UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

☒ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 29, 2003**

Or

☐ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from to .**

COMMISSION FILE NUMBER 000-22671

QUICKLOGIC CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE	**77-0188504**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1277 ORLEANS DRIVE SUNNYVALE, CA 94089
(Address of principal executive offices, including Zip Code)

(408) 990-4000
(Registrant's telephone number, including area code)

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 requirements for the past 90 days. Yes ☒ No ☐

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

As of August 7, 2003, 24,085,389 shares of the Registrant's common stock were outstanding.

QUICKLOGIC CORPORATION
FORM 10-Q
June 30, 2003

PART I. Financial Information

Item 1. Financial Statements

QUICKLOGIC CORPORATION
CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenue	$ 10,603	$ 8,360	$ 20,004	$ 15,841
Cost of revenue	5,040	4,598	9,577	8,965
Gross profit	5,563	3,762	10,427	6,876
Operating expenses:				
Research and development	2,420	3,391	4,748	6,668
Selling, general and administrative	3,842	3,764	7,977	7,397
Loss from operations	(699)	(3,393)	(2,298)	(7,189)
Gain on sale of investment in Tower Semiconductor Ltd.	696	—	696	—
Interest expense	(55)	(8)	(116)	(18)
Interest income and other, net	34	256	60	357
Loss before taxes	(24)	(3,145)	(1,658)	(6,850)
Provision for income tax	—	—	—	—
Net loss	$ (24)	$ (3,145)	$ (1,658)	$ (6,850)
Net loss per share:				
Basic and diluted	$ —	$ (0.13)	$ (0.07)	$ (0.30)
Weighted average shares:				
Basic and diluted	23,901	23,314	23,693	23,117

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements

QUICKLOGIC CORPORATION
CONDENSED UNAUDITED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value amount)

	June 30, 2003	Dec. 31, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 24,065	$ 13,001
Cash and cash equivalents, restricted	—	9,002
Accounts receivable, net of allowances for doubtful accounts of $1,140 and $740	3,555	4,900
Inventory	7,586	7,876
Other current assets	1,876	2,281
Total current assets	37,082	37,060
Property and equipment, net	10,668	11,967
Investment in Tower Semiconductor Ltd.	5,073	5,975
Other assets	6,431	7,129
TOTAL ASSETS	$ 59,254	$ 62,131
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade payables	$ 3,165	$ 3,013

Accrued liabilities	1,863	1,840
Deferred income on shipments to distributors	1,516	1,242
Current portion of long-term obligations	6,852	9,650
Total current liabilities	13,196	15,745
Long-term obligations	1,757	1,455
Total liabilities	14,953	17,200
Commitments and contingencies (see notes 4, 12 and 13)		
Stockholders' equity:		
Common stock, $0.001 par value; 100,000 shares authorized, 24,051 and 23,745 shares issued and outstanding, respectively	24	24
Additional paid-in capital	151,650	151,198
Deferred compensation	(26)	(145)
Accumulated other comprehensive income	457	—
Accumulated deficit	(107,804)	(106,146)
Total stockholders' equity	44,301	44,931
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 59,254	$ 62,131

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements

QUICKLOGIC CORPORATION
CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Six Months Ended June 30, 2003	2002
Cash flows from operating activities:		
Net loss	$ (1,658)	$ (6,850)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation and other non-cash charges	1,981	1,802
Long-lived asset write-off	251	—
Amortization of deferred compensation	119	167
Inventory write-down	150	—
Gain on sale of Tower Semiconductor Ltd. Ordinary Shares	(696)	—
Loss on disposal of assets	5	—
Changes in assets and liabilities:		
Accounts receivable, net of allowances for doubtful accounts	1,345	(2,158)
Inventory	140	2,082
Other assets	1,103	203
Trade payables	152	(472)
Accrued liabilities, deferred income, and other obligations	(473)	(330)
Net cash provided by (used for) operating activities	2,419	(5,556)
Cash flows from investing activities:		
Capital expenditures for property and equipment, net of dispositions	(938)	(1,190)
Investment in Tower Semiconductor Ltd.	—	(3,668)
Proceeds from sale of investment in Tower Semiconductor Ltd.	2,055	—
Net cash provided by (used for) investing activities	1,117	(4,858)
Cash flows from financing activities:		
Payment of bank borrowing and other long-term obligations	(926)	(70)
Proceeds from issuance of common stock, net	452	926
Net change in revolving line of credit	(1,000)	1,750
Restricted cash	9,002	—
Net cash provided by financing activities	7,528	2,606
Net increase (decrease) in cash and cash equivalents	11,064	(7,808)
Cash and cash equivalents at beginning of period	13,001	28,853
Cash and cash equivalents at end of period	$ 24,065	$ 21,045

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements

QUICKLOGIC CORPORATION

CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net loss	$ (24)	$ (3,145)	$ (1,658)	$ (6,850)
Other comprehensive income, net of tax:				
Gain on sale of investments	256	—	256	—
Unrealized gain on investments	649	119	201	119
Total comprehensive income (loss)	$ 881	$ (3,026)	$ (1,201)	$ (6,731)

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 1—The Company and Basis of Presentation

QuickLogic Corporation, founded in 1988, operates in a single industry segment where it designs, develops, markets and supports advanced field programmable gate array semiconductors ("FPGAs"), embedded standard products ("ESPs") and associated software tools.

The accompanying interim financial statements are unaudited. In the opinion of management, these statements have been prepared in accordance with generally accepted accounting principles and include all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the results of the interim periods. While management believes that the disclosures are adequate to make the financial information not misleading, these financial statements should be read in conjunction with our Form 10-K for the year ended December 31, 2002. Operating results for the six months ended June 30, 2003 are not necessarily indicative of the results that may be expected for the full year.

QuickLogic Corporation's fiscal year ends on the Sunday closest to December 31. The current six-month period ended Sunday, June 29, 2003. For presentation purposes, the financial statements and notes have been presented as ending on the last day of the nearest calendar month.

Liquidity

The Company anticipates that its existing cash resources will fund any operating losses, purchases of capital equipment and the potential investment in Tower Semiconductor Ltd., and will provide adequate working capital for the next twelve months. The Company's liquidity is affected by many factors including, among others, the extent to which the Company pursues additional capital expenditures, the level of the Company's product development efforts, and other factors related to the uncertainties of the industry and global economies. Accordingly, there can be no assurance that events in the future will not require the Company to seek additional capital sooner or, if so required, that such capital will be available on terms acceptable to the Company.

Principles of Consolidation

The consolidated financial statements include the accounts of QuickLogic Corporation and its wholly owned subsidiaries, QuickLogic International, Inc., QuickLogic Canada Company, QuickLogic Kabushiki Kaisha, QuickLogic (India) Private Limited, and QuickLogic GmbH. All significant intercompany accounts and transactions are eliminated in consolidation.

Uses of Estimates

The preparation of these financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates, particularly in relation to sales returns and allowances and product obsolescence.

Note 2—Significant Accounting Policies

Revenue Recognition

The Company generally recognizes revenue as products are shipped if evidence of an arrangement exists, the sales price is fixed or determinable, collection of the resulting receivable is reasonably assured, and product returns are reasonably estimable.

The Company sells products directly to original equipment manufacturers ("OEMs") and through distributors. The Company ships programmed parts and unprogrammed parts. Distributors or the end customer may program unprogrammed parts. Revenue is recognized upon shipment to OEM customers. QuickLogic sells to certain distributors under agreements, which, in the case of unprogrammed parts, allow certain rights of return, and price adjustments on unsold inventory. Contractually, the Company's distributors are permitted to return up to 10%, by value, of the products they purchase from QuickLogic every six months. Upon shipment of unprogrammed parts to a distributor, the Company records an accounts receivable from the distributor, relieves inventory by the cost of the product shipped, and records the gross profit, revenue less cost of revenue, on the balance sheet as "deferred income on shipments to distributors," until the inventory is resold by the distributor. Revenue for programmed parts, which do not have rights of return or price adjustments on unsold inventory, is recognized upon shipment to distributors. Reserves for estimated returns and allowances are provided against accounts receivable.

Software revenue from sales of design tool kits is recognized when persuasive evidence of an agreement exists, delivery of the software has occurred, no significant Company obligations with regard to implementation or integration exist, the fee is fixed or determinable and collection is probable. Software revenues amount to less than 2% of total revenues.

Comprehensive Income (Loss)

Comprehensive income (loss), as defined, includes all changes in equity (net assets) during a period from non-owner sources. The Company's comprehensive income (loss) includes unrealized gains and losses on investments available for sale. For the three months ended June 30, 2003, comprehensive income included $649,000 in unrealized gain on Ordinary Shares of Tower Semiconductor Ltd. ("Tower") that are available for sale and $256,000 of realized gain on the sale of Tower Ordinary Shares which were previously included in unrealized loss on investments. For the six months ended June 30, 2003, comprehensive income included $201,000 in unrealized gain on Ordinary Shares of Tower that are available for sale and $256,000 of realized gain on sale of Ordinary Shares of Tower which were previously included in unrealized loss on investments. Other than net loss, the Company had no other elements of comprehensive income or loss for the six months ended June 30, 2003 and 2002.

Stock-Based Compensation

The Company has elected to measure employee stock-based compensation costs using the intrinsic value method prescribed by the Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" and to comply with the pro forma disclosure requirements of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation." Stock-based compensation to non-employees is based on the fair value of the option, estimated using the Black-Scholes Option-Pricing Model on the date of grant, and re-measured until vested. The related stock-based compensation expense is recognized over the vesting period.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation (in thousands except per share amounts):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2003	**2002**	**2003**	**2002**
Net loss - as reported	$ (24)	$ (3,145)	$ (1,658)	$ (6,850)
Add: Stock-based employee compensation expense determined under APB No. 25, included in reported net loss, net of tax	57	83	119	167
Less: Stock-based employee compensation expense determined under fair value based method, net of tax	(1,544)	(1,696)	(2,889)	(3,167)
Less: Stock based purchase compensation expense determined under fair value based method, net of tax	(140)	(242)	(140)	(242)
Net loss - pro forma	$ (1,651)	$ (5,000)	$ (4,568)	$ (10,092)
Net loss per share:				
Basic - as reported	$ —	$ (0.13)	$ (0.07)	$ (0.30)
Basic - pro forma	$ (0.07)	$ (0.21)	$ (0.19)	$ (0.44)
Diluted - as reported	$ —	$ (0.13)	$ (0.07)	$ (0.30)
Diluted - pro forma	$ (0.07)	$ (0.21)	$ (0.19)	$ (0.44)

Foreign Currency Transactions

The Company uses the U.S. dollar as its functional currency. All of the Company's sales and costs of manufacturing are transacted in U.S. dollars. The Company conducts research and development activities in Canada and India and has sales and marketing activities in various countries outside of the United States. These costs are incurred in local currency. Foreign currency transaction gains and losses are included in other income as they occur. The effect of foreign currency exchange rate fluctuations has not been significant to date. In the six months ended June 30, 2003 and 2002, research and development expenses denominated in foreign currencies were 37% and 30%, respectively, of the Company's total research and development expenses. The Company incurred a majority of these expenses in Canada. The Company does not use derivative financial instruments.

Warranty Costs

The Company warrants finished goods against defects in material and workmanship under normal use for 12 months. The Company does not have significant product warranty related costs or liabilities. The one-time-programmable nature of QuickLogic products prevents the Company from incurring warranty cost to fix programmed parts.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and cash equivalents, restricted cash and accounts receivable. Cash and cash equivalents and restricted cash are maintained with high quality institutions. The Company's accounts receivable are denominated in U.S. dollars and are derived primarily from sales to customers located in North America, Europe, and Asia. The Company performs ongoing credit evaluations of its customers and generally does not require collateral.

New Accounting Pronouncements

In April 2003, the Financial Accounting Standards Board ("FASB") issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies financial accounting and reporting of derivative instruments and hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 149 amends SFAS No. 133 for decisions made: (i) as part of the Derivatives Implementation Group process that require amendment to SFAS No. 133; (ii) in connection with other FASB projects dealing with financial instruments; and (iii) in connection with the implementation issues raised related to the application of the definition of a derivative. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for designated hedging relationships after June 30, 2003. The Company believes that the adoption of SFAS No. 149 will not have a material impact on its financial position and results of operations.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." The Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and further requires that an issuer classify as a liability (or an asset in some circumstances) financial instruments that fall within its scope because that financial instrument embodies an obligation of the issuer. Many of such instruments were previously classified as equity. The statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company believes that the adoption of this standard will not have a material impact on its financial position and results of operations.

In November 2002, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 00-21 ("EITF No. 00-21"), "Multiple-Deliverable Revenue Arrangements." EITF No. 00-21 addresses how to account for arrangements that may involve the delivery or performance of multiple products, services, and/or rights to use assets. The consensus mandates how to identify whether goods or services or both that are to be delivered separately in a bundled sales arrangement should be accounted for separately because they are separate units of accounting. The guidance can affect the timing of revenue recognition for such arrangements, even though it does not change rules governing the timing or pattern of revenue recognition of individual items accounted for separately. The final consensus is applicable to agreements entered into in fiscal years beginning after June 15, 2003 with early adoption permitted. Additionally, companies will be permitted to apply the consensus guidance to all existing arrangements as the cumulative effect of a change in accounting principle in accordance with APB No. 20, "Accounting Changes." The Company is assessing the impact of EITF No. 00-21 and believes that the adoption will not have a material impact on its financial position and results of operations.

Note 3—Net Income Per Share

Basic net income (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed using the weighted average number of common and potentially dilutive common shares outstanding during the period under the treasury stock method. In computing diluted net income (loss) per share, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options. A reconciliation of the basic and diluted per share computations is as follows (in thousands, except per share amounts):

	Three Months Ended June 30,					
	2003			2002		
	Net loss	Shares	Per share amount	Net loss	Shares	Per share amount
Basic	$ (24)	23,901	$ —	$ (3,145)	23,314	$ (0.13)
Effect of stock options	—	—	—	—	—	—
Diluted	$ (24)	23,901	$ —	$ (3,145)	23,314	$ (0.13)

	Six Months Ended June 30,					
	2003			2002		
	Net loss	Shares	Per share amount	Net loss	Shares	Per share amount
Basic	$ (1,658)	23,693	$ (0.07)	$ (6,850)	23,117	$ (0.30)
Effect of stock options	—	—	—	—	—	—
Diluted	$ (1,658)	23,693	$ (0.07)	$ (6,850)	23,117	$ (0.30)

For the three months ended June 30, 2003 and 2002, 812,661 and 629,631 potential common shares were excluded from the calculation of diluted net loss per share because their effect would be anti-dilutive due to the net loss the Company experienced in these fiscal periods. For the six months ended June 30, 2003 and 2002, 431,000 and 674,885 potential common shares were excluded from the calculation of diluted net loss per share because their effect would be anti-dilutive due to the net loss the Company experienced in these fiscal periods. While these potential common shares are currently anti-dilutive, they could be dilutive in the future.

Note 4—Investment in Tower Semiconductor Ltd.

On December 12, 2000, the Company entered into a Share Purchase Agreement (the "Agreement") and Foundry Agreement with Tower Semiconductor Ltd. ("Tower"). Under the Agreement, the Company agreed to make a $25 million strategic investment in Tower as part of Tower's plan to build and equip a new wafer fabrication facility. The facility is expected to produce 200-mm wafers in geometries of 0.18 micron and below, using advanced CMOS technology from Toshiba. In return for the investment, the Company receives equity, prepaid wafer credits and committed production capacity in the advanced fabrication facility that Tower is building.

On May 28, 2002, the Company entered into an amendment to the Agreement primarily to change the allocation of the investment between Tower Ordinary Shares and wafer credits and to release the Company from its lockup on 700,000 Tower Ordinary Shares. The Company classifies these shares as available for sale.

During 2001 and 2002 the Company invested a total of $21.3 million in Tower under the terms of the Agreement, as amended. In partial consideration for the investment, the Company has received 1,757,368 Tower Ordinary Shares with an original cost of $16.6 million. The Company wrote down the Tower shares due to an "other than temporary" decline in their market value by $6.8 million and $3.8 million in 2001 and 2002, respectively. The Company also received $4.7 million in prepaid wafer credits in consideration for the investment. These credits can be applied immediately toward wafer purchases from Tower at 7.5% of the value of the purchases and, after July 1, 2005, at 15% of the value of the purchases.

During the three months ended June 30, 2003, the Company sold 399,607 of the Tower Ordinary Shares available for sale, for total proceeds of approximately $2.1 million. The Company recognized a gain on the sale of $696,000 in the statements of operations. As of June 30, 2003, the Company held 1,057,368 restricted Tower Ordinary Shares, which were valued at $3.40 per share, and 300,393 Tower Ordinary Shares that were available for sale, which were valued at $4.92 per share (the market value of the shares on June 30,

2003). As of June 30, 2003, the Company has recorded accumulated other comprehensive income in the amount of $457,000, which represents an unrealized gain on the 300,393 shares that are available for sale.

Under terms of the Agreement, as amended, the Company's remaining investment of $3.7 million would have become due to Tower, provided Tower achieved certain production milestones by July 2003. Tower has not achieved the production milestones required under the Agreement. The Company is negotiating with Tower and may decide to invest all or a portion of the remaining $3.7 million investment under renegotiated terms.

Note 5—Balance Sheet Components

	June 30, 2003	Dec. 31, 2002
	(in thousands)	
Inventory:		
Raw materials	$ 622	$ 705
Work-in-process	5,455	6,166
Finished goods	1,509	1,005
	$ 7,586	$ 7,876
Other assets:		
Prepaid deposits	$ 59	$ 69
Prepaid license fees	1,659	1,687
Deferred compensation plan assets	—	555
Prepaid wafer credits	4,713	4,713
Other assets-long term	—	105
Total other assets	$ 6,431	$ 7,129
Long-term obligations:		
Notes payable to bank	$ 7,574	$ 9,002
Notes payable	80	555
Deferred compensation	—	705
Deferred royalty income	889	750
Capital leases	22	45
Other	44	48
	8,609	11,105
Current portion of long-term obligations	(6,852)	(9,650)
Long-term obligations	$ 1,757	$ 1,455

Notes Payable to Bank

In June 2003, the Company signed an Amended and Restated Loan and Security Agreement with Silicon Valley Bank. Terms of the amended agreement include an $8.0 million revolving line of credit available through June 2004 and a $4.5 million equipment financing line of credit that can be drawn against through December 2003. The revolving line of credit provides for formula advances based upon a percentage of eligible accounts receivable and for non-formula advances not to exceed $5.0 million. Advances under the equipment line of credit must be repaid in either 30 or 36 equal installments, depending upon the nature of the items financed. Terms of the various advances under the amended agreement are as follows:

	Original Balance	Balance at June 30, 2003	Available Credit	Interest Rate	Maturity Date
Revolving Line of Credit:					
Formula advances	n/a	$ 2,114,000	$ —	Prime + 1%	June 28, 2004
Non-formula advances	n/a	3,736,000	1,264,000	Prime + 2%	June 28, 2004
Equipment Line of Credit:					
Term loan A	$ 850,000	638,000	—	Prime + 0.75%	September 1, 2005
Term loan B	1,095,000	766,000	—	Prime + 0.75%	March 1, 2005
Term loan C	303,000	252,000	—	Prime + 0.75%	December 31, 2005
Term loan D	84,000	68,000	—	Prime + 0.75%	June 1, 2005
Equipment advances	n/a	—	2,168,000	Prime + 2%	36 months from date of advance
Total		$ 7,574,000			

The bank has a first priority security interest in the tangible and intangible assets of the Company to secure any outstanding amounts under the amended agreement. Under the terms and definitions of the amended agreement, the Company must maintain a minimum tangible net worth and adjusted quick ratio. The amended agreement also has certain restrictions on other indebtedness, the maintenance of depository accounts at banks other than Silicon Valley Bank, and the payment of dividends. However, the Company is no longer required to maintain any specified amount in demand deposit or investment accounts at Silicon Valley Bank. As a result, none of the Company's cash and cash equivalents was classified as restricted at June 30, 2003.

At June 30, 2003, the prime rate under the credit facility was 4.25%. As of June 30, 2003 and December 31, 2002, $868,000 and $0, respectively, of amounts outstanding under the equipment line of credit were classified as long-term obligations.

Notes Payable

In November 2002, the Company signed a $949,000 credit agreement with a financial institution to finance its insurance payments, at an interest rate of 3.7% per annum. Terms of the agreement required the Company to make a down payment of $237,000, and to repay the principal and interest in monthly installments of $80,000 through July 2003. As of June 30, 2003 and December 31, 2002, the Company had $80,000 and $555,000, respectively, outstanding under this agreement.

Deferred Compensation Plan

During fiscal year 2000, the Company established a non-qualified deferred compensation plan that covers executives and certain other key employees. This non-qualified plan was funded entirely by participants through voluntary deferrals of compensation. Income deferrals made by participants under this plan were deposited into a common trust account. The participants were allowed to diversify the assets, and the deferred compensation obligation was adjusted to reflect gains or losses on the assets in the trust. The assets were classified as trading assets and were reported as other assets, with changes in the assets' fair value recorded as other income or loss. The related obligations are recorded as long-term obligations on the balance sheet, with changes in the amount of the obligations recorded as compensation expense. As of December 31, 2002, the assets and liabilities recorded under the Company's Deferred Compensation Plan were $555,000 and $705,000, respectively, and participants were no longer contributing to the plan. During the first quarter of 2003, the Company terminated the plan and distributed plan funds to the participants. The Company no longer has any assets or liabilities related to the plan.

Deferred Royalty Income

In October 2000, the Company entered into a technology license and wafer supply agreement with Aeroflex UTMC. Under the terms of the agreement, the Company received $750,000 of prepaid royalty from Aeroflex UTMC. In addition, Aeroflex receives prepaid royalty credit for a portion of the amounts paid for wafers purchased from the Company under the agreement. These prepaid royalties are recorded as long-term obligations and will be recognized as revenue when Aeroflex UTMC sells products incorporating the licensed technology. As of June 30, 2003 and December 31, 2002 the Company had recorded $889,000 and $750,000, respectively, of deferred royalty income under this agreement.

Note 6—Deferred Stock Compensation

During the year ended December 31, 1999, the Company granted options to purchase 866,000 shares of common stock at a price less than the fair market value of its common stock at the time of the grant and recorded related deferred stock compensation of $908,000. Such deferred stock compensation is being amortized ratably over the four-year vesting period of the options, net of reversals associated with unvested shares of terminated employees. During the six months ended June 30, 2003 and 2002, deferred stock compensation amortization was $119,000 and $167,000, respectively. At June 30, 2003, $26,000 of deferred stock compensation was included in stockholders' equity.

Note 7—Employee Stock Option Plans

1989 Stock Option Plan

In July 1996, the 1989 Stock Option Plan (the "1989 Plan") was amended to allow options to be exercised prior to vesting. Unvested shares are deposited to an escrow agent and the Company has a right to repurchase unvested shares at the original issuance price if the employee is terminated prior to the lapsing of the Company's repurchase right. In April 1999, an additional 1,333,000 shares were authorized for issuance. The 1989 Plan provided for the issuance of incentive and nonqualified options for the purchase of up to 4,617,000 shares of common stock. Options could be granted to employees, directors and consultants to the Company. Options granted under the 1989 Plan have a term of up to 10 years, and typically vest at a rate of 25% of the total grant per year over a four-year period. However, the Company could, at its discretion, implement a different vesting schedule with respect to any new stock option grant. In September 1999, the Company adopted the 1999 Stock Plan and all subsequent stock option grants are made under this later plan.

1999 Stock Plan

The 1999 Stock Plan (the "1999 Plan") was adopted by the board of directors in August 1999 and was approved by the Company's stockholders in September 1999. As of June 30, 2003, approximately 11 million shares were reserved for issuance under the 1999 Plan. In addition, each January, an annual increase will be added to the 1999 Plan equal to the lesser of (i) 5,000,000 shares, (ii) 5% of the outstanding shares on such date, or (iii) a lesser amount determined by the board of directors. Options that are cancelled under the 1989 Plan become available for grant under the 1999 Plan. Options granted under the 1999 Plan have a term of up to 10 years. Options typically vest at a rate of 25% one year after the vesting commencement date, and one forty-eighth for each month of service thereafter. However, the Company may, at its discretion, implement a different vesting schedule with respect to any new stock option grant.

Employee Stock Purchase Plan

The 1999 Employee Stock Purchase Plan ("ESPP") was adopted by the board of directors in August 1999 and was approved by the Company's stockholders in September 1999. As of June 30, 2003, approximately 4.7 million shares were reserved for issuance under the ESPP. In addition, each August, an annual increase will be added to the ESPP equal to the lesser of (i) 1,500,000 shares, (ii) 4% of the outstanding shares on such date, or (iii) a lesser amount determined by the board of directors. The ESPP contains consecutive, overlapping, twenty-four month offering periods. Each offering period includes four six-month purchase periods. The ESPP permits participants to purchase shares through payroll deductions of up to 20% of an employee's total compensation (maximum of 20,000 shares per purchase period) at 85% of the lower of the fair market value of the common stock at the beginning or end of a purchase period.

Stock-based employee compensation

Using the Black-Scholes Option-Pricing Model ("Black-Scholes"), the per share weighted average estimated fair value for employee options granted was $1.11 and $3.05 during the three months ended June 30, 2003 and 2002, respectively, and $1.08 and $2.66 during the six months ended June 30, 2003 and 2002, respectively. The Black-Scholes model was developed for use in estimating the fair value of traded options that have no restrictions and are fully transferable and negotiable in a free trading market. Black-Scholes does not consider the employment, transfer or vesting restrictions that are inherent in the Company's employee options. Use of an option valuation model, as required by SFAS No. 123, includes highly subjective assumptions based on long-term predictions, including the expected stock price volatility and average life of each option grant. Because the Company's employee options have characteristics significantly different from those of freely traded options, and because changes in the subjective input assumptions can

materially affect the Company's estimate of the fair value of those options, in the Company's opinion, the existing valuation models, including Black-Scholes, are not reliable single measures and may misstate the fair value of the Company's employee options.

The following weighted average assumptions are included in the estimated fair value calculations for stock option grants in the three and six months ended June 30, 2003 and 2002:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Expected life (years)	5.3	5.3	5.3	5.3
Risk-free interest rate	2.81%	3.68%	2.81%	3.68%
Volatility	70%	72%	70%	72%
Dividend yield	—	—	—	—

Using Black-Scholes, the per share weighted average estimated fair value of rights issued pursuant to the Company's ESPP during the three months ended June 30, 2003 and 2002 was $0.54 and $1.45, respectively. Using Black-Scholes, the per share weighted average estimated fair value of rights issued pursuant to the Company's ESPP during the six months ended June 30, 2003 and 2002 was $0.54 and $1.45, respectively.

The following weighted average assumptions are included in the estimated grant date fair value calculations for rights to purchase stock under ESPP:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Expected life	6 months	6 months	6 months	6 months
Risk-free interest rate	1.28%	2.61%	1.28%	2.61%
Volatility	50%	63%	50%	63%
Dividend yield	—	—	—	—

If the Company had applied the fair value recognition provisions of SFAS No. 123 to stock based employee compensation, net loss for the three months ended June 30, 2003 and June 30, 2002 would have been $1.7 million and $5.0 million, respectively, and net loss for the six months ended June 30, 2003 and June 30, 2002 would have been $4.6 million and $10.1 million, respectively.

Note 8—Income Taxes

Due to the uncertainties surrounding the realization of the deferred tax assets resulting from the Company's accumulated deficit and net tax losses in 2002 and 2001, the Company has provided a full valuation allowance against the deferred tax assets The Company has evaluated both positive and negative evidence about the recoverability of its net tax assets and determined that it is more likely than not that they will not be realized. Accordingly, no provision for income taxes was recorded for the six month periods ended June 30, 2003 and 2002. The Company will continue to assess the realizability of the deferred tax assets in future periods.

At December 31, 2002, the Company had net operating loss carryforwards for federal and state income tax purposes of approximately $67 million and $27 million, respectively. These carryforwards, if not utilized to offset future taxable income and income taxes payable, will expire through 2022.

Note 9—Related Party Transactions

In July 2000, an executive officer of the Company borrowed $150,000 from the Company pursuant to an unsecured full-recourse promissory note. The note, as amended, bears simple interest at the rate of 5.00% per annum, and is payable upon demand by the Company. The total amount of principal and interest outstanding under the note was $172,000 and $168,000 at June 30, 2003 and December 31, 2002, respectively.

Note 10—Restructuring Charges

In November 2002, the Company reduced its worldwide headcount by 55 employees and closed offices in La Palma, CA and Richardson, TX. In connection with this decision, the Company recognized a $783,000 restructuring charge. Restructuring activity through June 30, 2003 was (in thousands):

	2002 Provision	2002 Cash Payment	Balance at December 31, 2002	2003 Cash Payment	Balance at June 30, 2003
Employee severance	$ 669	$ (530)	$ 139	$ (139)	$ —
Lease termination	114	(8)	106	(91)	15
Total	$ 783	$ (538)	$ 245	$ (230)	$ 15

The Company anticipates that the restructuring will be completed no later than September 2003. The balance of the restructuring accrual represents lease termination and facility costs and is included in accrued liabilities on the consolidated balance sheets.

Note 11—Information Concerning Business Segments and Major Customers

All of the Company's sales originate in the United States and are denominated in U.S. dollars. The following is a breakdown of revenue by shipment destination for the six months ended June 30, 2003 and 2002:

	June 30, 2003	June 30, 2002
	(in thousands)	
Revenue by country:		
United States	$ 8,077	$ 7,921
China	4,763	488
Japan	2,571	2,023
Europe	3,024	3,282
Rest of Asia Pacific	855	1,072

Rest of North America	714	1,055
Total revenue	$ 20,004	$ 15,841

As of June 30, 2003, less than 10% of the Company's long-lived assets, including property and equipment and other assets, were located outside the United States.

For the six months ended June 30, 2003, five distributors of the Company's products accounted for approximately 24%, 16%, 9%, 6% and 6% of revenues. For the six months ended June 30, 2002, five distributors of the Company's products accounted for approximately 17%, 12%, 9%, 6% and 6% of revenues.

Note 12—Commitments

Certain of the Company's wafer manufacturers require the Company to forecast wafer starts several months in advance. The Company is committed to take delivery of and pay for a portion of forecasted wafer volume. As of June 30, 2003 and December 31, 2002, the Company had $3.9 million and $626,000 of outstanding commitments for the purchase of wafers, respectively.

Note 13—Litigation

On October 26, 2001, a putative securities class action was filed in the U.S. District Court for the Southern District of New York against some investment banks that underwrote QuickLogic's initial public offering, QuickLogic and some of QuickLogic's officers and directors. This lawsuit is now captioned *In re QuickLogic Corp. Initial Public Offering Sec. Litig.,* Case No. 01-cv-9503. The complaint alleges excessive and undisclosed commissions in connection with the allocation of shares of common stock in QuickLogic's initial and secondary public offerings and artificially high prices through "tie-in" arrangements which required the underwriters' customers to buy shares in the aftermarket at pre-determined prices in violation of the federal securities laws. Plaintiffs seek an unspecified amount of damages on behalf of persons who purchased QuickLogic's stock pursuant to the registration statements between October 14, 1999 and

December 6, 2000. The court has appointed a lead plaintiff in this litigation. On April 19, 2002, plaintiffs filed an amended complaint. Various plaintiffs have filed similar actions asserting virtually identical allegations against over 300 other public companies, their underwriters, and their officers and directors arising out of each company's public offering. These actions, including the action against QuickLogic, have been coordinated for pretrial purposes and captioned *In re Initial Public Offering Securities Litigation,* 21 MC 92. Defendants in these cases filed an omnibus motion to dismiss on common pleading issues. In October 2002, QuickLogic's officers and directors were voluntarily dismissed without prejudice. On February 19, 2003, the court denied in part and granted in part the motion to dismiss filed on behalf of defendants, including QuickLogic. The court's order did not dismiss any claims against QuickLogic. As a result, discovery may now proceed.

A proposal has been made for the settlement and release of claims against the issuer defendants, including QuickLogic, in exchange for a guaranteed recovery to be paid by the issuer defendants' insurance carriers and an assignment of certain claims. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. If the settlement does not occur, and litigation against QuickLogic continues, QuickLogic believes it has meritorious defenses and intends to defend the case vigorously.

On July 3, 2003, a putative securities class action was filed in the U.S. District Court for the Southern District of New York by shareholders of Tower against Tower, several of its directors, and several of its investors, including QuickLogic. Although the case is in its earliest stages, the Company believes it has meritorious defenses and intends to defend the case vigorously.

No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies and, accordingly, the Company has not recorded a liability.

From time to time, the Company is involved in legal actions arising in the ordinary course of business. Absolute assurance cannot be given that third party assertions will be resolved without costly litigation in a manner that is not adverse to the Company's financial position, results of operations or cash flows or without requiring royalty payments in the future which may adversely impact gross profit.

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

The following discussion should be read in conjunction with the attached condensed unaudited consolidated financial statements and notes thereto, and with our audited financial statements and notes thereto for the fiscal year ended December 31, 2002, found in our Annual Report on Form 10-K filed March 20, 2003.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as information contained in "Risk Factors" below and elsewhere in this Quarterly Report on Form 10-Q, contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are generally written in the future tense and/or are preceded by words such as "will," "may," "should," "forecast," "could," "expect," "suggest," "believe," "anticipate," "intend," "plan," or other similar words. Forward-looking statements include statements *regarding (1) our revenue levels, (2) our gross profit and factors that affect gross profit, (3) our ability to control and reduce operating expenses, (4) our research and development efforts, (5) our liquidity, (6) our partners and suppliers, and (7) the commercial success of our products.*

The forward-looking statements contained in this Quarterly Report involve a number of risks and uncertainties, many of which are outside of our control. Factors that could cause actual results to differ materially from projected results include, but are not limited to, risks associated with (1) our relationship with Tower, (2) the liquidity required to support our future operating and capital requirements, and (3) limited visibility into long-term demand for our product from a significant customer. Although we believe that the assumptions underlying the forward-looking statements contained in this Quarterly Report are reasonable, any of the assumptions could be inaccurate, and therefore there can be no assurance that such statements included in this Report will be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that the results or conditions described in such statements or our objectives and plans will be achieved.

Overview

QuickLogic Corporation, founded in April 1988, designs and sells field programmable gate arrays, embedded standard products, associated software and programming hardware. In 1991, we introduced our first line of field programmable gate array products, or FPGAs, based upon our ViaLink technology. We currently have four FPGA product families: pASIC1, pASIC 2, pASIC 3, and Eclipse. The newer product families generally contain greater logic capacity, but do not necessarily replace sales of older generation products.

In September 1998, we introduced our first line of Embedded Standard Products, or ESPs. Our ESPs are based on our FPGA technology. Our ESP product families include QuickRAM, QuickPCI, and QuickMIPS. We also license our QuickWorks and QuickTools design software and sell our programming hardware, which together have typically accounted for less than 2% of total revenue.

In April 2001, we signed a definitive agreement with V3 Semiconductor, Inc. to acquire certain assets of V3 in a stock transaction. V3, based in Toronto, Canada, designed and sold application specific standard products, or ASSPs, that enhance high-speed data throughput within telecommunications and Internet infrastructure systems. To facilitate the asset sale and the subsequent windup of V3 as a distinct entity, V3 filed for relief under Chapter 11 of the bankruptcy laws in May 2001. In August 2001, we completed the acquisition of certain assets of V3 for approximately 2.5 million shares of our common stock, valued at $13.1 million on the date of the transaction. We believe the acquisition has accelerated our ESP strategy by strengthening our ability to develop and market system-level products.

On December 12, 2000, we entered into a Share Purchase Agreement, Foundry Agreement and other related agreements with Tower Semiconductor Ltd. Under the agreements, we agreed to make a strategic investment of up to $25 million in Tower as part of Tower's plan to build a new wafer fabrication facility. The new fabrication facility is expected to produce 200-mm wafers in geometries of 0.18 micron and below, using advanced CMOS technology from Toshiba. In return for our investment, we receive equity, prepaid wafer credits and committed production capacity in the advanced fabrication facility that Tower is building.

On May 28, 2002, we entered into an amendment to the Share Purchase Agreement. The primary purpose of the amendment was to change the allocation of the investment between Tower Ordinary Shares and wafer credits and to release 700,000 Tower Ordinary Shares from a lock up period. The released Tower shares are classified as available for sale.

During 2001 and 2002, we invested $21.3 million in Tower under the terms of the Share Purchase Agreement, as amended. In partial consideration for the investment, we received 1,757,368 Tower Ordinary Shares with an original cost of $16.6 million. We wrote down the Tower shares due to an "other than temporary" decline in their market value by $6.8 million and $3.8 million in 2001 and 2002, respectively. We also received $4.7 million in prepaid wafer credits in consideration for the investment. These credits can be applied immediately toward wafer purchases from Tower at 7.5% of the value of the purchases and, after July 1, 2005, at 15% of the value of the purchases.

During the three months ended June 30, 2003, we sold 399,607 of the Tower Ordinary Shares available for sale, for total proceeds of approximately $2.1 million. We recognized a gain on the sale of $696,000. As of June 30, 2003, we held 1,057,368 restricted Tower Ordinary Shares valued at $3.40 per share. We also had 300,393 Tower Ordinary Shares available for sale valued at $4.92 per share, the market value of the shares on that date. As of June 30, 2003, we have recorded accumulated other comprehensive income in the amount of $457,000 on the 300,393 Tower available for sale shares.

We sell our products through distributors and directly to system manufacturers. We sell the majority of our products through distributors who have contractual rights to earn a negotiated margin on the sale of our products. We refer to these distributors as point-of-sale distributors. We defer recognition of revenue for sales of unprogrammed products to these point-of-sale distributors until after they have sold these products to systems manufacturers. Approximately 65% of our products sold by point-of-sale distributors are programmed by us and are not returnable by these point-of-sale distributors. We recognize revenue on programmed products at the time of shipment. We also sell products directly to systems manufacturers and recognize revenue at the time of shipment. The percentage of sales derived through distributors and through direct sales to systems manufacturers in the six months ended June 30, 2003 was 72% and 28%, respectively, and in the six months ended June 30, 2002 was 69% and 31%, respectively.

Five distributors of the Company's products accounted for 24%, 16%, 9%, 6% and 6% of sales, respectively, in the six months ended June 30, 2003. Five distributors of the Company's products accounted for 17%, 12%, 9%, 6% and 6% of sales, respectively, in the six months ended June 30, 2002. We expect that a limited number of distributors will continue to account for a significant portion of our total sales. We believe our products are proprietary and sole source, and that the loss of a particular distributor would not result in a short term disruption in sales of our products, since our customers would either buy our products from another distributor or directly from us.

A large number of systems manufacturers purchase our products either through our distributors or directly from us. One Chinese customer, purchasing ESP products through a distributor, accounted for 27%, 13% and 12% of revenue in the second quarter of 2003, the first quarter of 2003 and the fourth quarter of 2002, respectively.

Our international sales were 60% and 50% of revenue for the six months ended June 30, 2003 and 2002, respectively. Revenue from sales to international customers may continue to represent a significant and growing portion of our total revenue. All of our sales originate in the United States and are denominated in U.S. dollars.

Our products' average selling price typically decline rapidly during the first six to twelve months after introduction, then decline less rapidly as the products mature. We attempt to maintain overall gross profit through the introduction of new products with higher margins and through manufacturing efficiencies and cost reductions. However, the markets in which we operate are highly competitive, and there can be no assurance that we will be able to successfully maintain gross profit margins. Any significant decline in our gross profits will materially harm our business.

We outsource the wafer manufacturing, assembly and test of all of our products. We rely upon Taiwan Semiconductor Manufacturing Company, Ltd., Cypress Semiconductor Corporation, and Samsung Electronics Co., Ltd. to manufacture our products, and we rely primarily upon Amkor Technology, Inc. and ASE Test Ltd. to assemble, test and program our products. We also expect to manufacture products at Tower by the end of 2003. Our wafer suppliers' lead times are often as long as three months and sometimes longer. In addition, Cypress and Tower require us to provide them with a wafer start forecast on a regular basis. We are committed, under the terms of our agreements with them, to take delivery of and pay for a portion of the forecasted wafer volume. Our long manufacturing cycle times are at odds with our customers' desire for short delivery lead times and as a result we typically forecast wafer purchases and purchase wafers based on internal forecasts of customer demand. In the future, if the total volume or product mix of our internal forecasts are inaccurate, we may not be able to meet customer demand or may be required to purchase excess wafers from our wafer suppliers.

Results of Operations

The following table sets forth the percentage of revenue for certain items in our statements of operations for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	47.5%	55.0%	47.9%	56.6%
Gross profit	52.5%	45.0%	52.1%	43.4%
Research and development	22.8%	40.6%	23.7%	42.1%
Selling, general and administrative	36.2%	45.0%	39.9%	46.7%
Loss from operations	(6.5)%	(40.6)%	(11.5)%	(45.4)%
Interest expense	(0.5)%	(0.1)%	(0.6)%	(0.1)%
Interest income and other, net	0.2%	3.1%	0.3%	2.3%
Gain on sale of investment in Tower Semiconductor Ltd.	6.6%	—	3.5%	—
Net loss	(0.2)%	(37.6)%	(8.3)%	(43.2)%

Three and six months ended June 30, 2003 and June 30, 2002

Revenue. Our revenue increased to $10.6 million in the second quarter of 2003 from $8.4 million in the second quarter of 2002, an increase of 27%. Our revenue increased to $20.0 million in the first half of 2003 from $15.8 million in the first half of 2002, an increase of 26%. The increase is primarily due to an increase in ESP revenues of $1.8 million in the second quarter of 2003 compared to the second quarter of 2002, and of $3.1 million in the first half of 2003 compared to the first half of 2002. The ESP increase is primarily due to the sale of a QuickRAM product to a Chinese customer, purchased through a distributor. We also had an increase of $500,000 in pASIC3 product revenue and of $500,000 in Eclipse product revenue in the first half of 2003 compared to the first half of 2002. ESP products contributed 42% of revenue in the first half of 2003 compared to 34% in the first half of 2002.

The Chinese customer accounted for 27% of revenue in the second quarter of 2003 and 20% of revenue in the first half of 2003. During the second quarter of 2003 this customer's purchase of QuickRAM products represented 21% of total revenue, and its purchase of FPGA products represented 6% of total revenue. This customer did not purchase our products in the first half of 2002.

Our second quarter revenue was 13% higher sequentially, increasing to $10.6 million from $9.4 million in the first quarter of 2003. Increased sales to our largest customer in China accounted for this increase.

Gross Profit. Gross profit was $5.6 million and $3.8 million in the three months ended June 30, 2003 and 2002, respectively, which was 52.5% and 45.0% of revenue for those periods. The 7.5% improvement in gross profit as a percent of revenues resulted from $600,000 of additional absorbed overhead due to higher production volumes, a $300,000 increased benefit from the sale of previously reserved inventory, and $200,000 of lower scrap costs, partially offset by higher standard costs due to product mix.

Gross profit was $10.4 million and $6.9 million in the six months ended June 30, 2003 and 2002, respectively, which was 52.1%

and 43.4% of revenue for those periods. The 8.7% improvement in gross margin as a percent of revenues resulted from $700,000 of additional absorbed overhead due to higher production volumes, a $800,000 increased benefit from the sale of previously reserved inventory, $400,000 lower scrap costs, and $400,000 of lower costs due to higher production yields, partially offset by higher standard costs due to product mix.

Research and Development Expense. Research and development expense was $2.4 million and $3.4 million in the three months ended June 30, 2003 and 2002, respectively, which was 22.8% and 40.6% of revenue for those periods. Research and development expense was $4.7 million and $6.7 million in the six months ended June 30, 2003 and 2002, respectively, which was 23.7% and 42.1% of revenue for those periods. The lower research and development expense compared to prior periods is due to lower compensation costs resulting from a reduction in force and reduced outside service expenses due to changes in the timing and nature of our product development efforts. The lower research and development expense as a percent of revenue from prior periods is a result of these expense reductions and higher revenue levels.

Selling, General and Administrative Expense. Selling, general and administrative expense, or SG&A, was $3.8 million and $3.8 million for the three months ended June 30, 2003 and 2002, respectively, which was 36.2% and 45.0% of revenue for those periods. SG&A was $8.0 million and $7.4 million for the six months ended June 30, 2003 and 2002, respectively, which was 39.9% and 46.7% of revenue for those periods. SG&A in the second quarter of 2003 is approximately the same as the second quarter of 2002. Higher insurance costs, primarily for directors' and officers' insurance, higher commissions due to higher revenue and higher bad debt expense were offset by lower compensation costs resulting from our reduction in force. SG&A is approximately $600,000 higher in the first half of 2003 as compared to the first half of 2002 due to $400,000 higher bad debt expense, $200,000 higher commissions due to higher revenue and $100,000 higher insurance costs, primarily directors' and officers' insurance, partially offset by lower compensation costs from our reductions in force.

Interest Expense. Interest expense was $55,000 for the three months ended June 30, 2003 compared to $8,000 for the three months ended June 30, 2002. Interest expense was $116,000 for the six months ended June 30, 2003 compared to $18,000 for the six months ended June 30, 2002. The increase in interest expense is due primarily to amortization of loan fees charged to renew our credit facility.

Interest Income and Other, Net. Interest income and other, net was $34,000 for the three months ended June 30, 2003 compared to $256,000 for the three months ended June 30, 2002. Interest income and other, net was $60,000 for the six months ended June 30, 2003 compared to $357,000 for the six months ended June 30, 2002. This decline in income is due primarily to foreign exchange fluctuations due to the weakening of the U.S. Dollar against foreign currencies.

Deferred Stock Compensation. Deferred stock compensation recorded in years prior to 2000 is being amortized ratably over the four-year vesting period of the options that ends in 2003. During the six months ended June 30, 2003 and 2002, deferred stock compensation amortization was $119,000 and $167,000, respectively.

Provision for Income Taxes. No provision for income taxes was recorded for the six months ended June 30, 2003 or 2002 because we incurred a loss. We believe that, based on a number of factors, the available objective evidence creates sufficient uncertainty regarding the realizability of the deferred tax assets such that we recorded a full valuation allowance against the related tax benefit. These factors include the Company's history of losses, the intensely competitive and rapidly changing market in which we compete, the lack of carry back capacity to realize deferred tax assets, and uncertainty regarding market acceptance of our products. As a result, no provision for federal or state income taxes has been recorded. We will continue to assess the realizability of the deferred tax assets in future periods.

Liquidity and Capital Resources

We have financed our operating losses and capital investments through sales of common stock, private equity investments, capital and operating leases, bank lines of credit and cash flow from operations. At June 30, 2003, our principal sources of liquidity consisted of our cash and cash equivalents of $24.1 million, available credit under our credit facility with Silicon Valley Bank of $3.4 million, and Tower shares available for sale of $1.5 million.

At June 30, 2003, our interest-bearing debt consisted of $7.6 million outstanding from Silicon Valley Bank and approximately $100,000 outstanding from other sources. At June 30, 2003, our accumulated deficit was $107.8 million. Under terms of the Tower agreement, as amended, our remaining investment of $3.7 million was due to Tower, provided Tower achieved certain production milestones by July 2003. Tower has not achieved the production milestones necessary for the investment. We are negotiating with Tower and may decide to invest all or a portion of the final $3.7 million investment under renegotiated terms. Capital expenditures, which are largely driven by the introduction and initial manufacturing of new products, could exceed $3.0 million in the next twelve months.

In June 2003, we signed an Amended and Restated Loan and Security Agreement with Silicon Valley Bank. Terms of the amended agreement include an $8.0 million revolving line of credit available through June 2004 and a $4.5 million equipment financing line of credit that can be drawn against through December 2003. The revolving line of credit provides for formula advances based upon a percentage of eligible accounts receivable and for non-formula advances not to exceed $5.0 million. At June 30, 2003 under the revolving line of credit, we had borrowed $5.9 million and had available non-formula advances of $1.3 million. At June 30, 2003, our equipment line of credit included outstanding balances of $1.7 million and available credit of $2.2 million. The bank has a first priority security interest in our tangible and intangible assets to secure any outstanding amounts under the agreement. Under the terms and definitions of the agreement, we must maintain a minimum tangible net worth and adjusted quick ratio. The agreement also has certain restrictions on other indebtedness, the maintenance of depository and investment accounts outside of Silicon Valley Bank, and the payment of dividends. However, we are no longer required to maintain any specified amount in demand deposit or investment accounts at Silicon Valley Bank. As a result, none of the Company's cash and cash equivalents was classified as restricted at June 30, 2003.

As of June 30, 2003 we also had $80,000 of short-term debt outstanding to finance insurance payments and $22,000 outstanding under capital lease obligations. The insurance-related debt bears interest at the rate of 3.7% and is being repaid in monthly amounts of $80,000 through July 2003. The capital lease obligations are being repaid in monthly amounts of $4,000 through December 2003.

Our Statement of Cash Flows reflects the changes in our unrestricted cash and cash equivalents.

We had a positive operating cash flow in the first half of 2003. Cash provided by operating activities in the first half of 2003 was $2.4 million compared to cash used by operating activities in the first half of 2002 of $5.6 million.

In the six months ended June 30, 2003, our positive operating cash flow resulted from a net loss of $1.7 million, adjusted for non-cash charges including depreciation of $2.0 million, the gain on sale of Tower shares of $700,000, and a $300,000 write-off of long-lived assets related to a specific product that is not expected to achieve significant volume production. In addition, changes in working capital accounts provided cash of $2.3 million primarily as a result of lower accounts receivable balances of $1.3 million due to strong shipments early in the quarter and improved collection efforts, and lower other assets of $1.1 million due primarily to the termination of the deferred compensation plan, partially offset by lower accrued liabilities due to increased operating activity.

In the six months ended June 30, 2002, our negative operating cash flow resulted from a net loss of $6.9 million adjusted for non-cash charges including depreciation of $1.8 million and amortization of deferred compensation of $200,000. In addition, changes in working capital accounts used cash of $700,000, primarily as a result of higher accounts receivable balances of $2.2 million due to existing economic conditions and the timing of shipments to customers, and lower accounts payable and accrued liability balances of $800,000 due to decreased operating activity and capital purchases, partially offset by lower inventory balances of $2.1 million primarily due to the write-off of die inventory during the period.

Cash provided by investing activities was $1.1 million in the first half of 2003 compared to cash used by investing activities of $4.9 million in the first half of 2002.

In the six months ended June 30, 2003, our positive cash flow from investing activities was due to $2.1 million in proceeds from the sale of Tower shares, offset by $900,000 in capital expenditures. The capital expenditures were primarily for equipment to develop and produce our products.

In the six months ended June 30, 2002, our negative cash flow from investing activities was due to a $3.7 million investment in Tower and $1.2 million in capital expenditures. The capital expenditures were primarily for equipment to develop and produce our products.

Cash provided by financing activities was $7.5 million and $2.6 million for the six months ended June 30, 2003 and 2002, respectively. In the six months ended June 30, 2003, our positive cash flow from financing activities was due to $9.0 million of restricted cash being reclassified as unrestricted under the terms of our amended credit facility with Silicon Valley Bank, and due to $500,000 of proceeds from the issuance of common shares under our employee stock purchase program and the exercise of stock options by employees, offset by $1.9 million for debt and revolving line of credit repayments.

In the six months ended June 30, 2002, our positive cash flow from financing activities was due to $1.8 million of borrowings under our revolving line of credit and $900,000 of proceeds from the issuance of common shares under our employee stock purchase program and the exercise of stock options by employees, offset by $100,000 of debt repayments.

We require substantial working capital to fund our business, particularly to finance our operating losses, for potential future investments in Tower, for the acquisition of property and equipment, for working capital and the repayment of debt. Our future liquidity will depend on many factors such as these, as well as our level of sales and gross profit, market acceptance of our existing and new products, the amount and timing of research and development expenditures, the timing of new product introductions and production volumes, sales and marketing efforts, changes in operating assets and liabilities, our ability to obtain debt financing and remain in compliance with the terms of the credit facility, our ability to raise funds from the sale of Tower shares, our ability to sell equity and other factors related to the uncertainties of the industry and global economics. We anticipate that our existing cash resources will fund any operating losses, capital expenditures of $3.0 million or more, our potential $3.7 million investment in Tower, and provide adequate working capital for the next 12 months, although we could seek to raise additional capital during that period. In addition, as our liquidity

is affected by many factors as mentioned above and as discussed in our Risk Factors, there can be no assurance that events in the future will not require us to seek additional capital during the next twelve months or, if so required, that such capital will be available on terms acceptable to us. After the next 12 months, our capital and operating requirements will depend on many factors, including the levels at which we maintain inventory and accounts receivable, costs of securing access to adequate manufacturing capacity, our level of revenue and gross profit, capital expenditures and the level of our operating expenses.

Contractual Obligations and Commercial Commitments

The following table summarizes our contractual obligations and commercial commitments as of June 30, 2003 and the effect such obligations and commitments are expected to have on our liquidity and cash flows in future periods (in thousands).

	Total	Less than 1 Year	Years 2 and 3	Years 4 and 5	After 5 Years
Contractual cash obligations					
Operating leases	$ 3,344	$ 709	$ 1,058	$ 1,132	$ 445
Capital leases	24	24	—	—	—
Investment in Tower	3,667	3,667	—	—	—
Wafer purchases	3,934	3,934	—	—	—
Total contractual cash obligations	$ 10,969	$ 8,334	$ 1,058	$ 1,132	$ 445
Other commercial commitments					
Notes payable to bank	$ 1,724	$ 856	$ 868	$ —	$ —
Bank revolving line of credit	5,850	5,850	—	—	—
Insurance credit facility	80	80	—	—	—
Total commercial commitments	$ 7,654	$ 6,786	$ 868	$ —	$ —

Capital lease amounts and other commercial commitment amounts are included as liabilities on our balance sheets as of June 30, 2003. We are not contractually obligated to make the $3.7 million investment in Tower included in this table, but may decide to invest all or a portion of these funds.

Inflation

The impact of inflation on our business has not been material for the periods presented.

Critical Accounting Policies

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires our management to make judgments and estimates that affect the amounts reported in our financial statements and accompanying notes. Our management believes that we consistently apply judgments and estimates and such consistent application results in financial statements and accompanying notes that fairly represent all periods presented. However, any factual errors or errors in these judgments and estimates may have a material impact on our statement of operations and financial conditions. For a discussion of our general accounting policies, please see the discussion in our Annual Report on Form 10-K for fiscal year ended December 31, 2002 filed on March 20, 2003.

Recently Issued Accounting Pronouncements

In April 2003, the Financial Accounting Standards Board ("FASB") issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies financial accounting and reporting of derivative instruments and hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 149 amends SFAS No. 133 for decisions made: (i) as part of the Derivatives Implementation Group process that require amendment to SFAS No. 133; (ii) in connection with other FASB projects dealing with financial instruments; and (iii) in connection with the implementation issues raised related to the application of the definition of a derivative. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for designated hedging relationships after June 30, 2003. We believe that the adoption of SFAS No. 149 will not have a material impact on our financial position and results of operations.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." The Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and further requires that an issuer classify as a liability (or an asset in some circumstances) financial instruments that fall within its scope because that financial instrument embodies an obligation of the issuer. Many of such instruments were previously classified as equity. The statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We believe that the adoption of this standard will not have a material impact on our financial position and results of operations.

In November 2002, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 00-21 ("EITF No. 00-21"), "Multiple-Deliverable Revenue Arrangements." EITF No. 00-21 addresses how to account for arrangements that may involve the delivery or performance of multiple products, services, and/or rights to use assets. The consensus mandates how to identify whether goods or services or both that are to be delivered separately in a bundled sales arrangement should be accounted for separately because they are separate units of accounting. The guidance can affect the timing of revenue recognition for such arrangements, even though it does not change rules governing the timing or pattern of revenue recognition of individual items accounted for separately. The final consensus is applicable to agreements entered into in fiscal years beginning after June 15, 2003 with early adoption permitted. Additionally, companies will be permitted to apply the consensus guidance to all existing arrangements as the cumulative effect of a change in accounting principle in accordance with APB No. 20, "Accounting Changes." We are assessing the impact of EITF No. 00-21 and believe that the adoption will not have a material impact on our financial position and results of operations.

Risk Factors

We may not have the liquidity to support our future capital requirements

Our cash balance at June 30, 2003 was $24.1 million. At June 30, 2003, our interest-bearing debt consisted of $7.6 million owed to Silicon Valley Bank and approximately $100,000 owed to other sources. At June 30, 2003, we had $3.4 million available to borrow under our credit facility with Silicon Valley Bank, and we had 300,393 available to sell Tower Ordinary Shares worth $1.5 million.

Capital expenditures, which are largely driven by the introduction and initial manufacturing of new products, could exceed $3.0 million in the next twelve months. In addition, we may invest up to $3.7 million pursuant to our strategic relationship with Tower.

As a result of these planned investments, as well as research and development, selling, marketing and administrative expenses, changes in working capital and interest and debt payments, we will need to generate significantly higher revenue and gross profit to maintain positive cash flow. Whether we can achieve cash flow levels sufficient to support our operations, and whether we will then be able to maintain positive cash flow, cannot be accurately predicted. Unless such cash flow levels are achieved, we may borrow additional funds or sell debt or equity securities, or some combination thereof, to provide funding for our operations. If adequate funds are not available when needed, our financial condition and operating results would be materially adversely affected and we may not be able to operate our business without significant changes in our operations or at all.

We cannot assure you that we will return to profitability because we have a history of losses

We incurred significant losses in 2001, 2002 and in the first half of 2003. Our accumulated deficit as of June 30, 2003 was $107.8 million. We cannot assure you that we will be profitable in any future periods, and you should not rely on our historical revenue or our previous profitability as any indication of our future operating results or prospects.

Our future results depend on our relationship with Tower

We have devoted significant resources to our relationship with Tower and, through June 30, 2003, we have invested approximately $21.3 million toward the completion of its wafer foundry facility. Our final payment to Tower of $3.7 million was due upon Tower's achievement of operational milestones related to its fabrication facility provided that Tower met these milestones by July 2003. Tower has not satisfied the performance milestones. We are negotiating with Tower and may decide to invest all or a portion of the final $3.7 million investment under renegotiated terms. We believe that Tower's completion and production ramp of this fabrication facility depends on its ability to obtain additional financing and the release of grants and approvals for changes in grant programs from the Israeli government's Investment Center. The current political uncertainty and security situation in the Middle East, the market for foundry manufacturing services, the early stage of operation of Tower's fabrication facility, Tower's financial condition, or other factors may adversely impact Tower's business prospects and may discourage investments in Tower from outside sources. If Tower is unable to obtain adequate financing, complete foundry construction in a timely manner, complete the development and transfer of

advanced CMOS process technologies and our process technology, or ramp-up production, the value of our investment in Tower will decline significantly or possibly become worthless and we would have to identify and qualify a substitute supplier to manufacture our products. This would require significant development time, would cause product shipment delays, would impair long-lived assets and would severely harm our business.

In addition, the value of our investment in Tower and its corresponding wafer credits may be adversely affected by a further deterioration of conditions in the market for foundry manufacturing services and the market for semiconductor products generally. If the fair value of our Tower investment declines further or the wafer credits are deemed to be impaired, we may record additional losses.

We have a significant customer and limited visibility into the long-term demand for our products from this customer

One Chinese customer, purchasing product through a distributor, represented 27% of our total revenue in the second quarter of 2003. This customer became a customer in the fourth quarter of 2002, accounting for 12% of revenue in that quarter and 13% of revenue in the first quarter of 2003. Future demand from this customer may fluctuate significantly. This customer typically orders product with short requested delivery lead times, and has not provided a firm commitment to purchase product past the period covered by purchase orders. In addition, our manufacturing lead times are longer than the delivery lead times requested by the customer, and we make significant inventory purchases in anticipation of future demand. If revenue from this customer were to decline significantly, we may be unable to offset this decline with revenue growth from other customers, we may have a significant decline in manufacturing activity and related overhead absorption, and we may purchase excess inventory. These factors could severely harm our business.

We depend upon third party distributors to market and sell our products, and they may discontinue sale of our products, fail to give our products priority or be unable to successfully market, sell and support our products

We contract with third-party distributors to market and sell a significant portion of our products. During the six months ended June 30, 2003, approximately 72% of our sales were made through distributors. Although we have contracts with our distributors, our agreements with them may be terminated on short notice. The loss of one or more of our principal distributors, or our inability to attract new distributors, could materially harm our business. We may lose distributors in the future and we may be unable to recruit additional or replacement distributors. As a result, our future performance will depend in part on our ability to retain our existing distributors and attract new distributors that will be able to market, sell and support our products effectively.

Many of our distributors, including our principal distributors, market and sell products for other companies, and many of these products may compete directly or indirectly with our products. We generally are not one of the principal suppliers of products to our distributors. If our distributors give higher priority or greater attention to the products of other companies, including products that compete with our products, our business would be materially harmed.

Individual distributors and OEM customers often represent a significant portion of our accounts receivable. If we are unable to collect funds due from these distributors and customers our financial results may be materially harmed.

Our future operating results are likely to fluctuate and therefore may fail to meet expectations, which could cause our stock price to decline

Our operating results have varied widely in the past and are likely to do so in the future. In addition, our operating results may not follow any past trends. Our future operating results will depend on many factors and may fail to meet our expectations for a number of reasons, including those set forth in these risk factors. Any failure to meet expectations could cause our stock price to significantly fluctuate or decline.

Factors that could cause our operating results to fluctuate include:

- a significant decline in sales to our largest customers;
- successful development and market acceptance of our products, especially embedded system products;
- our ability to accurately forecast product volumes and mix and to respond to rapid changes in customer demand;
- our inability to quickly adjust our fixed and manufacturing costs in response to economic and competitive pressures;

- our reliance on subcontract manufacturers for product capacity, yield and quality;
- our competitors' product portfolio and product pricing policies;
- the cyclical nature of the semiconductor industry and general economic, market, political and social conditions in the countries where we sell our products and the related effect on our customers, distributors and suppliers; and
- our ability to obtain capital, debt financing and insurance on commercially reasonable terms.

Although certain of these factors are out of our immediate control, unless we can anticipate and be prepared with contingency plans that respond to these factors, we will be unsuccessful in carrying out our business plan.

If we fail to successfully develop, introduce and sell new products, we may be unable to compete effectively in the future

We operate in a highly competitive, quickly changing environment marked by rapid obsolescence of existing products. To compete successfully, we must specify, design, develop, manufacture and sell new or enhanced products that provide increasingly higher levels of performance, new features, reliability and/or cost savings to our customers. If we are unable to design, produce and sell new products that meet design specifications, address customer requirements, and generate sufficient gross profit, or if market demand for our products fails to materialize, or our customers do not successfully introduce products incorporating our devices, our business will be materially harmed.

We expend substantial resources in developing and selling our products, and we may be unable to generate significant revenue and gross profit as a result of these efforts

We must dedicate significant resources to develop, produce, market and sell our products. We experience a long delay between the time when we expend these resources and the time when we begin to generate revenue, if any, from these expenditures. Typically, this delay is one year or more. We generally record as expenses the internal costs related to the development of new semiconductor products and software as these expenses are incurred. As a result, our profitability from quarter to quarter and from year to year may be materially and adversely affected by the number and timing of our new product introductions in any period and the level of acceptance gained by these products.

Our customers may cancel or change their product plans after we have expended substantial time and resources in the design of their products

If one of our potential customers cancels, reduces or delays product orders from us or chooses not to release equipment that incorporates our products after we have spent substantial time and resources in designing a product, our business could be materially harmed. Our customers often evaluate our products for six months or more before designing them into their systems, and they may not commence volume shipments for up to an additional six to twelve months, if at all. During this lengthy sales cycle, our potential customers may also cancel or change their product plans. Even when customers incorporate one or more of our products into their systems, they may ultimately discontinue the shipment of their systems that incorporate our products. The customers whose products achieve high volume production may choose to replace our products with lower cost semiconductors.

We will be unable to compete effectively if we fail to anticipate product opportunities based upon emerging technologies and standards and fail to develop products that incorporate these technologies and standards

We may spend significant time and money to design and develop products around an industry standard or emerging technology. To date, we have introduced product families, such as QuickMIPS, that are designed to support a specific industry standard. If an industry standard or emerging technology that we have identified fails to achieve broad market acceptance in our target markets, or if we are unable to bring the technology to market in a timely manner, we may be unable to generate significant revenue from our research and development efforts. Moreover, even if we are able to develop products using adopted standards, our products may not be accepted in our target markets. As a result, our business would be materially harmed.

We have limited experience in designing and developing products that support industry standards. If systems manufacturers move away from the use of industry standards that we support with our products and adopt alternative standards, we may be unable to

design and develop new products that conform to these new standards. The expertise required is unique to each industry standard, and we would have to either hire individuals with the required expertise or acquire such expertise through a licensing arrangement or by other means. The demand for individuals with the necessary expertise to develop a product relating to a particular industry standard is generally high, and we may not be able to hire such individuals. The cost to acquire such expertise through licensing or other means may be high and such arrangements may not be possible in a timely manner, if at all.

We may encounter periods of industry-wide semiconductor oversupply, resulting in pricing pressure and underutilization of manufacturing capacity, as well as undersupply, resulting in a risk that we could be unable to fulfill our customers' requirements

The semiconductor industry has historically been characterized by wide fluctuations in the demand for, and supply of, its products. These fluctuations have resulted in circumstances when supply and demand for the industry's products have been widely out of balance. Our operating results may be materially harmed by an industry-wide semiconductor oversupply, which could result in severe pricing pressure and underutilization of our manufacturing capacity. In a market with undersupply of manufacturing capacity, we would have to compete with larger foundry customers for limited manufacturing resources. In such an environment, we may be unable to have our products manufactured in a timely manner or at the costs or in quantities necessary to meet our requirements. Since we outsource all of our manufacturing, we are particularly vulnerable to such supply shortages. As a result, we may be unable to fulfill orders and may lose customers. Any future industry-wide oversupply or undersupply of semiconductors could materially harm our business.

If we fail to adequately forecast demand for our products, we may incur product shortages or excess product inventory

Our agreements with third-party manufacturers require us to provide forecasts of our anticipated manufacturing orders, and place binding manufacturing orders in advance of receiving purchase orders from our customers. This may result in product shortages or excess product inventory because we are limited in our ability to increase or decrease our forecasts under such agreements. Obtaining additional supply in the face of product shortages may be costly or not possible, especially in the short term. Our failure to adequately forecast demand for our products could materially harm our business.

Fluctuations in our product yields, especially new products, may increase the costs of our manufacturing process

Difficulties in the complex semiconductor manufacturing process can render a substantial percentage of semiconductor wafers nonfunctional. We have, in the past, experienced manufacturing runs that have contained substantially reduced or no functioning devices. Varying degrees of these yield reductions occur frequently in our manufacturing process. These yield reductions, which can occur without warning, may result in substantially higher manufacturing costs and inventory shortages to us. We may experience yield problems in the future that may materially harm our business. In addition, yield problems may take a significant period of time to analyze and correct. Our reliance on third party suppliers may extend the period of time required to analyze and correct these problems. As a result, if we experience higher costs or are unable to respond rapidly to yield reductions, our business would suffer.

Yield reductions frequently occur in connection with the manufacture of newly introduced products or with manufacturing at new facilities or on new manufacturing processes. Newly introduced products are often more complex and more difficult to produce, increasing the risk of manufacturing-related defects. New manufacturing facilities or processes, such as at Tower, are often more complex and take a period of time to refine procedures to achieve expected service levels, quality levels and product costs. While we test our products, they may still contain errors or defects that we find only after we have commenced commercial production. If our products have reliability problems, our customers may not place new orders, which would materially harm our business.

We may be unable to grow our business if the markets in which our customers sell their products do not grow

Our success depends in large part on the continued growth of various markets that use our products. Any decline in the demand for our products in the following markets could materially harm our business:

- high-performance computing;
- instrumentation and test;
- data communications and telecommunications;
- video/audio, graphics and imaging; or

- military and aerospace systems.

Slower growth in any of the other markets in which our products are sold may also materially harm our business. Many of these markets are characterized by rapid technological change and intense competition. As a result, systems sold by our customers that use our products may face severe price competition, become obsolete over a short time period, or fail to gain market acceptance. Any of these occurrences could materially harm our business.

We may be unable to accurately estimate quarterly results, which could adversely affect the trading price of our stock

A significant portion of our revenue is recognized when our distributors complete sales to end customers. Therefore we are highly dependent on the accuracy and timeliness of their resale and inventory reports. Inaccurate distributor resale or inventory reports contribute to our difficulty in predicting and reporting our quarterly revenue and results of operations, particularly in the last month of the quarter. In addition, we offer our customers a short delivery lead-time and a majority of our shipments during a quarter are ordered by the customer in that quarter. As a result, we often have low visibility of current quarter revenue, and our revenue level can change significantly in a short period of time. If we fail to accurately predict our revenue and results of operations on a quarterly basis, our results of operations could be harmed and our stock price could materially fluctuate.

Customers may cancel or defer significant purchase orders or our distributors may return our products, which would cause our inventory levels to increase and our revenue to decline

Our distributors or customers may cancel purchase orders at any time with little or no penalty. In addition, our distributor agreements generally permit our distributors to return un-programmed products to us. Contractually, our distributors are permitted to return up to 10%, by value, of the products they purchase from us every six months. If our distributors or customers cancel or defer significant purchase orders or our distributors or customers return our products, our accounts receivable collections would decrease and inventories would increase, which would materially harm our business.

Many systems manufacturers may be unwilling to switch to our products because of their familiarity with the products offered by our direct competitors, such as Xilinx and Altera, which dominate the programmable logic market

The semiconductor industry is intensely competitive and characterized by:

- erosion of selling prices over product lives;
- rapid technological change;
- short product life cycles; and
- strong domestic and foreign competition.

If we are not able to compete successfully in this environment, our business will be materially harmed. Many of our competitors have substantially greater financial, technical, manufacturing, marketing, sales, distribution, name recognition and other resources than we do. In addition, many of our competitors have well-established relationships with our current and potential customers and have extensive knowledge of system applications. In the past, we have lost potential customers to competitors for various reasons, including, but not limited to, re-programmability and lower price. Our current direct competitors include suppliers of complex programmable logic devices and field programmable gate arrays, such as Xilinx, Inc., Altera Corporation, Actel Corporation, and Lattice Semiconductor Corporation. Xilinx and Altera together have a majority share of the programmable logic market. Many systems manufacturers may be unwilling or unable to switch to our products due to their familiarity with competitors' products or other inhibiting factors.

We also face competition from companies that offer ASICs, which may be obtained at lower costs for higher volumes and typically have greater logic capacity, additional features and higher performance than those of our products. We may also face competition from suppliers of embedded microprocessors, such as IDT Corporation and Motorola, Inc., or from suppliers of products based on new or emerging technologies. Our inability to successfully compete in any of the following areas could materially harm our business:

- the development of new products and manufacturing technologies;
- the quality, price and availability of products, devices, hardware and software and development tools;
- the diversity of product lines; or
- the quality and cost effectiveness of design, development, manufacturing and marketing efforts.

We may be unable to successfully grow our business if we fail to compete effectively with others to attract and retain key personnel

We believe our future success will depend upon our ability to attract and retain engineers and other highly skilled personnel. Our employees are at-will and not subject to employment contracts. Hiring and retaining qualified sales and technical personnel is difficult due to the limited number of qualified professionals. Competition for these types of employees is intense. In addition, new hires frequently require extensive training before they achieve desired levels of productivity. We have in the past experienced difficulty in recruiting and retaining qualified senior management, sales and technical personnel. Failure to attract, hire, train and retain personnel, particularly senior management, sales and technical personnel, could materially harm our business.

We may be unable to adequately protect our intellectual property rights, and may face significant expenses as a result of future litigation

Protection of intellectual property rights is crucial to our business, since that is how we keep others from copying the innovations that are central to our existing and future products. From time to time, we receive letters alleging patent infringement or inviting us to license other parties' patents. We evaluate these letters on a case-by-case basis. These situations may lead to litigation if we reject the offer to obtain the license.

We have in the past and may again become involved in litigation relating to alleged infringement by us of others' patents or other intellectual property rights. This kind of litigation is expensive and consumes large amounts of management's time and attention. For example, we incurred substantial costs associated with the litigation and settlement of our dispute with Actel, which materially harmed our business. In addition, if the letters we sometimes receive alleging patent infringement or other similar matters result in litigation that we lose, a court could order us to pay substantial damages and/or royalties, and prohibit us from making, using, selling or importing essential technologies. For these and other reasons, this kind of litigation could materially harm our business.

Also, although we may seek to obtain a license under a third party's intellectual property rights in order to bring an end to certain claims or actions asserted against us, we may not be able to obtain such a license on reasonable terms, or at all. We have entered into technology license agreements with third parties which give those parties the right to use patents and other technology developed by us, and which give us the right to use patents and other technology developed by them. We anticipate that we will continue to enter into these kinds of licensing arrangements in the future; however, it is possible that desirable licenses will not be available to us on commercially reasonable terms. If we lose existing licenses to key technology, or are unable to enter into new licenses that we deem important, it could materially harm our business.

Because it is critical to our success that we are able to prevent competitors from copying our innovations, we intend to continue to seek patent and trade secret protection for our products. The process of seeking patent protection can be long and expensive, and we cannot be certain that any currently pending or future applications will actually result in issued patents, or that, even if patents are issued, they will be of sufficient scope or strength to provide meaningful protection or any commercial advantage to us. Furthermore, others may develop technologies that are similar or superior to our technology or design around the patents we own. We also rely on trade secret protection for our technology, in part through confidentiality agreements with our employees, consultants and third parties. However, employees may breach these agreements, and we may not have adequate remedies for any breach. In any case, others may come to know about or determine our trade secrets through a variety of methods. In addition, the laws of certain territories in which we develop, manufacture or sell our products may not protect our intellectual property rights to the same extent, as do the laws of the United States.

Problems associated with international business operations could affect our ability to manufacture and sell our products

Most of our products are manufactured outside of the United States at manufacturing facilities operated by our suppliers in Taiwan, South Korea, the Philippines, Israel and Malaysia. We expect to manufacture a majority of the products that we have under development in Israel and to assemble these products in South Korea, the Philippines or Malaysia. As a result, our manufacturing

operations and new product introductions are subject to risks of political instability, including the risk of conflict between Taiwan and the People's Republic of China and conflict between North Korea and South Korea, and conflicts involving Israel or Malaysia.

A significant portion of our total revenue comes from sales to customers located outside the United States. We anticipate that sales to customers located outside the United States will continue to represent a significant portion of our total sales in future periods and the trend of foreign customers accounting for an increasing portion of our total sales may continue. In addition, most of our domestic customers sell their products outside of North America, thereby indirectly exposing us to risks associated with foreign commerce. Asian economic instability could also materially and adversely affect our business, particularly to the extent that this instability impacts the sale of products manufactured by our customers. In addition to overseas sales offices, we have significant research and development activities in Canada and India. Foreign research and development activities accounted for 37% of our research and development expenses for the six months ended June 30, 2003. Accordingly, our operations and revenues are subject to a number of risks associated with foreign commerce, including the following:

- managing foreign distributors;
- staffing and managing foreign offices;
- political and economic instability;
- foreign currency exchange fluctuations;
- changes in tax laws, tariffs and freight rates;

- timing and availability of export licenses;
- inadequate protection of intellectual property rights in some countries; and
- obtaining governmental approvals for certain products.

In the past we have denominated sales of our products to foreign countries exclusively in U.S. dollars. As a result, any increase in the value of the U.S. dollar relative to the local currency of a foreign country will increase the price of our products in that country so that our products become relatively more expensive to customers in the local currency of that foreign country. As a result, sales of our products in that foreign country may decline. To the extent any such risks materialize, our business would be materially harmed.

In addition, we may incur costs that are difficult to reduce quickly because of employee-related laws and practices in foreign countries.

We may engage in manufacturing or technology agreements that involve numerous risks, including the use of cash, diversion of resources and significant write-offs

In the past, we have entered into agreements that have involved numerous risks, including the use of significant amounts of our cash, diversion of the attention of employees from other development projects or market opportunities, significant expenses and costs, our ability to utilize the technology in our products, our ability to introduce related products in a cost-effective and timely manner, and market acceptance of related products. For instance, we have licensed certain microprocessor technology from MIPS Technologies and obtained other elements of our products from other third-party companies.

Our current agreements and future agreements entail similar risks. If we fail to recover, or if in our judgment we will not recover, the cost of these assets from the gross profits of the related products, our assets will become impaired, or we may decide to write-down these investments for other reasons, and our financial results would be harmed. We cannot be certain that these third-party elements will continue to be available to us on commercially reasonable terms. The loss of, or inability to use or maintain, such elements could result in shipment delays or reductions until equivalent design elements or software is developed internally or licensed from a third party, and integrated into our products, which could seriously harm our business.

Business interruptions could adversely affect our business

Our operations are vulnerable to interruption by fire, earthquake, power loss, terrorist acts and other events beyond our control. In particular, our headquarters are located near earthquake fault lines in the San Francisco Bay area and may be susceptible to the risk of earthquakes. If there is an earthquake in the region, our business could be seriously harmed. In addition, we rely on sole suppliers to manufacture our products. These suppliers often hold significant inventory of QuickLogic product and, in the event of a disaster or other loss of supply, our ability to use this inventory and to move production to new suppliers may significantly impact QuickLogic resources for several quarters. We may also be adversely affected by business interruptions at systems manufacturers. We do not have a detailed disaster recovery plan. In addition, we do not carry sufficient business interruption insurance to compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business.

Our products are complex and may contain undetected or unresolved defects

Our products are complex and may contain undetected or unresolved defects when first introduced, as new intellectual property is incorporated into our products, as a result of changes in the manufacturing process, or as new versions are released. We cannot assure you that, despite our testing, defects will not be found in our products following commercial release. If our products do contain undetected or unresolved defects, we may lose market share, experience delays in or loss of market acceptance or be required to issue a product recall. In addition, we would be at risk of product liability litigation for financial or other damages to our customers because of defects in our products. Although we attempt to limit our liability to end users through disclaimers of special, consequential and indirect damages and similar provisions, we cannot assure you that such limitations of liability will be legally enforceable.

Our principal stockholders have significant voting power and may vote for actions that may not be in the best interests of our stockholders

Our officers, directors and principal stockholders together control approximately 44% of our outstanding common stock. As a result, these stockholders, if they act together, will be able to significantly influence the management and affairs of QuickLogic and all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership may have the effect of delaying or preventing a change in control and might affect the market price of our common stock. This concentration of ownership may not be in the best interest of our other stockholders.

Our Shareholder Rights Plan, certificate of incorporation, bylaws and Delaware law contain provisions that could discourage a takeover

Our Shareholder Rights Plan as well as provisions of our certificate of incorporation, our bylaws and Delaware law could make it difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders.

Litigation

From time to time, the Company is involved in legal actions arising in the ordinary course of business. Absolute assurance cannot be given that third party assertions will be resolved without costly litigation in a manner that is not adverse to the Company's financial position, results of operations or cash flows or without requiring royalty payments in the future which may adversely impact gross profit.

The market price of our common stock may fluctuate significantly

Stock prices for many companies in the technology and emerging growth sectors have experienced wide fluctuations that have often been unrelated to the operating performance of such companies. In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. In the future, we may be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

We do not use derivative financial instruments in our investment portfolio. Our investment portfolio is generally comprised of government issued securities and commercial paper. We place investments in instruments that meet high credit quality standards. These securities are subject to interest rate risk, and could decline in value if interest rates fluctuate. Due to the short duration and conservative nature of our investment portfolio, we do not expect any material loss with respect to our investment portfolio. A 10% move in interest rates as of June 30, 2003 would have an immaterial effect on our pretax earnings and the carrying value of our investments over the next fiscal year.

Foreign Currency Exchange Rate Risk

All of our sales and cost of manufacturing are transacted in U.S. dollars. In late 2001, we began to conduct research and development in Canada and India. We also have sales and marketing activities outside the United States. These costs are incurred in local currency. If these local currencies strengthen against the dollar, our payroll and other local expenses will be higher than we currently anticipate. Since our sales are transacted in dollars, this negative impact on expenses would not be offset by any positive effect on revenue. Operating expenses denominated in foreign currencies were approximately 22% and 24% of total operating expenses in the six months ended June 30, 2003 and 2002, respectively. A majority of these expenses were incurred in Canada. A currency exchange rate fluctuation of 10% would have caused our operating expenses to change by approximately $300,000 in the six months ended June 30, 2003.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures.

Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report on Form 10-Q. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our current disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Control Over Financial Reporting.

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

On October 26, 2001, a putative securities class action was filed in the U.S. District Court for the Southern District of New York against some investment banks that underwrote QuickLogic's initial public offering, QuickLogic and some of QuickLogic's officers and directors. This lawsuit is now captioned *In re QuickLogic Corp. Initial Public Offering Sec. Litig.,* Case No. 01-cv-9503. The complaint alleges excessive and undisclosed commissions in connection with the allocation of shares of common stock in QuickLogic's initial and secondary public offerings and artificially high prices through "tie-in" arrangements which required the underwriters' customers to buy shares in the aftermarket at pre-determined prices in violation of the federal securities laws. Plaintiffs seek an unspecified amount of damages on behalf of persons who purchased QuickLogic's stock pursuant to the registration statements between October 14, 1999, and December 6, 2000. The court has appointed a lead plaintiff in this litigation. On April 19, 2002, plaintiffs filed an amended complaint. Various plaintiffs have filed similar actions asserting virtually identical allegations against over 300 other public companies, their underwriters, and their officers and directors arising out of each company's public offering. These actions, including the action against QuickLogic, have been coordinated for pretrial purposes and captioned *In re Initial Public Offering Securities Litigation,* 21 MC 92.

Defendants in these cases filed an omnibus motion to dismiss on common pleading issues. In October 2002, QuickLogic's officers and directors were voluntarily dismissed without prejudice. On February 19, 2003, the court denied in part and granted in part the motion to dismiss filed on behalf of defendants, including QuickLogic. The court's order did not dismiss any claims against QuickLogic. As a result, discovery may now proceed.

A proposal has been made for the settlement and release of claims against the issuer defendants, including QuickLogic, in exchange for a guaranteed recovery to be paid by the issuer defendants' insurance carriers and an assignment of certain claims. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. If the settlement does not occur, and litigation against QuickLogic continues, QuickLogic believes it has meritorious defenses and intends to defend the case vigorously.

On July 3, 2003, a putative securities class action was filed in the U.S. District Court for the Southern District of New York by shareholders of Tower against Tower, several of its directors, and several of its investors, including QuickLogic. Although the case is in its earliest stages, the Company believes it has meritorious defenses and intends to defend the case vigorously.

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

The Annual Meeting of Stockholders of QuickLogic was held on April 22, 2003. The following matters were voted upon at the meeting:

(i) The following nominees were elected to hold office as Class I directors until 2006:

Nominee	Votes For	Votes Withheld	Abstentions
Donald P. Beadle	21,426,898	203,799	—
Michael J. Callahan	21,426,922	203,775	—

(ii) The ratification of PricewaterhouseCoopers LLP as independent accountants of QuickLogic for the fiscal year ending December 31, 2003.

Votes For:	21,543,116
Votes Against:	87,581
Abstentions:	—
Broker Non-votes:	—

Item 6. Exhibits and Reports on Form 8-K

a. Exhibits

The following Exhibits are filed with this report:

Exhibit Number	Description
10.1	Amended and Restated Loan and Security Agreement between Silicon Valley Bank and registrant dated June 20, 2003
99.1	CEO and CFO Certifications under Section 906 of the Sarbanes-Oxley Act

b. Reports on Form 8-K

On April 23, 2003, QuickLogic furnished its earnings release for the first quarter of 2003 to the Securities and Exchange Commission (the "SEC") on Form 8-K.

On May 20, 2003, QuickLogic filed a Form 8-K with the SEC announcing the election of Henry Montgomery to QuickLogic's board of directors.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

QUICKLOGIC CORPORATION

/s/ CARL M. MILLS

Dated: August 12, 2003

Carl M. Mills
Vice President of Finance and Chief Financial Officer
(as principal accounting and financial officer and on behalf of Registrant)

CERTIFICATIONS

I, E. Thomas Hart, certify that:

1. I have reviewed this quarterly report on Form 10-Q of QuickLogic Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

   (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: August 12, 2003

/s/ E. Thomas Hart
E. Thomas Hart
Chief Executive Officer

I, Carl M. Mills, certify that:

1. I have reviewed this quarterly report on Form 10-Q of QuickLogic Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

   (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: August 12, 2003

/s/ Carl M. Mills
Carl M. Mills
Chief Financial Officer

EXHIBIT INDEX

Exhibit Number	Description
10.1	Amended and Restated Loan and Security Agreement between Silicon Valley Bank and registrant dated June 20, 2003
99.1	CEO and CFO Certifications under Section 906 of the Sarbanes-Oxley Act

AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT

between

SILICON VALLEY BANK

and

QUICKLOGIC CORPORATION

June 20, 2003

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This AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT dated June 20, 2003, between SILICON VALLEY BANK ("Bank"), whose address is 3003 Tasman Drive, Santa Clara, California 95054 and QUICKLOGIC CORPORATION, a Delaware corporation ("Borrower"), whose address is 1277 New Orleans Drive, Sunnyvale, CA 94089-1138, provides the terms on which Bank will lend to Borrower and Borrower will repay Bank.

RECITALS

WHEREAS, Borrower and Bank have previously entered into that certain Loan and Security Agreement, dated as of June 28, 2002 (the "Prior Agreement").

WHEREAS, Borrower and Bank desire to amend and restate the Prior Agreement as set forth herein.

NOW, THEREFORE, Borrower and Bank hereby amend and restate the Prior Agreement as follows:

1. ACCOUNTING AND OTHER TERMS.

Accounting terms not defined in this Agreement will be construed following GAAP. Calculations and determinations must be made following GAAP. The term "financial statements" includes the notes and schedules. The terms "including" and "includes" always mean "including (or includes) without limitation," in this or any Loan Document.

2. LOAN AND TERMS OF PAYMENT

2.1 Credit Extensions.

Borrower will pay Bank the unpaid principal amount of all Credit Extensions and interest due on the unpaid principal amount of the Credit Extensions.

2.1.1 Formula Revolving Advances.

(a) Formula and Non-Formula Advances.

(i) Formula Advances. If at any time, and so long as, the then outstanding Revolving Obligations are less than or equal to the Formula Line Availability, Bank will make advances ("Formula Advances") not exceeding the amount calculated as the lesser of (A) the Committed Formula Revolving Line minus the sum: (x) FX Reserve, plus, (y) the aggregate amounts deemed outstanding under the sublimit described in Section 2.1.5, (the "CMS Reserve"), plus (z) the amount of all outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit) (the "L/C Reserve") or (B) the Borrowing Base minus the sum of: (x) FX Reserve, plus, (y) the CMS Reserve, plus, (z) the L/C Reserve. Amounts borrowed under this Section may be repaid and reborrowed during the term of this Agreement.

(ii) Non-Formula Advances. If at any time, and so long as, the then outstanding Revolving Obligations maximize the Formula Line Availability, Bank will make

Advances ("Non-Formula Advances") not exceeding the amount calculated as the Committed Non-Formula Revolving Line minus the sum of any portion of the following not reserved against the Formula Line Availability: (x) FX Reserve, plus, (y) the CMS Reserve, plus, (z) the L/C Reserve. Amounts borrowed under this Section may be repaid and reborrowed during the term of this Agreement.

(b) All Advances and reserves shall be applied first to the Committed Formula Revolving Line and only after the Formula Line Availability has been exhausted, second to the Committed Non-Formula Revolving Line. In the event that Formula Line Availability increases, Advances and reserves under the Committed Non-Formula Revolving Line shall automatically convert as follows until Formula Line Availability has been exhausted: (i) first, any outstanding Non-Formula Advances shall convert to Formula Advances until all such Non-Formula Advances have been so converted; (ii) second, the L/C Reserve reserved against the Non-Formula Revolving Line shall be converted to L/C Reserve reserved against Formula Line Availability until all such reserves have been so converted; (iii) third, the CMS Reserve reserved against the Committed Non-Formula Revolving Line shall be converted to CMS Reserve reserved against Formula Line Availability until all such reserves have been so converted; and (iv) fourth, the FX Reserve reserved against the Committed Non-Formula Line shall be converted to FX Reserve reserved against Formula Line Availability. In the event that Formula Line Availability decreases, Advances and sublimit reserves that exceed the Formula Line Availability shall automatically convert as follows: (i) first, the portion of the FX Reserve that exceeds the Formula Line Availability shall be converted to FX Reserve reserved against the Committed Non-Formula Revolving Line; (ii) second, the portion of the CMS Reserve that exceeds the Formula Line Availability shall be converted to CMS Reserve reserved against the Committed Non-Formula Revolving Line, until all of the CMS Reserve has been so converted; (iii) third, the portion of the L/C Reserve that exceeds the Formula Line Availability shall be converted to L/C Reserve reserved against the Committed Non-Formula Revolving Line, until all of the L/C Reserve has been so converted; and (iv) fourth, any outstanding Formula Advances that exceed Formula Line Availability shall convert to Non-Formula Advances until all such Formula Advances have been so converted.

(c) The Committed Non-Formula Revolving Line and the Committed Formula Revolving Line terminate on the Revolving Maturity Date, when all outstanding Advances are immediately payable.

2.1.2 Requesting Advances.

To obtain an Advance, Borrower must notify Bank by facsimile or telephone by 12:00 noon Pacific time on the Business Day the Advance is to be made. Borrower must promptly confirm the notification by delivering to Bank the Payment/Advance Form attached as Exhibit B. Bank will credit Advances to Borrower's deposit account. Bank may make Advances under this Agreement based on instructions from a Responsible Officer or his or her designee or without instructions if the Advances are necessary to meet Obligations which have become due. Bank may rely on any telephone notice given by a person whom Bank believes is a Responsible Officer or designee. Borrower will indemnify Bank for any loss Bank suffers due to such reliance unless such loss is due to Bank's gross negligence or willful misconduct.

2.1.3 Letters of Credit Sublimit.

(a) Bank will issue Letters of Credit for Borrower's account not exceeding the lesser of: (i) $500,000 and (ii) Availability.

(b) Each Letter of Credit will have an expiry date of no later than one hundred eighty (180) days after the Revolving Maturity Date, but Borrower's reimbursement obligation will be secured by cash on terms acceptable to Bank at any time after the Revolving Maturity Date if the term of this Agreement is not extended by Bank. Borrower agrees to execute any further documentation in connection with the Letters of Credit as Bank may reasonably request.

2.1.4 Foreign Exchange Sublimit.

Subject to the limits set forth below in this Section 2.1.4, Borrower may enter into foreign exchange forward contracts with the Bank under which Borrower commits to purchase from or sell to Bank a set amount of foreign currency more than one business day after the contract date (the "FX Forward Contract") (the amount equal to 10% of the aggregate outstanding FX Forward Contracts is hereinafter referred to as the "FX Reserve"). The FX Reserve may not exceed the lesser of: (i) $500,000 and (ii) Availability. The total FX Forward Contracts at any one time may not exceed the amount calculated as 10 multiplied by the FX Reserve. Bank may terminate the FX Forward Contracts if an Event of Default occurs and continues.

2.1.5 Cash Management Services Sublimit.

Borrower may use for Bank's Cash Management Services up to an amount equal to the lesser of: (i) $500,000 and (ii) Availability (Cash Management Services Sublimit"). Such services may include merchant services, direct deposit of payroll, business credit card, clearing house services, control disbursement accounts and check cashing services identified in various cash management services agreements related to such services (the "Cash Management Services"). The aggregate amount of the credit limits under all such agreements with respect to Cash Management Services shall be deemed to be the amount of the Cash Management Services for the purposes of calculating the Cash Management Services Sublimit. All amounts Bank pays for any Cash Management Services will be treated as Advances under Section 2.1.1. Bank will advise Borrower of any amounts that would affect the Cash Management Services Sublimit.

2.1.6 Equipment Advances.

(a) Through December 31, 2003 (the "Equipment Availability End Date"), Bank will make advances ("Equipment Advance" and, collectively, "Equipment Advances") not exceeding the Committed Equipment Line. The Equipment Advances may only be used to finance the acquisition of hardware and shall exclude taxes, shipping, warranty charges, freight discounts and installation expense ("Hardware Equipment"). Hardware Equipment shall be limited to that purchased within 90 days of the date of the requested Equipment Advance. Each Equipment Advance must be for a minimum of $50,000 and only one Equipment Advance per month shall be available.

(b) Interest accrues from the date of each Equipment Advance at the rate in Section 2.3(a). Each Equipment Advance is payable in 36 equal monthly installments of principal, plus accrued interest, beginning on the first day of each month following the date of the Equipment Advance. Equipment Advances when repaid may not be reborrowed.

(c) To obtain an Equipment Advance, Borrower must notify Bank (the notice is irrevocable) by facsimile no later than 12:00 noon Pacific time 1 Business Day before the day on which the Equipment Advance is to be made. The notice in the form of Exhibit B (Payment/Advance Form) must be signed by a Responsible Officer or designee and include a copy of the invoice for the Equipment being financed.

2.1.7 Term Loan A.

(a) Pursuant to the terms of the Prior Agreement, Bank has made a term loan (the "Term Loan A") to Borrower. As of the Closing Date the outstanding principal balance of Term Loan A is $637,691.06 plus accrued and unpaid interest.

(b) Interest accrues (starting on the date of the Term Loan A funding under the Prior Agreement) at the rate specified in Section 2.3(a)(iv), and shall be payable monthly on the first day of each month through the Term Loan A Maturity Date. The principal balance of the Term Loan A that is outstanding on the Closing Date shall be payable in 27 equal monthly installments of principal, plus all accrued and unpaid interest, beginning on July 1, 2003, and continuing on the first day of each month thereafter through the Term Loan A Maturity Date, at which time all amounts due under this Section 2.1.7 shall be immediately due and payable.

2.1.8 Term Loan B.

(a) Pursuant to the terms of the Prior Agreement, Bank has made a term loan (the "Term Loan B") to Borrower. As of the Closing Date the outstanding principal balance of Term Loan B is $766,441.05 plus accrued and unpaid interest.

(b) Interest accrues (starting on the date of the Term Loan B funding under the Prior Agreement) at the rate specified in Section 2.3(a)(iv), and shall be payable monthly on the first day of each month through the Term Loan B Maturity Date. The principal balance of the Term Loan B that is outstanding on the Closing Date shall be payable in 21 equal monthly installments of principal, plus all accrued and unpaid interest, beginning on July 1, 2003, and continuing on the first day of each month thereafter through the Term Loan B Maturity Date, at which time all amounts due under this Section 2.1.8 shall be immediately due and payable.

2.1.9 Term Loan C.

(a) Pursuant to the terms of the Prior Agreement, Bank has made a term loan (the "Term Loan C") to Borrower. As of the Closing Date the outstanding principal balance of Term Loan C is $252,132.19 plus accrued and unpaid interest.

(b) Interest accrues (starting on the date of the Term Loan C funding under the Prior Agreement) at the rate specified in Section 2.3(a)(iv), and shall be payable monthly on the first

day of each month through the Term Loan C Maturity Date. The principal balance of the Term Loan C that is outstanding on the Closing Date shall be payable in 30 equal monthly installments of principal, plus all accrued and unpaid interest, beginning on July 1, 2003, and continuing on the first day of each month thereafter through the Term Loan C Maturity Date, at which time all amounts due under this Section 2.1.9 shall be immediately due and payable.

2.1.10 Term Loan D.

(a) Pursuant to the terms of the Prior Agreement, Bank has made a term loan (the "Term Loan D") to Borrower. As of the Closing Date the outstanding principal balance of Term Loan D is $67,475.99 plus accrued and unpaid interest.

(b) Interest accrues (starting on the date of the Term Loan D funding under the Prior Agreement) at the rate specified in Section 2.3(a)(iv), and shall be payable monthly on the first day of each month through the Term Loan D Maturity Date. The principal balance of the Term Loan D that is outstanding on the Closing Date shall be payable in 24 equal monthly installments of principal, plus all accrued and unpaid interest, beginning on July 1, 2003, and continuing on the first day of each month thereafter through the Term Loan D Maturity Date, at which time all amounts due under this Section 2.1.10 shall be immediately due and payable.

2.2 Overadvances.

If Borrower's Obligations under Section 2.1.1, 2.1.2, 2.1.3, 2.1.4 and 2.1.5 at any time exceed: (A) the lesser of: (i) the Committed Formula Revolving Line or (ii) the Borrowing Base, plus (B) the Committed Non-Formula Revolving Line, Borrower must immediately pay Bank the excess.

2.3 Interest Rate, Payments.

(a) Interest Rate. (i) Formula Advances accrue interest on the outstanding principal balance at a per annum rate equal to 100 basis points (1%) above the Prime Rate; (ii) Non-Formula Advances accrue interest on the outstanding principal balance at a per annum rate equal to 200 basis points (2%) above the Prime Rate; (iii) Equipment Advances accrue interest on the outstanding principal balance at a per annum rate of 200 basis points (2.00%) above the Prime Rate; and (iv) Term Loan A, Term Loan B, Term Loan C, and Term Loan D accrue interest on the outstanding principal balance at a per annum rate of 75 basis points (0.75%) above the Prime Rate. After an Event of Default, Obligations accrue interest at 5 percent above the rate effective immediately before the Event of Default. The interest rate increases or decreases when the Prime Rate changes. Interest is computed on a 360 day year for the actual number of days elapsed.

(b) Payments. Interest due on the Committed Formula Revolving Line and the Committed Non-Formula Revolving Line is payable on the first day of each month. Interest due on the Equipment Advances is payable on the first day of each month. Bank may debit any of Borrower's deposit accounts for principal and interest payments owing under this Agreement or any amounts Borrower owes Bank. Bank will promptly notify Borrower when it debits Borrower's accounts. These debits are not a set-off. Payments received after 12:00 noon Pacific time are considered received at the opening of business on the next Business Day. When a

payment is due on a day that is not a Business Day, the payment is due the next Business Day and additional fees or interest accrue, however solely making such payment on the next Business Day shall not result in an Event of Default.

2.4 Fees.

Borrower will pay:

(a) Bank Expenses. All Bank Expenses (including reasonable attorneys' fees and reasonable expenses) incurred through and after the date of this Agreement, payable when due.

(b) Loan Fee. On or before the Closing Date, a loan fee equal to $70,000 due, payable and fully earned on the Closing Date.

3. CONDITIONS OF LOANS

3.1 Conditions Precedent to Initial Credit Extension.

Bank's obligation to make the initial Credit Extension is subject to the condition precedent that it receive the agreements, documents and fees it requires.

3.2 Conditions Precedent to all Credit Extensions.

Bank's obligations to make each Credit Extension, including the initial Credit Extension, is subject to the following:

(a) timely receipt of any Payment/Advance Form; and

(b) the representations and warranties in Section 5 must be materially true on the date of the Payment/Advance Form and on the effective date of each Credit Extension except for representations and warranties made as of a specified earlier date, which must be materially true as of such earlier date and no Event of Default may have occurred and be continuing, or result from the Credit Extension. Each Credit Extension is Borrower's representation and warranty on that date that the representations and warranties of Section 5 remain true except for representations and warranties made as of a specified earlier date, which must be materially true as of such earlier date.

4. CREATION OF SECURITY INTEREST

4.1 Grant of Security Interest.

(a) Borrower grants Bank a continuing security interest in all presently existing and later acquired Collateral to secure all Obligations and performance of each of Borrower's duties under the Loan Documents. Except for Permitted Liens, any security interest will be a first priority security interest in the Collateral. Bank may place a "hold" on any deposit account pledged as Collateral. Notwithstanding the foregoing, the security interest granted herein does not extend to and the term "Collateral" does not include: (A) any license or contract rights to the

extent (i) the granting of a security interest in it would be contrary to applicable law, or (ii) that such rights are nonassignable by their terms (but only to the extent such prohibition is enforceable under applicable law) without the consent of the licensor or other party (but only to the extent such consent has not been obtained) and (B) pledges of more than 65% of foreign subsidiaries' stock. If this Agreement is terminated, Bank's lien and security interest in the Collateral will continue until Borrower fully satisfies its Obligations.

5. REPRESENTATIONS AND WARRANTIES

Borrower represents and warrants as follows:

5.1 Due Organization and Authorization.

Borrower and each material Subsidiary is duly existing and in good standing in its state of formation and qualified and licensed to do business in, and in good standing in, any state in which the conduct of its business or its ownership of property requires that it be qualified, except where the failure to do so could not reasonably be expected to cause a Material Adverse Change.

The execution, delivery and performance of the Loan Documents have been duly authorized, and do not conflict with Borrower's formation documents, nor constitute an event of default under any material agreement by which Borrower is bound. Borrower is not in default under any agreement to which or by which it is bound in which the default could reasonably be expected to cause a Material Adverse Change.

5.2 Collateral.

Borrower has good title to the Collateral, free of Liens except Permitted Liens. The Accounts are bona fide, existing obligations, and the service or property has been performed or delivered to the account debtor or its agent for immediate shipment to and unconditional acceptance by the account debtor. All Inventory, net of inventory reserves, is in all material respects of good and marketable quality, free from material defects. To the best of Borrower's knowledge, Borrower is the sole owner of the Intellectual Property, except for non-exclusive licenses granted to its customers in the ordinary course of business. To the best of Borrower's knowledge, each Patent is valid and enforceable and no part of the Intellectual Property has been judged invalid or unenforceable, in whole or in part, and no claim has been made that any part of the Intellectual Property violates the rights of any third party, except to the extent such claim could not reasonably be expected to cause a Material Adverse Change.

5.3 Litigation.

Except as shown in the Disclosure Letter, there are no actions or proceedings pending or, to the knowledge of Borrower's Responsible Officers, threatened by or against Borrower or any material Subsidiary in which a likely adverse decision could reasonably be expected to cause a Material Adverse Change.

5.4 No Material Adverse Change in Financial Statements.

All consolidated financial statements for Borrower delivered to Bank fairly present in all material respects Borrower's consolidated financial condition and Borrower's consolidated results of operations as of the date of such financial statements. There has not been any material adverse change in Borrower's consolidated financial condition since the date of the most recent financial statements submitted to Bank.

5.5 Solvency.

The fair salable value of Borrower's assets (including goodwill minus disposition costs) exceeds the fair value of its liabilities; the Borrower is not left with unreasonably small capital after the transactions in this Agreement; and Borrower is able to pay its debts (including trade debts) as they mature.

5.6 Regulatory Compliance.

Borrower is not an "investment company" or a company "controlled" by an "investment company" under the Investment Company Act. Borrower is not engaged as one of its important activities in extending credit for margin stock (under Regulations T and U of the Federal Reserve Board of Governors). Borrower has complied in all material respects with the Federal Fair Labor Standards Act. Borrower has not violated any laws, ordinances or rules, the violation of which could reasonably be expected to cause a Material Adverse Change. None of Borrower's or any Subsidiary's properties or assets has been used by Borrower or any Subsidiary or, to the best of Borrower's knowledge, by previous Persons, in disposing, producing, storing, treating, or transporting any hazardous substance other than legally. Borrower and each Subsidiary has timely filed all required tax returns and paid, or made adequate provision to pay, all material taxes, except those being contested in good faith with adequate reserves under GAAP. Borrower and each Subsidiary has obtained all consents, approvals and authorizations of, made all declarations or filings with, and given all notices to, all government authorities that are necessary to continue its business as currently conducted, except where the failure to do so could not reasonably be expected to cause a Material Adverse Change.

5.7 Subsidiaries.

Borrower does not own any stock, partnership interest or other equity securities except for Permitted Investments.

5.8 Full Disclosure.

No written representation, warranty or other statement of Borrower in any certificate or written statement given to Bank (taken together with all such written certificates and written statements to Bank and Borrower's filings with the Securities & Exchange Commission) contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements contained in the certificates or statements not misleading. It being recognized by Bank that the projections and forecasts provided by Borrower in good faith and based upon reasonable assumptions are not viewed as facts and that actual results during the

period or periods covered by such projections and forecasts may differ from the projected and forecasted results.

6. AFFIRMATIVE COVENANTS

Borrower will do all of the following:

6.1 Government Compliance.

Borrower will maintain its and all Subsidiaries' legal existence and good standing in its jurisdiction of formation and maintain qualification in each jurisdiction in which the failure to so qualify would reasonably be expected to cause a material adverse effect on Borrower's business or operations. Borrower will comply, and have each Subsidiary comply, with all laws, ordinances and regulations to which it is subject, noncompliance with which could have a material adverse effect on Borrower's business or operations or would reasonably be expected to cause a Material Adverse Change.

6.2 Financial Statements, Reports, Certificates.

(a) Borrower will deliver to Bank: (i) as soon as available, but no later than 45 days after the last day of each month, a company prepared consolidated balance sheet and income statement, prepared under GAAP, consistently applied, without footnotes and subject to year-end adjustments, covering Borrower's consolidated operations during the period, in a form and certified by a Responsible Officer acceptable to Bank; (ii) as soon as available, but no later than 120 days after the last day of Borrower's fiscal year, audited consolidated financial statements prepared under GAAP, consistently applied, together with an opinion which is unqualified or as is otherwise consented to by Bank on the financial statements from an independent certified public accounting firm reasonably acceptable to Bank; (iii) within 5 days of filing, notice to Bank of the filing of all statements, reports and notices made available to Borrower's security holders or to any holders of Subordinated Debt and all reports on Form 10-K, 10-Q and 8-K filed with the Securities and Exchange Commission ("SEC") unless such 10-K, 10-Q, and 8-K reports are available in the SEC's EDGAR database in which case Borrower shall not be required to deliver the same; (iv) as soon as available but in no event after December 20 of every year, Borrower's budget and financial projections as approved by the Borrower's Board of Directors; (v) such other financial information Bank reasonably requests; and (vi) prompt notice of any material change in the composition of the Intellectual Property, including any subsequent ownership right of Borrower in or to any Copyright, Patent or Trademark not shown in any intellectual property security agreement between Borrower and Bank or knowledge of an event that materially adversely affects the value of the Intellectual Property.

(b) Within 45 days after the last day of each month, Borrower will deliver to Bank with the monthly financial statements a Compliance Certificate signed by a Responsible Officer in the form of Exhibit C.

(c) Within 30 days after the last day of each month, Borrower will deliver to Bank a Borrowing Base Certificate signed by a Responsible Officer in the form of Exhibit D, with aged listings of accounts receivable and accounts payable.

(d) Bank has the right to audit Borrower's Collateral at Borrower's expense, but the audits will be conducted no more often than every year unless an Event of Default has occurred and is continuing.

6.3 Inventory; Returns.

Borrower will keep all Inventory in good and marketable condition, free from material defects. Returns and allowances between Borrower and its account debtors will follow Borrower's customary practices as they exist at execution of this Agreement. Borrower must promptly notify Bank of all returns, recoveries, disputes older than 30 days and claims, that involve more than $200,000, excluding "ship from stock and debit transactions" and any returns from distributors of unprogrammed Inventory which involve less than $500,000.

6.4 Taxes.

Borrower will make, and cause each Subsidiary to make, timely payment of all material federal, state, and local taxes or assessments and will deliver to Bank, on demand, appropriate certificates attesting to the payment.

6.5 Insurance.

Borrower will keep its business and the Collateral insured for risks and in amounts, as Bank may reasonably request. Insurance policies will be in a form, with companies, and in amounts that are satisfactory to Bank in Bank's reasonable discretion. All property policies will have a lender's loss payable endorsement showing Bank as an additional loss payee and all liability policies will show the Bank as an additional insured and provide that the insurer must give Bank at least 20 days notice before canceling its policy. At Bank's request, Borrower will deliver certified copies of policies and evidence of all premium payments. If no Event of Default has occurred and is continuing, proceeds payable under any casualty policy will, at Borrower's option, be payable to Borrower to replace the property subject to the claim, provided that any such replacement property shall be deemed Collateral in which Bank has been granted a first priority security interest. If an Event of Default has occurred and is continuing, then, at Bank's option, proceeds payable under any policy will be payable to Bank on account of the Obligations.

6.6 Deposit and Investment Accounts.

Borrower will maintain 85% of its cash and cash equivalents in depository, investment and operating accounts with Bank and Bank's affiliates which shall be held in the form of cash and such other investments as are consistent with Borrower's investment policy as approved by its Board of Directors.

6.7 Financial Covenants.

Borrower will maintain as of the last day of each month:

(i) **Tangible Net Worth**. A Tangible Net Worth of at least $33,000,000.

(ii) **Quick Ratio (Adjusted)**. A ratio of Quick Assets to Current Liabilities minus Deferred Revenue of at least 1.40 to 1.00.

6.8 Registration of Intellectual Property Rights.

(a) Borrower will promptly notify Bank upon Borrower's filing of any application or registration of any Intellectual Property rights with the United States Patent and Trademark Office or the United States Copyright Office and Borrower will execute and deliver any and all instruments and documents and do all necessary things, as Bank may require to evidence or perfect Bank's security interest in such application or registration.

(b) Borrower will (i) protect, defend and maintain the validity and enforceability of the Intellectual Property and promptly advise Bank in writing of material infringements and (ii) not allow any Intellectual Property to be abandoned, forfeited or dedicated to the public without Bank's written consent.

6.9 Control Agreements.

With respect to deposit accounts or investment accounts maintained at domestic financial institutions other than Bank, within 10 Business Days of the opening of any such deposit account or investment account, Borrower will execute and deliver to Bank, control agreements in form satisfactory to Bank in order for Bank to perfect its security interest in Borrower's deposit accounts or investment accounts; provided that with respect to deposit accounts existing as of the Closing Date, Borrower shall provide such control agreements with respect to all such accounts as are reasonably deemed material by Bank on or before July 30, 2003.

6.10 Further Assurances.

Borrower will execute any further instruments and take further action as Bank reasonably requests to perfect or continue Bank's security interest in the Collateral or to effect the purposes of this Agreement.

7. NEGATIVE COVENANTS

Borrower will not do any of the following without Bank's prior written consent, which will not be unreasonably withheld:

7.1 Dispositions.

Convey, sell, lease, transfer or otherwise dispose of (collectively "Transfer"), or permit any of its Subsidiaries to Transfer, all or any part of its business or property, other than Transfers (i) of Inventory in the ordinary course of business; (ii) of non-exclusive licenses and similar arrangements for the use of the property of Borrower or its Subsidiaries in the ordinary course of business; (iii) of worn-out or obsolete Equipment; (iv) other Transfers which in the aggregate do not exceed $200,000 in any fiscal year; or (v) other Transfers otherwise permitted pursuant to Section 7 hereof.

7.2 Changes in Business, Ownership, Management or Business Locations.

(i) Engage in or permit any of its Subsidiaries to engage in any business other than the businesses currently engaged in by Borrower or reasonably related thereto, (ii) direct or indirect acquisition by any persons (as such term is used in Section 13(d) and Section 14(d) (2) of the Exchange Act) or related persons constituting a group (as such term is used in Rule 13d-5 under the Exchange Act), of beneficial ownership of the issued and outstanding shares of voting stock of the Borrower, the result of which acquisition is that such person or group possesses in excess of 35% of the combined voting power of all then issued and outstanding stock of the Borrower, (iii) without contemporaneous written notice, relocate its chief executive office, or add any new offices or business locations, or (iv) without at least 30 days written notice, change the jurisdiction of its incorporation.

7.3 Mergers or Acquisitions.

Merge or consolidate, or permit any of its Subsidiaries to merge or consolidate, with any other Person, or acquire, or permit any of its Subsidiaries to acquire, all or substantially all of the capital stock or property of another Person, except where (i) such transactions do not in the aggregate result in a decrease of more than 25% of Tangible Net Worth and (ii) no Event of Default has occurred, is continuing or would exist after giving effect to the transactions. A Subsidiary may merge or consolidate into another Subsidiary or into Borrower.

7.4 Indebtedness.

Create, incur, assume, or be liable for any Indebtedness, or permit any Subsidiary to do so, other than Permitted Indebtedness.

7.5 Encumbrance.

Create, incur, or allow any Lien on any of its property, or assign or convey any right to receive income, including the sale of any Accounts, or permit any of its Subsidiaries to do so, except for Permitted Liens, or permit any Collateral not to be subject to the first priority security interest granted here, subject to Permitted Liens.

7.6 Distributions; Investments.

Directly or indirectly acquire or own any Person, or make any Investment in any Person, other than Permitted Investments, or permit any of its Subsidiaries to do so. Pay any dividends or make any distribution or payment or redeem, retire or purchase any capital stock, except for (A) repurchases of stock from former employees, consultants or directors of Borrower provided no Default or Event of Default has occurred and is continuing, or would be caused by such repurchase, and provided that the aggregate amount of such repurchases shall not exceed $100,000 in the aggregate in any fiscal year, (B) distributions payable solely in Borrower's capital stock, (C) conversion of any convertible debt into capital stock of Borrower.

7.7 Transactions with Affiliates.

Directly or indirectly enter into or permit any material transaction with any Affiliate except transactions that are in the ordinary course of Borrower's business, on terms less favorable to Borrower than would be obtained in an arm's length transaction with a non-affiliated Person.

7.8 Subordinated Debt.

Make or permit any payment on any Subordinated Debt, except under the terms of the Subordinated Debt, or amend any provision in any document relating to the Subordinated Debt without Bank's prior written consent.

7.9 Compliance.

Become an "investment company" or a company controlled by an "investment company," under the Investment Company Act of 1940 or undertake as one of its important activities extending credit to purchase or carry margin stock, or use the proceeds of any Credit Extension for that purpose; fail to meet the minimum funding requirements of ERISA, permit a Reportable Event or Prohibited

Transaction, as defined in ERISA, to occur; fail to comply with the Federal Fair Labor Standards Act or violate any other law or regulation, if the violation could reasonably be expected to have a material adverse effect on Borrower's business or operations or would reasonably be expected to cause a Material Adverse Change, or permit any of its Subsidiaries to do so.

8. EVENTS OF DEFAULT

Any one of the following is an Event of Default:

8.1 Payment Default.

If Borrower fails to pay any of the Obligations within 3 days after their due date. During the additional period the failure to cure the default is not an Event of Default (but no Credit Extension will be made during the cure period);

8.2 Covenant Default.

If Borrower does not perform any obligation in Section 6 or violates any covenant in Section 7 or does not perform or observe any other material term, condition or covenant in this Agreement, any Loan Documents, or in any agreement between Borrower and Bank and as to any default under a term, condition or covenant that can be cured, has not cured the default within 10 business days after it occurs, or if the default cannot be cured within 10 business days or cannot be cured after Borrower's attempts within 10 business day period, and the default may be cured within a reasonable time, then Borrower has an additional period (of not more than 30 days) to attempt to cure the default. During the additional time, the failure to cure the default is not an Event of Default (but no Credit Extensions will be made during the cure period);

8.3 Material Adverse Change.

(i) A material impairment in the perfection or priority of Bank's security interest in the Collateral or in the value of such Collateral other than normal depreciation which is not covered by adequate insurance occurs; or (ii) Bank determines, based upon information available to it and in its reasonable judgment, that there is a reasonable likelihood that Borrower will fail to comply with one or more of the financial covenants in Section 6 during the next succeeding financial reporting period.

8.4 Attachment.

If any material portion of Borrower's assets is attached, seized, levied on, or comes into possession of a trustee or receiver and the attachment, seizure or levy is not removed in 10 business days, or if Borrower is enjoined, restrained, or prevented by court order from conducting a material part of its business or if a judgment or other claim becomes a Lien on a material portion of Borrower's assets, or if a notice of lien, levy, or assessment is filed against any of Borrower's assets by any government agency and not paid within 10 business days after Borrower receives notice. These are not Events of Default if stayed or if a bond is posted pending contest by Borrower (but no Credit Extensions will be made during the cure period);

8.5 Insolvency.

If Borrower becomes insolvent or if Borrower begins an Insolvency Proceeding or an Insolvency Proceeding is begun against Borrower and not dismissed or stayed within 45 days (but no Credit Extensions will be made before any Insolvency Proceeding is dismissed);

8.6 Other Agreements.

If there is a default in any agreement between Borrower and a third party that gives the third party the right to accelerate any Indebtedness exceeding $250,000 or that could reasonably be expected to cause a Material Adverse Change;

8.7 Judgments.

If a money judgment(s) in the aggregate of at least $250,000 is rendered against Borrower and is unsatisfied and unstayed for 10 Business Days (but no Credit Extensions will be made before the judgment is stayed or satisfied);

8.8 Misrepresentations.

If Borrower or any Responsible Officer of Borrower makes any material misrepresentation or material misstatement (when taken together with Borrower's filings with the Securities & Exchange Commission) now or later in any warranty or representation in this Agreement or in any communication delivered to Bank or to induce Bank to enter this Agreement or any Loan Document; or

8.9 Guaranty.

Any guaranty of any Obligations ceases for any reason to be in full force or any Guarantor does not perform any obligation under any guaranty of the Obligations, or any material misrepresentation or material misstatement exists now or later in any warranty or representation in any guaranty of the Obligations or in any certificate delivered to Bank in connection with the guaranty, or any circumstance described in Sections 8.4, 8.5 or 8.7 occurs to any Guarantor.

9. BANK'S RIGHTS AND REMEDIES

9.1 Rights and Remedies.

When an Event of Default occurs and continues Bank may, without notice or demand, do any or all of the following:

(a) Declare all Obligations immediately due and payable (but if an Event of Default described in Section 8.5 occurs all Obligations are immediately due and payable without any action by Bank);

(b) Stop advancing money or extending credit for Borrower's benefit under this Agreement or under any other agreement between Borrower and Bank;

(c) Settle or adjust disputes and claims directly with account debtors for amounts, on terms and in any order that Bank considers advisable;

(d) Make any payments and do any acts it considers necessary and reasonable to protect its security interest in the Collateral. Borrower will assemble the Collateral if Bank requires and make it available as Bank designates. Bank may enter premises where the Collateral is located, take and maintain possession of any part of the Collateral, and pay, purchase, contest, or compromise any Lien which appears to be prior or superior to its security interest and pay all expenses incurred. Borrower grants Bank a license to enter and occupy any of its premises, without charge, to exercise any of Bank's rights or remedies;

(e) Apply to the Obligations any (i) balances and deposits of Borrower it holds, or (ii) any amount held by Bank owing to or for the credit or the account of Borrower;

(f) Ship, reclaim, recover, store, finish, maintain, repair, prepare for sale, advertise for sale, and sell the Collateral. Bank is granted a non-exclusive, royalty-free license or other right to use, without charge, Borrower's labels, Patents, Copyrights, Mask Works, rights of use of any name, trade secrets, trade names, Trademarks, service marks, and advertising matter, or any similar property as it pertains to the Collateral, in completing production of, advertising for sale, and selling any Collateral and, in connection with Bank's exercise of its rights under this Section, Borrower's rights under all licenses and all franchise agreements inure to Bank's benefit; and

(g) Dispose of the Collateral according to the Code.

9.2 Power of Attorney.

Effective only when an Event of Default occurs and continues until Borrower pays the Obligations in full, Borrower irrevocably appoints Bank as its lawful attorney to: (i) endorse Borrower's name on any checks or other forms of payment or security; (ii) sign Borrower's name on any invoice or bill of lading for any Account or drafts against account debtors, (iii) make, settle, and adjust all claims under Borrower's insurance policies; (iv) settle and adjust disputes and claims about the Accounts directly with account debtors, for amounts and on terms Bank determines reasonable; and (v) transfer the Collateral into the name of Bank or a third party as the Code permits. Bank may exercise the power of attorney to sign Borrower's name on any documents necessary to perfect or continue the perfection of any security interest regardless of whether an Event of Default has occurred. Bank's appointment as Borrower's attorney in fact, and all of Bank's rights and powers, coupled with an interest, are irrevocable until all Obligations have been fully repaid and performed and Bank's obligation to provide Credit Extensions terminates.

9.3 Accounts Collection.

When an Event of Default occurs and continues, Bank may notify any Person owing Borrower money of Bank's security interest in the funds and verify the amount of the Account. Borrower must collect all payments in trust for Bank and, if requested by Bank, immediately deliver the payments to Bank in the form received from the account debtor, with proper endorsements for deposit.

9.4 Bank Expenses.

If Borrower fails to pay any amount or furnish any required proof of payment to third persons, Bank may make all or part of the payment or obtain insurance policies required in Section 6.5, and take any action under the policies Bank deems prudent. Any amounts paid by Bank are Bank Expenses and due and payable within 10 Business Days of written notice to Borrower, bearing interest at the then applicable rate and secured by the Collateral. No payments by Bank are deemed an agreement to make similar payments in the future or Bank's waiver of any Event of Default.

9.5 Bank's Liability for Collateral.

If Bank complies with reasonable banking practices and Section 9-207 of the Code, it is not liable for: (a) the safekeeping of the Collateral; (b) any loss or damage to the Collateral; (c) any diminution in the value of the Collateral; or (d) any act or default of any carrier, warehouseman, bailee, or other person. Borrower bears all risk of loss, damage or destruction of the Collateral.

9.6 Remedies Cumulative.

Bank's rights and remedies under this Agreement, the Loan Documents, and all other agreements are cumulative. Bank has all rights and remedies provided under the Code, by law, or in equity. Bank's exercise of one right or remedy is not an election, and Bank's waiver of any

Event of Default is not a continuing waiver. Bank's delay is not a waiver, election, or acquiescence. No waiver is effective unless signed by Bank and then is only effective for the specific instance and purpose for which it was given.

9.7 Demand Waiver.

Borrower waives demand, notice of default or dishonor, notice of payment and nonpayment, notice of any default, nonpayment at maturity, release, compromise, settlement, extension, or renewal of accounts, documents, instruments, chattel paper, and guarantees held by Bank on which Borrower is liable.

10. NOTICES

All notices or demands by any party about this Agreement or any other related agreement must be in writing and be personally delivered or sent by an overnight delivery service, by certified mail, postage prepaid, return receipt requested, or by telefacsimile to the addresses set forth at the beginning of this Agreement. A party may change its notice address by giving the other party written notice.

11. CHOICE OF LAW , VENUE AND JURY TRIAL WAIVER

California law governs the Loan Documents without regard to principles of conflicts of law. Borrower and Bank each submit to the exclusive jurisdiction of the State and Federal courts in Santa Clara County, California.

BORROWER AND BANK EACH WAIVE THEIR RIGHT TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION ARISING OUT OF ANY OF THE LOAN DOCUMENTS OR ANY CONTEMPLATED TRANSACTION, INCLUDING CONTRACT, TORT, BREACH OF DUTY AND ALL OTHER CLAIMS. THIS WAIVER IS A MATERIAL INDUCEMENT FOR BOTH PARTIES TO ENTER INTO THIS AGREEMENT. EACH PARTY HAS REVIEWED THIS WAIVER WITH ITS COUNSEL.

12. GENERAL PROVISIONS

12.1 Successors and Assigns.

This Agreement binds and is for the benefit of the successors and permitted assigns of each party. Borrower may not assign this Agreement or any rights under it without Bank's prior written consent which may be granted or withheld in Bank's discretion. Bank has the right, without the consent of or notice to Borrower, to sell, transfer, negotiate, or grant participation in all or any part of, or any interest in, Bank's obligations, rights and benefits under this Agreement.

12.2 Indemnification.

Borrower will indemnify, defend and hold harmless Bank and its officers, employees, and agents against: (a) all obligations, demands, claims, and liabilities asserted by any other

party in connection with the transactions contemplated by the Loan Documents; and (b) all losses or Bank Expenses incurred, or paid by Bank from, following, or consequential to transactions between Bank and Borrower (including reasonable attorneys fees and expenses), and in each case of (a) and (b) above, except for any such obligations, claims, liabilities and losses caused by Bank's gross negligence or willful misconduct.

12.3 Time of Essence.

Time is of the essence for the performance of all obligations in this Agreement.

12.4 Severability of Provision.

Each provision of this Agreement is severable from every other provision in determining the enforceability of any provision.

12.5 Amendments in Writing, Integration.

All amendments to this Agreement must be in writing and signed by Borrower and Bank. This Agreement represents the entire agreement about this subject matter, and supersedes prior negotiations or agreements. All prior agreements, understandings, representations, warranties, and negotiations between the parties about the subject matter of this Agreement merge into this Agreement and the Loan Documents.

12.6 Counterparts.

This Agreement may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, are an original, and all taken together, constitute one Agreement.

12.7 Survival.

All covenants, representations and warranties made in this Agreement continue in full force while any Obligations remain outstanding. The obligations of Borrower in Section 12.2 to indemnify Bank will survive until all statutes of limitations for actions that may be brought against Bank have run.

12.8 Confidentiality.

In handling any confidential information, Bank will exercise the same degree of care that it exercises for its own proprietary information, but disclosure of information may be made (i) to Bank's subsidiaries or affiliates in connection with their present or prospective business relations with Borrower, (ii) to prospective transferees or purchasers of any interest in the loans so long as such transfer or purchase is subject to a confidentiality agreement reasonably acceptable to Borrower, (iii) as required by law, regulation, subpoena, or other order, (iv) as required in connection with Bank's examination or audit and (v) as Bank considers appropriate in exercising remedies under this Agreement. Confidential information does not include information that either: (a) is in the public domain or in Bank's possession when disclosed to Bank, or becomes

part of the public domain after disclosure to Bank; or (b) is disclosed to Bank by a third party, if Bank does not know that the third party is prohibited from disclosing the information.

12.9 Attorneys' Fees, Costs and Expenses.

In any action or proceeding between Borrower and Bank arising out of the Loan Documents, the prevailing party will be entitled to recover its reasonable attorneys' fees and other reasonable costs and expenses incurred, in addition to any other relief to which it may be entitled.

13. DEFINITIONS

13.1 Definitions.

In this Agreement:

"**Accounts**" are all existing and later arising accounts, contract rights, and other obligations owed Borrower in connection with its sale or lease of goods (including licensing software and other technology) or provision of services, all credit insurance, guaranties, other security and all merchandise returned or reclaimed by Borrower and Borrower's Books relating to any of the foregoing.

"**Advance**" or "**Advances**" is a Formula Advance or a Non-Formula Advance, as applicable.

"**Affiliate**" of a Person is a Person that owns or controls directly or indirectly the Person, any Person that controls or is controlled by or is under common control with the Person, and each of that Person's senior executive officers, directors, partners and, for any Person that is a limited liability company, that Person's managers and members.

"**Availability**" means, as of any date of determination, the amount that Borrower is entitled to borrow as Advances under Section 2.1.1 (after giving effect to all then outstanding Advances and all sublimit reserves applicable thereunder).

"**Bank Expenses**" are all audit fees and expenses and reasonable costs and reasonable expenses (including reasonable attorneys' fees and expenses) for preparing, negotiating, administering, defending and enforcing the Loan Documents (including appeals or Insolvency Proceedings).

"**Borrower's Books**" are all Borrower's books and records including ledgers, records regarding Borrower's assets or liabilities, the Collateral, business operations or financial condition and all computer programs or discs or any equipment containing the information.

"**Borrowing Base**" is (i) 80% of Eligible Accounts plus (ii) 50% of Eligible Foreign Accounts (but availability from Eligible Foreign Accounts can not be more than 1.5 times availability from Eligible Accounts) as determined by Bank from Borrower's most recent

Borrowing Base Certificate; provided, however, that Bank may lower the percentage of the Borrowing Base after performing an audit of Borrower's Collateral.

"**Business Day**" is any day that is not a Saturday, Sunday or a day on which the Bank is closed.

"Cash Management Services" are defined in Section 2.1.5.

"**Closing Date**" is the date of this Agreement.

"**CMS Reserve**" is defined in Section 2.1.1.

"**Code**" is the California Uniform Commercial Code.

"**Collateral**" is the property described on Exhibit A.

"**Committed Equipment Line**" is a Credit Extension of up to $2,167,925.83.

"**Committed Formula Revolving Line**" is Formula Advances outstanding at any time of up to $8,000,000. At no time shall the sum of the following exceed $8,000,000: (i) Committed Formula Revolving Line plus (ii) Committed Non-Formula Revolving Line.

"**Committed Non-Formula Revolving Line**" is Non-Formula Advances of up to $5,000,000. At no time shall the sum of the following exceed $8,000,000: (i) Committed Formula Revolving Line plus (ii) Committed Non-Formula Revolving Line.

"**Contingent Obligation**" is, for any Person, any direct or indirect liability, contingent or not, of that Person for (i) any indebtedness, lease, dividend, letter of credit or other obligation of another such as an obligation directly or indirectly guaranteed, endorsed, co-made, discounted or sold with recourse by that Person, or for which that Person is directly or indirectly liable; (ii) any obligations for undrawn letters of credit for the account of that Person; and (iii) all obligations from any interest rate, currency or commodity swap agreement, interest rate cap or collar agreement, or other agreement or arrangement designated to protect a Person against fluctuation in interest rates, currency exchange rates or commodity prices; but "Contingent Obligation" does not include endorsements in the ordinary course of business. The amount of a Contingent Obligation is the stated or determined amount of the primary obligation for which the Contingent Obligation is made or, if not determinable, the maximum reasonably anticipated liability for it determined by the Person in good faith; but the amount may not exceed the maximum of the obligations under the guarantee or other support arrangement.

"**Copyrights**" are all copyright rights, applications or registrations and like protections in each work or authorship or derivative work, whether published or not (whether or not it is a trade secret) now or later existing, created, acquired or held.

"**Credit Extension**" is each Advance, Equipment Advance, Letter of Credit, Exchange Contract, Term Loan A, Term Loan B, Term Loan C, and Term Loan D, or any other extension of credit by Bank for Borrower's benefit.

"**Current Liabilities**" are the aggregate amount of Borrower's Total Liabilities which mature within one (1) year, including Letters of Credit (including drawn but unreimbursed Letters of Credit).

"**Deferred Revenue**" means deferred revenue as defined by GAAP.

"**Disclosure Letter**" means the disclosure letter from Borrower to Bank.

"**Eligible Accounts**" are Accounts in the ordinary course of Borrower's business that meet all Borrower's representations and warranties in Section 5; but Bank may change eligibility standards by giving Borrower notice. Unless Bank agrees otherwise in writing, Eligible Accounts will not include:

(a) Accounts that the account debtor has not paid within 90 days of invoice date;

(b) Accounts for an account debtor, 50% or more of whose Accounts have not been paid within 90 days of invoice date;

(c) Credit balances over 90 days from invoice date;

(d) Accounts for an account debtor, including Affiliates, whose total obligations to Borrower exceed 25% of all Accounts, for the amounts that exceed that percentage, unless the Bank approves otherwise in writing;

(e) Accounts for which the account debtor does not have its principal place of business in the United States;

(f) Accounts for which the account debtor is a federal, state or local government entity or any department, agency, or instrumentality;

(g) Accounts for which Borrower owes the account debtor, but only up to the amount owed (sometimes called "contra" accounts, accounts payable, customer deposits or credit accounts);

(h) Accounts for demonstration or promotional equipment, or in which goods are consigned, sales guaranteed, sale or return, sale on approval, bill and hold, or other terms if account debtor's payment may be conditional;

(i) Accounts for which the account debtor is Borrower's Affiliate, officer, employee, or agent;

(j) Accounts in which the account debtor disputes liability or makes any claim and Bank reasonably believes there may be a basis for dispute (but only up to the disputed or claimed amount), or if the Account Debtor is subject to an Insolvency Proceeding, or becomes insolvent, or goes out of business; and

(k) Accounts for which Bank reasonably determines collection to be doubtful.

"**Eligible Foreign Accounts**" are Accounts for which the account debtor does not have its principal place of business in the United States but which are otherwise Eligible Accounts. It is understood that Eligible Foreign Accounts must meet all of the conditions set forth in the definition of Eligible Accounts, except for the exclusion set forth in subsection (e) therein.

"**Equipment**" is all present and future machinery, equipment, tenant improvements, furniture, fixtures, vehicles, tools, parts and attachments in which Borrower has any interest.

"**Equipment Advance**" is defined in Section 2.1.6.

"**Equipment Availability End Date**" is defined in Section 2.1.6.

"**Equipment Advance(s)**" is defined in Section 2.1.6.

"**ERISA**" is the Employment Retirement Income Security Act of 1974, and its regulations.

"**Formula Advance**" or "**Formula Advances**" is a loan advance (or advances) under the Committed Formula Revolving Line.

"**Formula Line Availability**" means, as of any date of determination, the amount that Borrower is entitled to borrow as Advances under Section 2.1.1 (a) (after giving effect to all then outstanding Advances and all sublimit reserves applicable thereunder) but such amount can never exceed $8,000,000.

"**FX Forward Contract**" is defined in Section 2.1.4.

"**FX Reserve** " is defined in Section 2.1.4.

"**GAAP**" is generally accepted accounting principles.

"**Guarantor**" is any present or future guarantor of the Obligations.

"**Hardware Equipment**" is defined in Section 2.1.6.

"**Indebtedness**" is (a) indebtedness for borrowed money or the deferred price of property or services, such as reimbursement and other obligations for surety bonds and letters of credit, (b) obligations evidenced by notes, bonds, debentures or similar instruments, (c) capital lease obligations and (d) Contingent Obligations.

"**Insolvency Proceeding**" are proceedings by or against any Person under the United States Bankruptcy Code, or any other bankruptcy or insolvency law, including assignments for the benefit of creditors, compositions, extensions generally with its creditors, or proceedings seeking reorganization, arrangement, or other relief.

"**Intellectual Property**" is:

(a) Copyrights, Trademarks, Patents, and Mask Works including amendments, renewals, extensions, and all licenses or other rights to use and all license fees and royalties from the use;

(b) Any trade secrets and any intellectual property rights in computer software and computer software products now or later existing, created, acquired or held;

(c) All design rights which may be available to Borrower now or later created, acquired or held;

(d) Any claims for damages (past, present or future) for infringement of any of the rights above, with the right, but not the obligation, to sue and collect damages for use or infringement of the intellectual property rights above;

All proceeds and products of the foregoing, including all insurance, indemnity or warranty payments.

"**Inventory**" is present and future inventory in which Borrower has any interest, including merchandise, raw materials, parts, supplies, packing and shipping materials, work in process and finished products intended for sale or lease or to be furnished under a contract of service, of every kind and description now or later owned by or in the custody or possession, actual or constructive, of Borrower, including inventory temporarily out of its custody or possession or in transit and including returns on any accounts or other proceeds (including insurance proceeds) from the sale or disposition of any of the foregoing and any documents of title.

"**Investment**" is any beneficial ownership of (including stock, partnership interest or other securities) any Person, or any loan, advance or capital contribution to any Person.

"**L/C Reserve**" is defined in Section 2.1.1.

"**Letter of Credit**" is defined in Section 2.1.3.

"**Lien**" is a mortgage, lien, deed of trust, charge, pledge, security interest or other encumbrance.

"**Loan Documents**" are, collectively, this Agreement, any note, or notes or guaranties executed by Borrower or Guarantor, and any other present or future agreement between Borrower and/or for the benefit of Bank in connection with this Agreement, all as amended, extended or restated.

"**Mask Works**" are all mask works or similar rights available for the protection of semiconductor chips, now owned or later acquired.

"**Material Adverse Change**" is defined in Section 8.3.

"**Non-Formula Advance**" or "**Non-Formula Advances**" is a loan advance (or advances) under the Committed Non-Formula Revolving Line.

"**Obligations**" are debts, principal, interest, Bank Expenses and other amounts Borrower owes Bank now or later, including cash management services, letters of credit and foreign exchange contracts, if any and including interest accruing after Insolvency Proceedings begin and debts, liabilities, or obligations of Borrower assigned to Bank.

"**Patents**" are patents, patent applications and like protections, including improvements, divisions, continuations, renewals, reissues, extensions and continuations-in-part of the same.

"**Permitted Indebtedness**" is:

(a) Borrower's indebtedness to Bank under this Agreement or any other Loan Document;

(b) Indebtedness existing on the Closing Date and shown on the Disclosure Letter;

(c) Subordinated Debt including, but not limited to Subordinated Debt associated with Borrower's future investment of up to $3,666,900 in Tower Semiconductor;

(d) Indebtedness to trade creditors incurred in the ordinary course of business;

(e) Indebtedness secured by Permitted Liens;

(f) Indebtedness of Borrower to any Subsidiary and Contingent Obligations of any Subsidiary with respect to obligations of Borrower (provided that the primary obligations are not prohibited hereby), and Indebtedness of any Subsidiary to any other Subsidiary and Contingent Obligations of any Subsidiary with respect to obligations of any other Subsidiary (provided that the primary obligations are not prohibited hereby);

(g) Other Indebtedness not otherwise permitted by Section 7.4 not exceeding $250,000 in the aggregate outstanding at any time; and

(h) Extensions, refinancings, modifications, amendments and restatements of any items of Permitted Indebtedness (a) through (f) above, provided that the principal amount thereof is not increased or the terms thereof are not modified to impose more burdensome terms upon Borrower or its Subsidiary, as the case may be.

"Permitted Investments" are:

(a) Investments shown on the Disclosure Letter and existing on the Closing Date; and

(b) (i) marketable direct obligations issued or unconditionally guaranteed by the United States or its agency or any State maturing within 1 year from its acquisition, (ii) commercial paper maturing no more than 1 year after its creation and having the highest

rating from either Standard & Poor's Corporation or Moody's Investors Service, Inc., and (iii) Bank's certificates of deposit issued maturing no more than 1 year after issue.

(c) Investments consisting of the endorsement of negotiable instruments for deposit or collection or similar transactions in the ordinary course of Borrower;

(d) Investments accepted in connection with Transfers permitted by Section 7.1, 7.3 and 7.6;

(e) Investments by Borrower in Subsidiaries in the form of: (A) capital stock of Subsidiaries not to exceed $500,000 in the aggregate in any fiscal year and (B) all other advancements, so long as any such investment is made for the purpose of funding operational requirements of the relevant Subsidiary and so long as no Subsidiary maintains cash and cash equivalents at any time in excess of: (i) $250,000 for Quicklogic India; (ii) $750,000 for Quicklogic Canada; and (iii) $75,000 for each subsidiary other than Quicklogic India and Quicklogic Canada. In the event that any Subsidiary does maintain cash and cash equivalents in excess of the aforementioned limitation, any transfer of cash by Borrower to any Subsidiary shall not be permitted under the terms of this Agreement.

(f) Investments consisting of (i) travel advances and employee relocation loans and other employee loans and advances in the ordinary course of business, and (ii) loans to employees, officers or directors relating to the purchase of equity securities of Borrower or its Subsidiaries pursuant to employee stock purchase plans or agreements approved by Borrower's Board of Directors;

(g) Investments (including debt obligations) received in connection with the bankruptcy or reorganization of customers or suppliers and in settlement of delinquent obligations of, and other disputes with, customers or suppliers arising in the ordinary course of business;

(h) Investments consisting of notes receivable of, or prepaid royalties and other credit extensions, to customers and suppliers who are not Affiliates, in the ordinary course of business; provided that this paragraph (h) shall not apply to Investments of Borrower in any Subsidiary;

(i) Investments made pursuant to Borrower's Investment Policy, dated as of and attached herein as Exhibit E.

(j) Joint ventures or strategic alliances in the ordinary course of Borrower's business consisting of the non-exclusive licensing of technology, the development of technology or the providing of technical support, provided that any cash investments by Borrower do not exceed $250,000 in the aggregate in any fiscal year; and

(k) Investments in Tower Semiconductor (Israel) of $3,666,900 in October of 2002 and of $3,666,900 on or after May 2003.

"Permitted Liens" are:

(a) Liens existing on the Closing Date and shown on the Disclosure Letter or arising under this Agreement or other Loan Documents;

(b) Liens for taxes, fees, assessments or other government charges or levies, either not delinquent or being contested in good faith and for which Borrower maintains adequate reserves on its Books, if they have no priority over any of Bank's security interests;

(c) Purchase money Liens (i) on Equipment or Software acquired or held by Borrower or its Subsidiaries incurred for financing the acquisition of the Equipment, or (ii) existing on equipment when acquired, if the Lien is confined to the property, attachments and improvements and the proceeds of the equipment;

(d) Licenses or sublicenses granted in the ordinary course of Borrower's business and any interest or title of a licensor or under any license or sublicense, if the licenses and sublicenses permit granting Bank a security interest;

(e) Leases or subleases granted in the ordinary course of Borrower's business, including in connection with Borrower's leased premises or leased property;

(f) Liens incurred in the extension, renewal or refinancing of the indebtedness secured by Liens described in (a) through (c), but any extension, renewal or replacement Lien must be limited to the property encumbered by the existing Lien and the principal amount of the indebtedness may not increase;

(g) Liens arising from judgments, decrees or attachments in circumstances not constituting an Event of Default under Section 8.4 or 8.7;

(h) Liens approved by Bank in writing, granted to lenders to secure Permitted Indebtedness;

(i) Liens in favor of other financial institutions arising in connection with Borrower's deposit accounts held at such institutions, provided that Bank has a perfected security interest in the amounts held in such deposit accounts; and

(j) Other Liens not described above arising in the ordinary course of business and not having or not reasonably likely to have a material adverse effect on Borrower and its Subsidiaries taken as a whole.

"**Person**" is any individual, sole proprietorship, partnership, limited liability company, joint venture, company association, trust, unincorporated organization, association, corporation, institution, public benefit corporation, firm, joint stock company, estate, entity or government agency.

"**Prime Rate**" is Bank's most recently announced "prime rate," even if it is not Bank's lowest rate but for purposes of this Agreement the Prime Rate will never be less than 4.25%.

"**Quick Assets**" is, on any date, the Borrower's consolidated, unrestricted and cash equivalents, net billed accounts receivable and investments with maturities of fewer than 12 months determined according to GAAP.

"**Quicklogic Canada**" means QuickLogic Canada Company.

"**Quicklogic India**" means QuickLogic (India) Private Limited.

"**Responsible Officer**" is each of the Chief Executive Officer, the President, the Chief Financial Officer, the Controller and the in-house general counsel of Borrower.

"**Revolving Maturity Date**" is June 28, 2004.

"Revolving Obligations" is the sum of : (i) any amounts deemed outstanding under the Cash Management Services Sublimit, plus (ii) the amount of all outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit), plus (iii) the FX Reserve, plus (iv) outstanding Advances.

"**Subordinated Debt**" is debt incurred by Borrower subordinated to Borrower's indebtedness owed to Bank and which is reflected in a written agreement in a manner and form reasonably acceptable to Bank and approved by Bank in writing.

"**Subsidiary**" is for any Person, or any other business entity of which more than 50% of the voting stock or other equity interests is owned or controlled, directly or indirectly, by the Person or one or more Affiliates of the Person.

"**Tangible Net Worth**" is, on any date, the consolidated total assets of Borrower and its Subsidiaries minus, (i) any amounts attributable to (a) goodwill, (b) intangible items such as unamortized debt discount and expense, Patents, trade and service marks and names, and Copyrights, (ii) Total Liabilities; plus realized or unrealized write downs relating to Borrower's investment in Tower Semiconductor that are charged on or after January 1, 2003.

"Term Loan A" is defined in Section 2.1.7.

"Term Loan B" is defined in Section 2.1.8.

"Term Loan C" is defined in Section 2.1.9.

"Term Loan D" is defined in Section 2.1.10.

"Term Loan A Maturity Date" is September 1, 2005.

"Term Loan B Maturity Date" is March 1, 2005.

"Term Loan C Maturity Date" is December 31, 2005.

"Term Loan D Maturity Date" is June 1, 2005.

"**Total Liabilities**" is on any day, obligations that should, under GAAP, be classified as liabilities on Borrower's consolidated balance sheet, including all Indebtedness, and current portion Subordinated Debt allowed to be paid, but excluding all other Subordinated Debt.

"**Trademarks**" are trademark and service mark rights, registered or not, applications to register and registrations and like protections, and the entire goodwill of the business of Assignor connected with the trademarks.

BORROWER:

QUICKLOGIC CORPORATION

By: /s/ Carl M. Mills
Title: VP FINANCE & CFO

BANK:

SILICON VALLEY BANK

By: /s/ Amy L. Drake
Title: Vice President

EXHIBIT A

The Collateral consists of all of Borrower's right, title and interest in and to the following:

All goods and equipment now owned or hereafter acquired, including, without limitation, all machinery, fixtures, vehicles (including motor vehicles and trailers), and any interest in any of the foregoing, and all attachments, accessories, accessions, replacements, substitutions, additions, and improvements to any of the foregoing, wherever located;

All inventory, now owned or hereafter acquired, including, without limitation, all merchandise, raw materials, parts, supplies, packing and shipping materials, work in process and finished products including such inventory as is held for sale or lease, or to be furnished under a contract of service or is temporarily out of Borrower's custody or possession or in transit and including any returns or repossession upon any accounts or other proceeds, including insurance proceeds, resulting from the sale or disposition of any of the foregoing and any documents of title representing any of the above;

All contract rights and general intangibles now owned or hereafter acquired, including, without limitation, goodwill, trademarks, service marks, trade styles, trade names, patents, patent applications, leases, license agreements, franchise agreements, blueprints, drawings, purchase orders, customer lists, route lists, infringements, claims, computer programs, computer discs, computer tapes, literature, reports, catalogs, design rights, income tax refunds, payments of insurance, payment intangibles, and rights to payment of any kind;

All now existing and hereafter arising accounts (including health-care insurance receivables), contract rights, royalties, license rights and all other forms of obligations owing to Borrower arising out of the sale or lease of goods, the licensing of technology or the rendering of services by Borrower, whether or not earned by performance, and any and all credit insurance, guaranties, and other security therefor, as well as all merchandise returned to or reclaimed by Borrower;

All documents (including negotiable documents), cash, deposit accounts, securities, securities entitlements, securities accounts, investment property, financial assets, letters of credit, letter of credit rights, money, certificates of deposit, instruments (including promissory notes) and chattel paper (including tangible and electronic chattel paper) now owned or hereafter acquired and Borrower's Books relating to the foregoing;

All copyright rights, copyright applications, copyright registrations and like protections in each work of authorship and derivative work thereof, whether published or unpublished, now owned or hereafter acquired; all trade secret rights, including all rights to unpatented inventions, know-how, operating manuals, license rights and agreements and confidential information, now owned or hereafter acquired; all claims for damages by way of any past, present and future infringement of any of the foregoing; and

All Borrower's Books relating to the foregoing, and the computers and equipment containing said books and records, and any and all claims, rights and interests in any of the above and all substitutions for, additions and accessions to and proceeds thereof.

Notwithstanding the foregoing, the collateral does not include any license or contract rights to the extent (i) the granting of a security interest in it would be contrary to applicable law, or (ii) that such rights are

nonassignable by their terms (but only to the extent such prohibition is enforceable under applicable law) without the consent of the licensor or other party (but only to the extent such consent has not been obtained).

EXHIBIT B

LOAN PAYMENT/ADVANCE TELEPHONE REQUEST FORM

DEADLINE FOR PROCESSING IS 12 NOON, P.S.T.

TO: CENTRAL CLIENT SERVICE DIVISION DATE: __________

FAX #: (408) 496-2426 TIME: __________

FROM: QuickLogic Corporation
CLIENT NAME (BORROWER)

REQUESTED BY: ______________________________

AUTHORIZED SIGNER'S NAME

AUTHORIZED SIGNATURE: ______________________________

PHONE NUMBER: ______________________________

FROM ACCOUNT # ______________ TO ACCOUNT # ______________

REQUESTED TRANSACTION TYPE	REQUESTED DOLLAR AMOUNT
PRINCIPAL INCREASE (ADVANCE)	$
PRINCIPAL PAYMENT (ONLY)	$
INTEREST PAYMENT (ONLY)	$
PRINCIPAL AND INTEREST (PAYMENT)	$

OTHER INSTRUCTIONS:

All Borrower's representations and warranties in the Loan and Security Agreement are true, correct and complete in all material respects on the date of the telephone request for and Advance confirmed by this Borrowing Certificate; but those representations and warranties expressly referring to another date shall be true, correct and complete in all material respects as of that date.

BANK USE ONLY

TELEPHONE REQUEST:

The following person is authorized to request the loan payment transfer/loan advance on the advance designated account and is known to me.

Authorized Requester | Phone #

Received By (Bank) | Phone #

Authorized Signature (Bank)

EXHIBIT C

COMPLIANCE CERTIFICATE

TO: SILICON VALLEY BANK
3003 Tasman Drive
Santa Clara, CA 95054

FROM: QUICKLOGIC CORPORATION
1227 Orleans Drive
Sunnyvale, CA 94089-1138

The undersigned authorized officer of QuickLogic Corporation ("Borrower") certifies that under the terms and conditions of the Loan and Security Agreement between Borrower and Bank (the "Agreement"), (i) Borrower is in complete compliance for the period ending with all required covenants except as noted below and (ii) all representations and warranties in the Agreement are true and correct in all material respects on this date, except for representations and warranties made as of a specific earlier date, which are to be true and correct in all material respects as of such earlier date. Attached are the required documents supporting the certification. The Officer certifies that these are prepared in accordance with Generally Accepted Accounting Principles (GAAP) consistently applied from one period to the next except as explained in an accompanying letter, footnotes or year end adjustments. The Officer acknowledges that no borrowings may be requested at any time or date of determination that Borrower is not in compliance with any of the terms of the Agreement, and that compliance is determined not just at the date this certificate is delivered.

Please indicate compliance status by circling Yes/No under "Complies" column .

Reporting and Financial Covenants	Required	Complies

Monthly financial statements + CC	Monthly within 45 days	Yes	No
Annual (Audited)	Annual within 120 of FYE	Yes	No
Board Approved Projections	Prior to December 20th	Yes	No
Accounts Payable and Accounts Receivable Listings	Within 30 days of the end of each month	Yes	No
10-Q, 10-K and 8-K	Within 5 days after filing with SEC	Yes	No
Minimum Tangible Net Worth	Monthly; $33,000,000	Yes	No
Quick Ratio (Adjusted)	1.40 to 1.00	Yes	No

Have there been updates to Borrower's intellectual property, if appropriate? Yes No

Comments Regarding Exceptions: See Attached.

Sincerely,

QuickLogic Corporation

SIGNATURE

TITLE

DATE

BANK USE ONLY

Received by: ______________________
AUTHORIZED SIGNER

Date: ______________________

Verified: ______________________
AUTHORIZED SIGNER

Date: ______________________

Compliance Status: Yes No

EXHIBIT D

BORROWING BASE CERTIFICATE

Borrower: **Quicklogic Corporation**
1227 Orleans Drive
Sunnyvale, CA 94089-1138

Bank: Silicon Valley Bank
3003 Tasman Drive
Santa Clara, CA 95054

Commitment Amount: $8,000,000

ACCOUNTS RECEIVABLE			
1.	Accounts Receivable Book Value as of		$
2.	Additions (please explain on reverse)		$
3.	TOTAL ACCOUNTS RECEIVABLE		$
ACCOUNTS RECEIVABLE DEDUCTIONS (without duplication)			
4.	Amounts over 90 days from invoice date	$	
5.	Balance of 50% over 90 day accounts	$	
6.	Credit balances over 90 days	$	
7.	Concentration Limits	$	
8.	Foreign Accounts	$	
9.	Governmental Accounts	$	
10.	Contra Accounts	$	
11.	Promotion or Demo Accounts	$	
12.	Intercompany/Employee Accounts	$	
13.	Other (please explain on reverse)	$	
14.	TOTAL ACCOUNTS RECEIVABLE DEDUCTIONS		$
15.	Eligible Accounts (#3 minus #14)	$	
16.	**AVAILABILITY/LOAN VALUE OF DOMESTIC ACCOUNTS (80% of #15)**		**$**
FOREIGN ACCOUNTS RECEIVABLE			
17.	Foreign Accounts Receivable Book Value as of	$	
18.	Additions (please explain on reverse)	$	
19.	TOTAL FOREIGN ACCOUNTS RECEIVABLE		$
FOREIGN ACCOUNTS RECEIVABLE DEDUCTIONS (without duplication)			
20.	Amounts over 90 days from invoice date	$	
21.	Balance of 50% over 90 day accounts	$	

22.	Credit Balances over 90 days	$	
23.	Concentration Limits	$	
24.	Governmental Accounts	$	
25.	Contra Accounts	$	
26.	Promotion or Demo Accounts	$	
27.	Intercompany/Employee Accounts	$	
28.	Other (please explain on reverse)	$	
29.	TOTAL FOREIGN ACCOUNTS RECEIVABLE DEDUCTIONS		$
30.	Eligible Foreign Accounts (#19 minus #29)	$	
31.	Loan Value of Foreign Accounts (50% of #30)	$	
32.	Maximum Availability (Loan Value) based on Foreign Accounts (1.5 times #16)	$	
33.	**AVAILABILITY/LOAN VALUE OF FOREIGN ACCOUNTS (Lesser of Line #31 or Line #32)**		**$**

BALANCES under Formula Revolving Line			
34.	Commitment Amount of Formula Revolving Line	$ 8,000,000	
35.	Combined Availability/Loan Value of Eligible Domestic and Foreign Accounts (#16 plus #33)	$	
36.	Availability (Enter the Lesser of #34 or #35)	$	
37.	Present Balance Owing on Formula Revolving Line	$	
38.	Outstanding under Sublimits (Cash Mgmt., FX, LCs)	$	
39.	**Net Availability under Formula Revolving Line “Reserve Position” (#36 minus #37 and #38)**		**$**
BALANCES under Non-Formula Revolving Line			
40.	Maximum Non-Formula Advance Amount Available [Lesser of $5,000,000 or ($8,000,000 minus #36)]	$	
41.	Present Balance Owing on Non-Formula Revolving Line	$	
42.	**Net Availability under Non-Formula Revolving Line (#40 minus #41)**		**$**
SUMMARY			
43.	Maximum Commitment Amount	$ 8,000,000	
44.	Present Balance Owing on Formula Revolving Line (#37)	$	
45.	Present Outstanding under Sublimits (#38)	$	
46.	Present Balance Owing on Non-Formula Line (#41)	$	
47.	Total Present Outstanding (#44 plus #45 plus #46)		$
48.	Net Availability under Formula Revolving Line (#39)	$	
49.	Net Availability under Non-Formula Revolving Line (#42)	$	
50.	**Total Funds Available (#48 plus #49) or Over-advanced (if negative)**		**$**

The undersigned represents and warrants that this is true, complete and correct, and that the information in this Borrowing Base Certificate complies with the representations and warranties in the Loan and Security Agreement between the undersigned and Silicon Valley Bank.

Comments

QUICKLOGIC CORPORATION

By: ______________________________
AUTHORIZED SIGNER

BANK USE ONLY

Received by: ______________________________
AUTHORIZED SIGNER

Date: ______________________________

Verified: ______________________________
AUTHORIZED SIGNER

Date: ______________________________

CORPORATE BORROWING RESOLUTION

Borrower: **QuickLogic Corporation**
1227 Orleans Drive

Bank: **Silicon Valley Bank**
3003 Tasman Drive

Sunnyvale, CA 94089-1138 **Santa Clara, CA 95054-1191**

I, the Secretary or Assistant Secretary of QuickLogic Corporation ("Borrower"), CERTIFY that Borrower is a corporation existing under the laws of the State of Delaware.

I certify that at a meeting of Borrower's Directors (or by other authorized corporate action) duly held the following resolutions were adopted.

It is resolved that **any one** of the following officers of Borrower, whose name, title and signature is below:

NAMES	POSITIONS	ACTUAL SIGNATURES

may act for Borrower and:

Borrow Money. Borrow money from Silicon Valley Bank ("Bank").

Execute Loan Documents. Execute any loan documents Bank requires.

Grant Security. Grant Bank a security interest in any of Borrower's assets.

Negotiate Items. Negotiate or discount all drafts, trade acceptances, promissory notes, or other indebtedness in which Borrower has an interest and receive cash or otherwise use the proceeds.

Letters of Credit. Apply for letters of credit from Bank.

Foreign Exchange Contracts. Execute spot or forward foreign exchange contracts.

Further Acts. Designate other individuals to request advances, pay fees and costs and execute other documents or agreements (including documents or agreement that waive Borrowers right to a jury trial) they think necessary to effectuate these Resolutions.

Further resolved that all acts authorized by these Resolutions and performed before they were adopted are ratified. These Resolutions remain in effect and Bank may rely on them until Bank receives written notice of their revocation.

I certify that the persons listed above are Borrower's officers with the titles and signatures shown following their names and that these resolutions have not been modified are currently effective.

CERTIFIED TO AND ATTESTED BY:

X ______________________________
*Secretary or Assistant Secretary

X ______________________________
*NOTE: In case the Secretary or other certifying officer is designated by the foregoing resolutions as one of the signing officers, this resolution should also be signed by a second Officer or Director of Borrower.

EXHIBIT 99.1

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, E. Thomas Hart, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of QuickLogic Corporation on Form 10-Q for the fiscal quarter ended June 30, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of QuickLogic Corporation.

By:	/s/ E. Thomas Hart
Date:	August 12, 2003
Name:	E. Thomas Hart
Title:	Chairman, President, and Chief Executive Officer

I, Carl M. Mills, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of QuickLogic Corporation on Form 10-Q for the fiscal quarter ended June 30, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of QuickLogic Corporation.

By:	/s/ Carl M. Mills
Date:	August 12, 2003
Name:	Carl M. Mills
Title:	Chief Financial Officer