646	76,419	79,957	61,924
Basic net income (loss) per common share	$ 0.03	$ (0.12)	$ 0.02	$ (0.09)
Diluted net income (loss) per common share	$ 0.03	$ (0.12)	$ 0.02	$ (0.09)

(12) Income Taxes

The Company records a valuation allowance for substantially all of its net deferred tax assets, which are primarily net operating loss carryforwards. The Company currently does not recognize a benefit from net operating losses. The establishment of this valuation allowance does not affect the Company s ability to reduce future tax expense through utilization of prior years net operating losses. Income tax expense for the three and nine months ended September 30, 2005 and 2004 primarily reflects foreign taxes as a result of the taxable income generated by the Company s foreign operations. Included in the income tax expense for the nine months ended September 30, 2005, is a $1.4 million credit due to the resolution of a foreign tax matter for an amount less than the Company s reserve for that potential liability. As a result of these items, the Company s effective tax rate was 16.8% and (8.2%) for the three and nine months ended September 30, 2005, respectively.

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

(13) Comprehensive Net Income (Loss)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005 (Restated)	**2004 (Restated)**	**2005 (Restated)**	**2004 (Restated)**
Net income (loss) applicable to common shares	$ 2,727	$ (8,950)	$ 1,554	$ (5,322)
Foreign currency translation adjustment	(512)	(146)	(2,481)	(859)
Comprehensive net income (loss)	$ 2,215	$ (9,096)	$ (927)	$ (6,181)

(14) Commitments and Contingencies

Legal Matters: On January 12, 2005, a putative class action lawsuit was filed against I/O, its chief executive officer, its chief financial officer and the president of GXT in the U.S. District Court for the Southern District of Texas, Houston Division. The action, styled *Harold Read, individually and on behalf of all others similarly situated v. Input/Output, Inc, Robert P. Peebler, J. Michael Kirksey, and Michael K. Lambert,* alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder. The action was filed purportedly on behalf of purchasers of I/O s common stock who purchased shares during the period from May 10, 2004 through January 4, 2005. The complaint sought damages in an unspecified amount plus costs and attorneys fees. The complaint alleged misrepresentations and omissions in public announcements and filings concerning the Company s business, sales and products. On February 4 and 10, 2005, and March 15, 2005, three similar lawsuits were filed in the U.S. District Court for the Southern District of Texas, Houston Division. The three complaints, styled (i) *Matt Brody, individually and on behalf of all others similarly situated v. Input/Output, Inc, Robert P. Peebler and J. Michael Kirksey,* (ii) *Giovanni Arca vs. Input/Output, Inc., Robert P. Peebler, J. Michael Kirksey, and Michael K. Lambert,* and (iii) *Schneur Grossberger, individually and on behalf of all others similarly situated v. Input/Output, Inc., Robert P. Peebler, J. Michael Kirksey, and Michael K. Lambert,* contained factual allegations similar to those in the *Read* complaint.

The *Brody* complaint was voluntarily dismissed by the plaintiff in that case on April 28, 2005. On May 13, 2005, the court ordered the three remaining cases to be consolidated into one case, styled *Harold Read, individually and on behalf of all others similarly situated v. Input/Output, Inc, Robert P. Peebler, J. Michael Kirksey, and Michael K. Lambert.* On August 26, 2005, the court ordered that the class action allegations contained in the consolidated lawsuit be stricken from the lawsuit for the plaintiffs failure to identify and designate a lead plaintiff in the lawsuit. On September 2, 2005, the court ordered that the former putative class action lawsuit be dismissed without prejudice.

A shareholder derivative lawsuit (*Kovalsky v. Robert P. Peebler, et al.*, No. 2005-17565) was filed on March 16, 2005 in the District Court of Harris County, Texas, 189th Judicial District, against certain of the Company s officers and all of the members of its board of directors as defendants, and against the Company as a nominal defendant. The complaint alleges breach of the officers and directors fiduciary duties by failing to correct publicly reported financial results and guidance, abuse of control, gross mismanagement, unjust enrichment and corporate waste. The plaintiff seeks judgment against the defendants for unspecified damages sustained by the Company, restitution, disgorgement of profits, benefits and compensation allegedly obtained by the defendants and attorneys and experts fees and costs. Based on the Company s review of the *Kovalsky* complaint, management believes that the derivative suit is without merit and intends to defend vigorously the Company and its officers and directors named as parties in this action. Management of the Company believes that the ultimate resolution of this case will not have a material adverse impact on the Company s financial condition, results of operations, or liquidity.

In October 2002, the Company filed a lawsuit against Paulsson Geophysical Services, Inc. (PGSI) and its owner in the 286th District Court for Fort Bend County, Texas, seeking recovery of approximately $0.7 million that was unpaid and due to the Company resulting from the sale of a custom product that PGSI asked the Company to construct in 2001. In 2002, the Company fully reserved for all amounts due from PGSI with regard to this sale. After the Company filed suit to recover the PGSI receivable, PGSI alleged that the delivered custom product was defective and counter-claimed against the Company, asserting breach of contract, breach of warranty and other related causes of action. The case was tried to a jury during May 2004. The jury returned a verdict in June 2004, the results of which would not have supported a judgment awarding damages to either the Company or the defendants. In August 2004, the presiding judge overruled the jury verdict and ordered a new trial. A new trial has been scheduled for March 2006. Company management continues to believe that the ultimate resolution of the case will not have a material adverse impact on the financial condition, results of operations, or liquidity of the Company.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	**2004**	**2005**	**2004**
Balance at beginning of period	$ 3,568	$ 3,561	$ 3,832	$ 3,433
Accruals for warranties issued during the period	1,817	1,954	4,149	3,331
Settlements made (in cash or in kind) during the period	(520)	(1,201)	(3,116)	(2,450)
Balance at end of period	$ 4,865	$ 4,314	$ 4,865	$ 4,314

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

Restatement

See Note 1 to Unaudited Consolidated Financial Statements for an explanation regarding the restatement of our consolidated financial statements as of and for the three and nine months ended September 30, 2005.

The restatement was necessitated principally due to the incorrect application of accounting principles for revenue recognition by our subsidiary, GX Technology Corporation (GXT), in connection with license sales of GXT s multi-client seismic survey data. The principal effects of the restatement on our historical results of operations for the accounting periods affected have been to shift amounts of revenue and associated costs and expenses recognized from these multi-client license transactions to subsequent accounting periods. For the three months ended September 30, 2005, the restatement decreased our consolidated net sales from $82.7 million to $79.5 million, increased our gross profit from $23.0 million to $23.8 million and increased our net income applicable to common shares from $1.4 million ($0.02 per common share (diluted)) to $2.7 million ($0.03 per common share (diluted)). For the nine months ended September 30, 2005, the restatement decreased our consolidated net sales from $233.6 million to $231.7 million, increased our gross profit from $61.6 million to $62.7 million and changed our net loss applicable to common shares of ($0.1) million ($0.00 loss per common share (diluted)) to net income of $1.6 million ($0.02 per common share (diluted)). Also, our consolidated balance sheets at September 30, 2005 and December 31, 2004 have been restated to include a deferred tax liability and a corresponding increase in goodwill related to book and tax differences between the intangible assets of our Concept Systems

Holding Limited (Concept Systems) subsidiary, which we had acquired in 2004. Our consolidated statements of cash flows for the nine months ended September 30, 2005 and 2004 have been restated resulting in changes within cash flows from operating activities, but no changes to net cash used in operating activities.

Executive Summary

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

After several years of decreased levels of seismic activity, we are seeing the businesses of our oil company and seismic contractor customers improve as they have increased their capital spending. We would expect this trend to escalate as our customers become more confident in the strength of the market, primarily driven by high oil and gas prices. The increase in levels of seismic spending has been primarily evidenced by the increase in sales within our Marine Imaging Systems segment and increased sales of our vibrator trucks within our Land Imaging Systems segment, which reflects the growing international land market. Also, during the second quarter of 2005, GXT returned to profitability due to improving results within their processing business and an increase in sales of their seismic data library.

In February 2005, we issued 30,000 shares of a newly designated Series D-1 Cumulative Convertible Preferred Stock (Series D-1 Preferred Stock) in a privately-negotiated transaction and received $29.8 million in net proceeds. Also, in May 2005, we obtained a $25.0 million revolving line of credit which has a maturity date in May 2008. We believe, based upon our forecasts and our liquidity requirements for the near term, that the combination of our projected internally generated cash, the availability of the revolving line of credit and our working capital (including cash and cash equivalents on hand) will provide further flexibility in meeting our growth plans and liquidity requirements for the next twelve months.

Our Marine Imaging Systems segment leases a 40,000-square foot facility located in Harahan, Louisiana, in the greater New Orleans metropolitan area. On August 27, 2005, we suspended operations at this facility and evacuated and locked down the facility in preparation for Hurricane Katrina. This facility did not experience flooding or significant damage during or after the hurricane. However, because of employee evacuations, power failures and lack of related support services, utilities and infrastructure in the New Orleans area, we were unable to resume full operations at the facility until September 26, 2005. While full operations remained suspended, many of the functions performed at the Harahan facility were performed at our facilities in Stafford, Texas and other locations. The suspension of operations at this facility did not have a material adverse impact on our results of operations for the quarter ended September 30, 2005.

We operate our company through four business segments: Land Imaging Systems, Marine Imaging Systems, Data Management Solutions and Seismic Imaging Solutions. The following table provides an overview of key financial metrics for our company as a whole and our four business segments during the three and nine months ended September 30, 2005 compared to those periods one year ago (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005 (Restated)	**2004 (Restated)**	**2005 (Restated)**	**2004 (Restated)**
Net sales:				
Land Imaging Systems	$ 38,809	$ 38,351	$ 106,811	$ 95,626
Marine Imaging Systems	16,338	19,145	43,984	43,699
Data Management Solutions	4,715	4,481	11,566	11,448
Seismic Imaging Solutions	19,646	14,507	69,356	23,685
Corporate and Other		277		916
Total	$ 79,508	$ 76,761	$ 231,717	$ 175,374
Income (loss) from operations:				
Land Imaging Systems	$ 4,257	$ 4,094	$ 12,077	$ 11,702
Marine Imaging Systems	4,090	(2,539)	9,588	2,635
Data Management Solutions	1,470	1,428	1,824	3,538
Seismic Imaging Solutions	1,613	(6,348)	2,663	(3,652)
Corporate and Other	(6,412)*	(3,954)*	(19,513)*	(14,898)*
Total	$ 5,018	$ (7,319)	$ 6,639	$ (675)

	Three Months Ended September 30,	Nine Months Ended September 30,

		2005 (Restated)		2004 (Restated)		2005 (Restated)		2004 (Restated)
Net income (loss) applicable to common shares	$	2,727	$	(8,950)	$	1,554	$	(5,322)
Basic and diluted net income (loss) per common share	$	0.03	$	(0.12)	$	0.02	$	(0.09)

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

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

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

The information contained in this Quarterly Report on Form 10-Q contains references to our trademarks, service marks and registered marks, as indicated. Except where stated otherwise or unless the context otherwise requires, the terms VectorSeis and VectorSeis System Four refer to our VectorSeis(R) and VectorSeis System Four(R) registered marks.

Results of Operations

The following descriptions of our results of operations for the three and nine month periods ended September 30, 2005 reflect the restated financial data for those periods.

Three Months Ended September 30, 2005 Compared to Three Months Ended September 30, 2004

Net Sales: Net sales of $79.5 million for the three months ended September 30, 2005 increased $2.7 million, compared to the corresponding period in 2004. Land Imaging Systems net sales increased slightly, by $0.4 million, to $38.8 million compared to $38.4 million in the corresponding period in 2004. This increase was due to an increase in our land acquisition system and vibrator truck sales, partially offset by a decline in our Sensor geophone sales. Marine Imaging System s net sales decreased $2.8 million to $16.3 million compared to $19.1 million in the corresponding period in 2004, as in last year s third quarter we made final deliveries under our first VectorSeis Ocean acquisition system contract.

Seismic Imaging Solutions net sales increased $5.1 million, to $19.6 million for the three months ended September 30, 2005 compared to $14.5 million in the corresponding period in 2004. GXT contributed $17.6 million to our net sales for the three months ending September 30, 2005, compared to $13.4 million in the corresponding period in 2004. This increase is related to sales of off-the-shelf seismic data primarily off the coast of West Africa. GXT s backlog of processing projects has improved since the end of 2004. Concept Systems contributed $4.7 million to our net sales for the third quarter, compared to $4.5 million in the corresponding period in 2004.

Gross Profit and Gross Profit Percentage: Gross profit of $23.8 million for the three months ended September 30, 2005 increased $9.5 million, compared to the corresponding period in 2004. Gross profit percentage for the three months ended September 30, 2005 was 30% compared to 19% in 2004. The improvement in our gross margin percentages was primarily due to an increase of higher margin positioning and acquisition system electronics sales within Marine Imaging Systems and an increase in sales of GXT s off-the-shelf seismic data library and improving results within their processing business. This increase is partially offset by continuing pricing pressures on our land acquisition systems.

General and Administrative: General and administrative expenses of $6.4 million for the three months ended September 30, 2005 decreased $5.1 million. This decrease is related to a third quarter of 2004 provision of $5.2 million for doubtful accounts and notes associated with receivables due from a former Russian customer within Marine Imaging Systems.

Gain on Sale of Assets: Gain on sale of assets for the three months ended September 30, 2004 primarily related to the sale of our Alvin, Texas manufacturing facility. There was no comparable sale of assets during the three months ended September 30, 2005.

Income Tax Expense: Income tax expense for the three months ended September 30, 2005 was $0.7 million compared to an income tax expense of $0.3 million for the three months ended September 30, 2004. Income tax expense reflected only state and foreign taxes, since we continue to maintain a valuation allowance for substantially all of our net deferred tax assets.

Preferred Dividend: The preferred dividend is a result of our issuance of Series D-1 Preferred Stock in February 2005, which resulted in $29.8 million of net proceeds. Dividends, which are contractually obligated to be paid quarterly, may be paid, at the option of the Company, either in cash or by the issuance of the Company s common stock. Dividends are paid at a rate equal to the greater of (i) five percent per annum or (ii) the three month LIBOR rate on the last day of the immediately preceding calendar quarter plus two and one-half percent per annum. The preferred dividend rate was 6.02% at September 30, 2005.

Nine Months Ended September 30, 2005 Compared to Nine Months Ended September 30, 2004

Net Sales: Net sales of $231.7 million for the nine months ended September 30, 2005 increased $56.3 million, compared to the corresponding period in 2004 due principally to the acquisition of GXT. Land Imaging Systems net sales increased by $11.2 million, to $106.8 million compared to $95.6 million during the nine months ended September 30, 2004. This increase was due to an increase in our land acquisition system and vibrator truck sales, partially offset by the decline in our Sensor geophone sales. Marine Imaging System s net sales increased $0.3 million to $44.0 million, compared to $43.7 million during the nine months ended September 30, 2004. During the first nine months of 2004 we sold our first VectorSeis Ocean acquisition system representing $16.9 million of revenues, compared to no VectorSeis Ocean revenues during the first nine months of 2005. Excluding the impact of VectorSeis Ocean, Marine Imaging Systems revenue significantly increased due to a stronger marine seismic market compared to last year.

Seismic Imaging Solutions net sales increased $45.7 million, to $69.4 million for the nine months ended September 30, 2005 compared to $23.7 million in the corresponding period in 2004, due to our acquisition of GXT in June 2004. GXT contributed $63.8 million to our net sales for the nine months ended September 30, 2005, compared to $19.0 million in the corresponding period in 2004. Concept Systems, which we acquired in February 2004, contributed $11.6 million to our net sales for the nine months ended September 30, 2005, compared to $11.4 million in the corresponding period in 2004.

Gross Profit and Gross Profit Percentage: Gross profit of $62.7 million for the nine months ended September 30, 2005 increased $15.3 million compared to the corresponding period in 2004. Gross profit percentages for the nine months ended September 30, 2005 and September 30, 2004 were 27%, respectively. Our gross profit percentage remained at a low level due primarily to pricing pressures on land acquisition systems related to entering new markets, in addition to a higher mix of lower margin vibrator truck sales during periods of comparison.

Marketing and Sales: Marketing and sales expense of $22.6 million for the nine months ended September 30, 2005 increased $7.1 million compared to the corresponding period in 2004. The increase is primarily a result of the acquisition of GXT in June 2004. Excluding the expenses of GXT, our sales and marketing expenses reflect additional sales personnel, an increase in business development personnel within our product groups, an increase in corporate marketing and advertising expenses and expenses related to our sales representative offices in Moscow and Beijing. We intend to continue investing significant sums in our marketing efforts as we penetrate markets for our new products.

General and Administrative: General and administrative expense of $19.2 million for the nine months ended September 30, 2005 decreased $2.8 million compared to the corresponding period in 2004. The decrease in general and administrative expense is primarily related to our Marine Imaging Systems third quarter of 2004 provision of $5.2 million for doubtful accounts and notes associated with our receivables due from a former Russian customer. This decrease is partially offset by the acquisition of GXT in June 2004, which added $2.0 million to our general and administrative expenses compared to $0.7 million in the corresponding period in 2004and an increase in fees associated with the implementation of requirements under section 404 of the Sarbanes-Oxley Act of 2002.

Gain on Sale of Assets: Gain on sale of assets for the nine months ended September 30, 2004 primarily related to the sale of our Alvin, Texas manufacturing facility and undeveloped land across from our headquarters in Stafford, Texas. There was no comparable sale of assets during the nine months ended September 30, 2005.

Income Tax Expense (Benefit): Our income tax benefit for the nine months ended September 30, 2005 was $0.2 million compared to an income tax expense of $1.2 million for the nine months ended September 30, 2004. This decreased expense was primarily due to the closure of a foreign tax matter, which resulted in a $1.4 million reduction in our reserve for that matter. Excluding this tax benefit, income tax expense for the nine months ended September 30, 2005 and 2004 reflected only state and foreign taxes, since we continue to maintain a valuation allowance for substantially all of our net deferred tax assets.

Liquidity and Capital Resources

The cash flow information described below reflects the restatement of our consolidated financial statements for the nine months ended September 30, 2005.

New Sources of Capital

In February 2005, we issued 30,000 shares of a newly designated Series D-1 Cumulative Convertible Preferred Stock (Series D-1 Preferred Stock) in a privately-negotiated transaction and received $29.8 million in net proceeds. The Series D-1 Preferred Stock may be converted, at the holder s election, into 3,812,428 shares of our common stock, subject to adjustment, at an initial conversion price of $7.869 per share (122% of the market price on the date of issuance), also subject to adjustment in certain events. We also granted the holder the right, commencing on August 16, 2005 and expiring on February 16, 2008 (subject to extension), to purchase up to an additional 40,000 shares of one or more additional series of Series D-1 Preferred Stock, having similar terms and conditions as the Series D-1 Preferred Stock, and having a conversion price equal to 122% of the prevailing market price of our common stock at the time of its issuance, but not less than $6.31 per share (subject to adjustment in certain events).

In May 2005, we obtained a $25.0 million revolving line of credit with a maturity date of May 24, 2008. The outstanding balance of indebtedness under this credit facility was $3.6 million at September 30, 2005. We can periodically elect to use either the lender s Base Rate (as defined in the credit agreement) or the three-month LIBOR Rate plus 2.25% to 2.75% (depending on our Fixed Charge Coverage Ratio, as defined in the credit agreement) in connection with borrowings under the revolving line of credit. In addition, we can issue letters of credit totaling up to $5 million under this facility, which, if issued, reduces our borrowing availability under this revolving line of credit. At September 30, 2005, there were no outstanding letters of credit under this facility.

A portion of our assets are pledged as collateral for outstanding borrowings under the line of credit. Total borrowings are subject to a borrowing base limitation based on a percentage of eligible accounts receivable and inventories. As of September 30, 2005, the borrowing base calculation permitted total borrowings of $25.0 million, of which $21.4 million remained available. Our borrowing base could decrease if our Eligible Collateral (as defined in the credit agreement) falls below $25.0 million. The credit agreement prohibits us from paying dividends on common stock and limits certain capital expenditures (as defined), incurring additional debt, selling significant assets, acquiring other businesses, and merging with other entities without the consent of the lenders. The credit agreement requires compliance with certain financial and non-financial covenants, including quarterly requirements related to Fixed Charge Coverage Ratio (not less than 1.25 to 1), as defined in the agreement. The credit agreement includes a contingent lockbox arrangement, which is triggered upon an event of default or if our availability under the line of credit falls below $5.0 million. If triggered, all available funds would be used to pay down the outstanding principal balance under the line of credit. We currently classify the outstanding balance under the line of credit as long-term; however, if the contingent lock box arrangement is triggered, we would be required to reflect the outstanding borrowings under this line of credit as short-term. We were in compliance with all of the covenants under the credit agreement as of September 30, 2005.

The issuance of the Series D-1 Preferred Stock and our obtaining a revolving line of credit resulted from our evaluation that began in late 2004 of our long-term and short-term capital needs. In connection with our assessment of 2004 s results of operations, we evaluated the amount of working capital required to manufacture certain of our sophisticated VectorSeis systems, the projections of our short-term and long-term working capital requirements, the potential for unanticipated delays in the adoption of new technologies, certain research and development opportunities and market trends in the seismic industry, and determined that an infusion of additional long-term capital and having the availability of a revolving line of credit were desirable. We believe, based upon our forecasts and our liquidity requirements for the near term, that the combination of our projected internally generated cash, the availability of this revolving line of credit and our working capital (including cash and cash equivalents on hand), will provide further flexibility in meeting our growth plans and liquidity requirements for the next twelve months.

Cash Flow from Operations

We have historically financed operations from internally generated cash and funds from equity and debt financings. Cash and cash equivalents were $15.7 million at September 30, 2005, an increase of $0.7 million. Net cash used in operating activities was $11.3 million for the nine months ended September 30, 2005, compared to net cash used in operating activities of $7.3 million for the nine months ended September 30, 2004. The increase in net cash used in our operating activities was primarily due to decreases in our payables and accrued expenses, which resulted from our payments to vendors for inventory received near the end of 2004, and an increase in our accounts receivable and receivables due to our higher sales levels.

Cash Flow from Investing Activities

Net cash flow used in investing activities was $18.0 million for the nine months ended September 30, 2005, compared to $168.9 million for the nine months ended September 30, 2004. During the nine months ended September 30, 2004, we acquired Concept Systems and GXT. The principal uses of our investing activities during the nine months ended September 30, 2005 were $4.2 million of equipment purchases, an $11.4 million investment in our multi-client data library and $1.85 million to acquire certain intellectual property rights. We expect to expend an additional $5 million to $10 million for equipment purchases and investments in our multi-client data library during the remaining three months of 2005. The range of expenditures for the remainder of the year could vary substantially depending on the level of multi-client projects that are initiated in the last three months of 2005.

Cash Flow from Financing Activities

Net cash flow provided by financing activities was $30.4 million for the nine months ended September 30, 2005, compared to $149.0 million of cash provided by financing activities for the nine months ended September 30, 2004. The net cash flow provided during the nine months ended September 30, 2005 was primarily related to the sale of our Series D-1 Preferred Stock, on which we paid $1.1 million of cash dividends during the period. During the period we made scheduled payments of $5.5 million on our notes payable, long-term debt and lease obligations and had net borrowings under our revolving line of credit of $3.6 million. Our employees exercised stock options, resulting in proceeds to us of $2.3 million during the period. In addition, we reclassified a $1.5 million deposit to cash and cash equivalents as the letter of credit the deposit was securing was terminated during the period.

Inflation and Seasonality

Inflation in recent years has not had a material effect on our costs of goods or labor, or the prices for our products or services. Traditionally, our business has been seasonal, with strongest demand in the first and fourth quarters of our fiscal year.

Future Contractual Obligations

The following table sets forth estimates of future payments for the remainder of 2005, and for 2006 through 2010 and thereafter, of our consolidated contractual obligations, as of September 30, 2005 (in thousands):

		Payments Due by Fiscal Year					
Contractual Obligations at September 30, 2005	**Total**	**Oct.-Dec. 2005**	**2006**	**2007**	**2008**	**2009**	**2010 and Thereafter**
Long-term debt obligations	$ 71,489	$ 669	$ 1,345	$ 406	$ 64,054	$ 541	$ 4,474
Interest on long-term debt obligations	15,586	1,871	4,103	4,057	3,876	430	1,249
Equipment capital lease obligations	4,841	857	2,580	1,185	219		
Operating leases	45,546	1,809	6,723	5,083	4,226	4,130	23,575
Product warranty	4,865	1,216	3,649				
Purchase obligations	83,602	36,412	24,442	7,958	7,395	7,395	
Total	$ 225,929	$ 42,834	$ 42,842	$ 18,689	$ 79,770	$ 12,496	$ 29,298

The long-term debt and lease obligations at September 30, 2005 included $60.0 million in indebtedness under our convertible senior notes that mature in December 2008. The remaining amount of these obligations consist of (i) $3.6 million under our revolving line of credit (ii) $6.2 million related to our sale-leaseback arrangement and (iii) $1.7 million of other short-term notes payable. The $4.8 million of capital lease obligations (including imputed interest) relates to GXT s financing of equipment purchases. For further discussion of our notes payable, long-term debt and lease obligations, see Note 9 of *Notes to Unaudited Consolidated Financial Statements.*

The operating lease commitments at September 30, 2005 relate to our leases for certain equipment, offices, and warehouse space under non-cancelable operating leases.

The liability for product warranties at September 30, 2005 relate to the estimated future warranty expenditures associated with our products. Our warranty periods generally range from 90 days to three years from the date of original purchase, depending on the product. We record an accrual for product warranties and other contingencies at the time of sale, which is when the estimated future expenditures associated with those contingencies become probable and the amounts can be reasonably estimated. We generally receive warranty support from our suppliers regarding equipment they manufactured.

Our purchase obligations primarily relate to our committed inventory purchase orders for which deliveries are scheduled to be made in 2005 and 2006. In December 2004, we entered into a five-year supply agreement with Colibrys Ltd. for the purchase of MEMS accelerometers. The five-year minimum commitment ranges between $7 million to $8 million per year through 2009.

Critical Accounting Policies and Estimates

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

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

Credit Risk

Historically, our principal customers have been seismic contractors that operate seismic data acquisition systems and related equipment to collect data in accordance with their customers specifications or for their own seismic data libraries. However, through the acquisition of GXT, we have diversified our customer base to include major integrated and independent oil and gas companies.

For the nine months ended September 30, 2005 and for all of 2004, approximately 11% and 15%, respectively, of our consolidated net sales were equipment sales to one customer headquartered in China. Approximately $9.8 million, or 11%, of our total accounts receivable at September 30, 2005 related to this same customer. The loss of this customer or a deterioration in our relationship with it could have a material adverse effect on our results of operations and financial condition.

In 2004, we sold our first VectorSeis Ocean system for seabed data acquisition. A portion of the purchase price was financed by us through a series of notes receivable totaling $6.9 million at December 31, 2004. During the second quarter of 2005, we advanced to the customer $4.6 million on a non-interest bearing basis. We imputed interest on a short-term basis as its expectation was that the advance would be repaid over a short-term period. In July 2005, we and the customer entered into an agreement, which provides for terms of repayment of the outstanding balances over a three year period. The notes are secured by a lien in the purchased equipment. During the third quarter of 2005, the customer made scheduled payments of $4.8 million, resulting in a total outstanding indebtedness under this arrangement of $10.4 million at September 30, 2005. Under this agreement, we also purchased for $1.85 million all intellectual property rights the customer may have regarding the VectorSeis Ocean system as a result of the customer s work on enhancing the system.

For the nine months ended September 30, 2005, we recognized $9.2 million of sales to customers in the Commonwealth of Independent States, or former Soviet Union (CIS), $6.6 million of sales to customers in Latin American countries, $60.1 million of sales to customers in Europe, $23.8 million of sales to customers in the Middle East, $19.6 million of sales to customers in Asia Pacific and $28.9 million of sales to customers in Africa. The majority of our foreign sales are denominated in U.S. dollars. In recent years, the CIS and certain Latin American countries have experienced economic problems and uncertainties. To the extent that world events or economic conditions negatively affect our future sales to customers in these and other regions of the world or the collectibility of our existing receivables, our future results of operations, liquidity and financial condition may be adversely affected. We currently require customers in these higher risk countries to provide their own financing and in some cases assist the customer in organizing international financing and Export-Import credit guarantees provided by the United States government. We do not currently extend long-term credit through notes or otherwise to companies in countries we consider to be inappropriate for credit risk purposes.

Risk Factors

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

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

- expected revenues, operating profit and net income;

- expected gross margins for our products and services;

future growth rates for certain of our products and services;

expectations of successfully marketing our products and services to oil and gas company end-users;

the degree and rate of future market acceptance of our new products;

the timing of anticipated sales;

anticipated timing and success of commercialization and capabilities of products and services under development, and start-up costs associated therewith;

potential future acquisitions;

success in integrating our acquired businesses;

our expectations regarding future mix of business and future asset recoveries;

future levels of capital expenditures;

future cash needs and future sources of cash, including availability under our revolving line of credit facility;

the outcome of pending or threatened disputes and other contingencies;

the adequacy of our future liquidity and capital resources;

future demand for seismic equipment and services;

future seismic industry fundamentals;

future oil and gas commodity prices;

future opportunities for new products and projected research and development expenses;

future worldwide economic conditions;

our expectations regarding realization of deferred tax assets;

our beliefs regarding accounting estimates we make; and

results from strategic alliances with third parties.

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

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

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

Due to the relatively high sales price of many of our products and data libraries and relatively low unit sales volume, our quarterly operating results have historically fluctuated from period to period due to the timing of orders and shipments and the mix of products and services sold. This uneven pattern has made financial predictions for any given period difficult, increases the risk of unanticipated variations in our quarterly results and financial condition and places challenges on our inventory management. Delays caused by factors beyond our control, such as the granting of permits for seismic surveys by third parties and the availability and equipping of marine vessels, can affect GXT s revenues from its processing services from period to period. Also, delays in ordering products or in shipping or delivering products in a given quarter could significantly affect our results of operations for that quarter. Fluctuations in our quarterly operating results may cause greater volatility in the price of our common stock and convertible notes.

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

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

The introduction of new seismic technologies and products has traditionally involved long development cycles. Because our full-wave digital products incorporate new technologies, we have experienced slow market acceptance and market penetration for these products. For these reasons, and despite the fact that industry-wide demand for seismic services and equipment has increased in 2005, we have continued to be unable to foresee and predict from period to period with the certainty we have desired, estimated future sales volumes, revenues and margins for these new products.

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

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

Certain of our facilities could be damaged by hurricanes and other natural disasters, which could have an adverse effect on our results of operations and financial condition.

Certain of our facilities are located in regions of the United States that are susceptible to damage from hurricanes and other weather events, and, during 2005, were impacted by hurricanes or weather events. Our Marine Imaging Systems Division leases a 40,000-square foot facility located in Harahan, Louisiana, in the greater New Orleans metropolitan area. On August 27, 2005, we suspended operations at this facility and evacuated and locked down the facility in preparation for Hurricane Katrina. This facility did not experience flooding or significant damage during or after the hurricane. However, because of employee evacuations, power failures and lack of related support services, utilities and infrastructure in the New Orleans area, we were unable to resume full operations at the facility until September 26, 2005. While full operations remained suspended in New Orleans, many of the functions performed at the Harahan facility were performed at our facilities in Stafford, Texas and other locations. The suspension of operations at this facility did not have a material adverse impact on our results of operations for the quarter ended September 30, 2005.

Future hurricanes or similar natural disasters that impact our facilities may negatively affect our financial position and operating results for those periods. These negative effects may include reduced production and product sales; costs associated with resuming production; reduced orders for our products from customers that were similarly affected by these events; lost market share; late deliveries; additional costs to purchase materials and supplies from outside suppliers; uninsured property losses; inadequate business interruption insurance and an inability to retain necessary staff.

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

Sales to customers outside of North America accounted for approximately 63% of our consolidated net sales for the nine months ended September 30, 2005, and we believe that export sales will remain a significant percentage of our revenue. United States export restrictions affect the types and specifications of products we can export. Additionally, to complete certain sales, United States laws may require us to obtain export licenses, and we cannot assure you that we will not experience difficulty in obtaining these licenses. Operations and sales in countries other than the United States are subject to various risks peculiar to each country. With respect to any particular country, these risks may include:

- expropriation and nationalization;
- political and economic instability;
- armed conflict and civil disturbance;
- currency fluctuations, devaluations and conversion restrictions;

- confiscatory taxation or other adverse tax policies;
- tariff regulations and import/export restrictions;
- customer credit risk;
- governmental activities that limit or disrupt markets, or restrict payments or the movement of funds; and
- governmental activities that may result in the deprivation of contractual rights.

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

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

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

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

We have traditionally relied on a relatively small number of significant customers. Consequently, our business is exposed to the risks related to customer concentration. For the nine months ended September 30, 2005 and for all of 2004, approximately 11% and 15%, respectively, of our consolidated net sales related to one Chinese customer. The loss of any of our significant customers or deterioration in our relations with any of them could materially and adversely affect our results of operations and financial condition.

GXT and Concept Systems increase our exposure to the risks experienced by more technology-intensive companies.

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

- future competition from more established companies entering the market;
- product obsolescence;
- dependence upon continued growth of the market for seismic data processing;
- the rate of change in the markets for GXT s and Concept Systems technology and services;
- research and development efforts not proving sufficient to keep up with changing market demands;
- dependence on third-party software for inclusion in GXT s and Concept Systems products and services;
- misappropriation of GXT s or Concept Systems technology by other companies;
- alleged or actual infringement of intellectual property rights that could result in substantial additional costs;

difficulties inherent in forecasting sales for newly developed technologies or advancements in technologies;

recruiting, training, and retaining technically skilled personnel that could increase the costs for GXT or Concept Systems, limit their growth; and

the ability to maintain traditional margins for certain of their technology or services.

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

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

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

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

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

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

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

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

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

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

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

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

Acquisitions expose us to:

increased costs associated with the acquisition and operation of the new businesses or technologies and the management of geographically dispersed operations;

risks associated with the assimilation of new technologies, operations, sites and personnel;

the possible loss of key employees and costs associated with their loss;

risks that any technology we acquire may not perform as well as we had anticipated;

the diversion of management s attention and other resources from existing business concerns;

the potential inability to replicate operating efficiencies in the acquired company s operations;

potential impairments of goodwill and intangible assets;

the inability to generate revenues to offset associated acquisition costs;

the requirement to maintain uniform standards, controls, and procedures;

the impairment of relationships with employees and customers as a result of any integration of new and inexperienced management personnel; and

the risk that acquired technologies do not provide us with the benefits we anticipated.

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

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

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

Disruption in vendor supplies may adversely affect our results of operations.

Our manufacturing processes require a high volume of quality components. Certain components used by us are currently provided by only one supplier. We may, from time to time, experience supply or quality control problems with suppliers, and these problems could significantly affect our ability to meet production and sales commitments. Reliance on certain suppliers, as well as industry supply conditions, generally involve several risks, including the possibility of a shortage or a lack of availability of key components and increases in component costs and reduced control over delivery schedules; any of these could adversely affect our future results of operations.

We may not be able to generate sufficient cash flows to meet our operational, growth and debt service needs.

Our ability to fund our operations, grow our business and make payments on our indebtedness and our other obligations will depend on our financial and operating performance, which in turn will be affected by general economic conditions in the energy industry and by many financial, competitive, regulatory and other factors beyond our control. We cannot assure you that our business will generate sufficient cash flow from operations or that future sources of capital will be available to us in an amount sufficient to enable us to service our indebtedness or to fund our other liquidity needs.

If we are unable to generate sufficient cash flows to fund our operations, grow our business and satisfy our debt obligations, we may have to undertake additional or alternative financing plans, such as refinancing or restructuring our debt, selling assets, reducing or delaying capital investments or seeking to raise additional capital. We cannot assure you that any refinancing would be possible, that any assets could be sold, or, if sold, of the timing of the sales and the amount of proceeds that may be realized from those sales, or that additional financing could be obtained on acceptable terms, if at all. Our inability to generate sufficient cash flows to satisfy debt obligations, or to refinance our indebtedness on commercially reasonable terms, would materially and adversely affect our financial condition and results of operations and our ability to satisfy our obligations under the notes.

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

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

We are exposed to risks relating to the effectiveness of our internal controls.

During 2004, we implemented a number of procedures to strengthen our internal controls, including procedures to comply with the annual internal controls assessment and attestation requirements under Section 404 of the Sarbanes-Oxley Act of 2002 and the related SEC rules. During the second quarter of 2005, we implemented and enhanced certain internal control procedures regarding GXT s royalty expenses related to its multi-client data library. As a result of these procedures, we discovered errors in the calculation of royalty expenses for the three months ended March 31, 2005. In August 2005, we announced that for the three months ended March 31, 2005, we had understated our royalty expenses and liabilities by $795,000 and therefore restated the results of operations for that period. These errors in the calculation of GXT royalty expenses did not have a material impact upon our reported results for the year ended December 31, 2004, any interim periods in 2004, or any prior period.

We announced in March 2006 that we were restating our consolidated financial statements for the year ended December 31, 2004 and those for the quarterly periods ended September 30, 2004, December 31, 2004, March 31, 2005 June 30, 2005 and September 30, 2005, as a result of incorrect application of accounting principles for revenue recognition by GXT in connection with licenses of its multi-client seismic survey data. We determined that the revenues from certain GXT multi- client data transactions in 2004 and the first three quarters of 2005 were recognized by GXT upon the signing of customer letter agreements and delivery of the multi-client data, but prior to the receipt from the customer of a signed final master geophysical data license agreement and accompanying license supplement. This accounting error had a material impact on the timing of recognition of reported revenues from certain multi-client data license transactions during 2004 and the first three quarters of 2005. The impact of the financial restatement of 2004 s results of operations reduced revenues and net income for 2004 by approximately $6.7 million and $5.6 million, respectively, and increased our basic and diluted net loss per share by approximately $0.08. For a description of material weakness in our internal control over financial reporting identified at December 31, 2005 and determined to have existed at September 30, 2005, see Item 4. Controls and Procedures.

We may experience controls deficiencies or material weakness in the future which could adversely impact the accuracy and timeliness of our future reporting and reports and filings we make with the SEC.

The addition of GXT may alienate a number of our traditional seismic contractor customers with whom GXT competes and adversely affect sales to and revenues from those customers.

GXT s business in processing seismic data competes with a number of our traditiona