
**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 July 2, 2006

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

(State or other jurisdiction of
incorporation or organization)

77-0188504

(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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes No

As of December 14, 2006, 28,679,626 shares of the registrant's common stock were outstanding.

**QUICKLOGIC CORPORATION
FORM 10-Q
JUNE 30, 2006**

Page

Part I. Financial Information

3

Item 1. Financial Statements

3

Condensed Unaudited Consolidated Statements of Operations for the three and six months ended June 30, 2006 and 2005

3

Condensed Unaudited Consolidated Balance Sheets as of June 30, 2006 and December 31, 2005

4

Condensed Unaudited Consolidated Statements of Cash Flows for the six months ended June 30, 2006 and 2005	5
Condensed Unaudited Consolidated Statements of Comprehensive Income (Loss) for the three and six months ended June 30, 2006 and 2005	6
Notes to Condensed Unaudited Consolidated Financial Statements	7
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	28
Item 3. Quantitative and Qualitative Disclosures about Market Risk	41
Item 4. Controls and Procedures	42
Part II. Other Information	43
Item 1. Legal Proceedings	43
Item 1A. Risk Factors	44
Item 4. Submission of Matters to a Vote of Security Holders	57
Item 6. Exhibits	58
Signatures	59

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.	
	2006	2005	2006	2005
Revenue	\$ 9,249	\$ 12,770	\$ 18,582	\$ 25,297
Cost of revenue	4,221	4,614	7,981	9,502
Gross profit	5,028	8,156	10,601	15,795
Operating expenses:				
Research and development	2,357	2,334	4,757	4,788
Selling, general and administrative	4,594	4,042	9,211	8,340
Income (loss) from operations	(1,923)	1,780	(3,367)	2,667
Write-down of marketable securities	—	(1,466)	—	(1,466)
Interest expense	(96)	(53)	(170)	(106)
Interest income and other, net	341	90	633	170
Income (loss) before income taxes	(1,678)	351	(2,904)	1,265
Provision for income taxes	21	31	23	81
Net income (loss)	\$ (1,699)	\$ 320	\$ (2,927)	\$ 1,184
Net income (loss) per share:				
Basic	\$ (0.06)	\$ 0.01	\$ (0.10)	\$ 0.04
Diluted	\$ (0.06)	\$ 0.01	\$ (0.10)	\$ 0.04
Weighted average shares:				
Basic	28,519	26,747	28,290	26,566
Diluted	28,519	27,921	28,290	27,678

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements.

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

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 30,173	\$ 28,283
Short-term investment in Tower Semiconductor Ltd.	1,252	1,297
Accounts receivable, net of allowances for doubtful accounts of \$669 and \$1,042, respectively	4,475	5,556
Inventory	7,433	7,830
Other current assets	1,206	1,265
Total current assets	<u>44,539</u>	<u>44,231</u>
Property and equipment, net	6,019	5,697
Investment in Tower Semiconductor Ltd.	630	653
Other assets	4,385	4,415
TOTAL ASSETS	<u>\$ 55,573</u>	<u>\$ 54,996</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade payables	\$ 3,806	\$ 3,338
Accrued liabilities	2,686	3,434
Deferred income on shipments to distributors	1,498	1,626
Current portion of debt and capital lease obligations	1,970	1,790
Total current liabilities	<u>9,960</u>	<u>10,188</u>
Long-term liabilities:		
Debt and capital lease obligations, less current portion	1,488	1,163
Deferred royalty revenue	1,502	1,408
Total long-term liabilities	<u>2,990</u>	<u>2,571</u>
Total liabilities	<u>12,950</u>	<u>12,759</u>
Commitments and contingencies (see Notes 15 and 16)		
Stockholders' equity:		
Common stock, \$0.001 par value; 100,000 shares authorized; 28,668 and 27,896 shares issued and outstanding, respectively	29	28
Additional paid-in capital	163,523	159,179
Accumulated other comprehensive income	309	377
Accumulated deficit	(121,238)	(117,347)
Total stockholders' equity	<u>42,623</u>	<u>42,237</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 55,573</u>	<u>\$ 54,996</u>

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,	
	2006	2005
Cash flows from operating activities:		
Net income (loss)	\$ (2,927)	\$ 1,184
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,491	1,359
Loss on disposal of property and equipment	—	7
Stock-based compensation	855	—
Utilization of wafer credits from Tower Semiconductor Ltd.	56	215
Inventory write-down	470	205
Write-down of marketable securities	—	1,466
Changes in assets and liabilities:		

Accounts receivable, net of allowances for doubtful accounts	1,081	(1,716)
Inventory	(73)	(2,051)
Other assets	191	452
Trade payables	468	(824)
Accrued liabilities	(748)	(490)
Deferred income and royalty revenue	(34)	465
Net cash provided by operating activities	<u>830</u>	<u>272</u>
Cash flows from investing activities:		
Capital expenditures for property and equipment	(1,180)	(682)
Net cash used for investing activities	<u>(1,180)</u>	<u>(682)</u>
Cash flows from financing activities:		
Payment of debt and capital lease obligations	(1,218)	(1,370)
Proceeds from debt obligations	932	550
Proceeds from issuance of common stock	2,526	1,424
Net cash provided by financing activities	<u>2,240</u>	<u>604</u>
Net increase in cash and cash equivalents	1,890	194
Cash and cash equivalents at beginning of period	28,283	24,914
Cash and cash equivalents at end of period	<u>\$ 30,173</u>	<u>\$ 25,108</u>
Supplemental disclosures of cash flow information:		
Interest paid	\$ 126	\$ 115
Income taxes paid	\$ 11	\$ 24
Supplemental schedule of non-cash investing and financing activities:		
Capital lease obligation to finance capital expenditures and related maintenance	\$ 791	\$ —

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements.

5

QUICKLOGIC CORPORATION
CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income (loss)	\$ (1,699)	\$ 320	\$ (2,927)	\$ 1,184
Other comprehensive gain (loss), net of tax:				
Unrealized gain (loss) on investments	161	592	(68)	—
Total comprehensive income (loss)	<u>\$ (1,538)</u>	<u>\$ 912</u>	<u>\$ (2,995)</u>	<u>\$ 1,184</u>

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements.

6

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 1—The Company and Basis of Presentation

QuickLogic Corporation (“QuickLogic” or the “Company”), founded in 1988, is a Delaware corporation. The Company operates in a single reportable industry segment where it designs, develops, markets and supports advanced field programmable gate arrays (“FPGAs”), Embedded Standard Products (“ESPs”), associated solutions, software tools and programming hardware.

The accompanying interim consolidated financial statements are unaudited. In the opinion of management, these statements have been prepared in accordance with generally accepted accounting principles (“GAAP”) and include all adjustments, consisting only of normal recurring adjustments, necessary to provide a fair statement of results for the interim periods presented. The Company recommends that these consolidated financial statements be read in conjunction with the Company’s Form 10-K for the year ended December 31, 2005 and Form 10-Q for the first fiscal quarter ended March 31, 2006. Operating results for the three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the full year.

QuickLogic's fiscal year ends on the Sunday closest to December 31. QuickLogic's fiscal second quarters for 2006 and 2005 ended Sunday, July 2, 2006 and July 3, 2005, respectively. For presentation purposes, the consolidated financial statements and notes have been presented as ending on the last day of the nearest calendar month.

Cumulative effect adjustment upon the adoption of Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB No. 108")

Under the direction of the Audit Committee of the Board of Directors, the Company voluntarily conducted an internal review of the Company's historical stock option granting practices and related accounting for the period from October 15, 1999, the date of its initial public offering, through July 28, 2006. The review was initiated by the Audit Committee in response to media attention about stock option practices at other companies. The Company did not find any systematic or pervasive practices to account for stock options in a manner inconsistent with GAAP or the Company's stated policies and procedures. However, based on the results of the review and the Company's analysis of the facts, the Company determined that there were certain errors committed in the process of documenting grants and accounting for stock options associated with measurement dates, grants prior to meeting the definition of an employee under GAAP, non-employee grants, modification of options and previously reported deferred stock compensation charges. A total pre-tax stock-based compensation charge of \$964,000 is associated with these identified errors that should have been reported in previously issued consolidated financial statements had they been identified in the proper period. After considering all of the quantitative and qualitative factors in accordance with Staff Accounting Bulletin No. 99, "Materiality," the Company determined that these adjustments were not material to any prior year and, thus, the Company has not restated its consolidated financial statements for prior periods. However, given that the effect of correcting these errors in 2006 would cause the 2006 consolidated financial statements to be materially misstated, the Company concluded that the cumulative effect adjustment method of initially applying the guidance of SAB No. 108 was appropriate. Accordingly, the cumulative effect of the adjustment was reflected as an increase to the carrying amount of additional paid-in capital as of January 1, 2006, with an offsetting entry to accumulated deficit. In addition, less than \$50,000 of the adjustment to previously issued consolidated financial statements was due to errors that occurred after October 2002. See Note 3 for additional information regarding the review conducted at the direction of the Audit Committee of the Board of Directors and the cumulative effect adjustment to previously issued consolidated financial statements.

Liquidity

The Company anticipates that its existing cash resources will fund operations, finance purchases of capital equipment and provide adequate working capital for the next twelve months. The Company's liquidity is affected by many factors including, among others, the level of revenue and gross profit, market acceptance of existing and new products including Eclipse™ II, QuickPCI® II and PolarPro™ devices, the decline in pASIC® 1 and pASIC 2 revenue as a result of their end-of-life, costs of securing access to and availability of adequate manufacturing capacity, inventory levels, wafer purchase commitments, customer credit terms, the amount and timing of research and development expenditures, the timing of new product introductions, production volumes, product quality, sales and marketing efforts, the amount and financing arrangements for purchases of capital equipment, changes in operating assets and liabilities, the ability to obtain or renew debt financing and to remain in compliance with the terms of existing credit facilities, the ability to raise funds from the sale of shares of Tower Semiconductor Ltd. ("Tower") and equity in the Company, the issuance and exercise of stock options, the terms of and participation in the Company's employee stock purchase plan, and other factors related to the uncertainties of the industry and global economics. Accordingly, there can be no assurance that events in the future will not require the Company to seek additional capital or, if so required, that such capital will be available on terms acceptable to the Company.

QUICKLOGIC CORPORATION

NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 Software (India) Private Ltd., and QuickLogic GmbH. The Company uses the U.S. dollar as its functional currency. All significant intercompany accounts and transactions are eliminated in consolidation.

Uses of Estimates

The preparation of these consolidated 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 disclosures of contingent assets and liabilities, and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates, particularly in relation to revenue recognition, the allowance for doubtful accounts, sales returns, valuation of investments, valuation of long-lived assets, inventory valuation including identification of excess quantities and obsolescence, measurement of stock-based compensation awards, accounting for income taxes and estimating accrued liabilities.

Note 2—Significant Accounting Policies

Revenue Recognition

The Company supplies standard products which must be programmed before they can be used in an application. The Company's products may be programmed by the Company, distributors, end customers or third parties. Once programmed, the Company's parts

cannot be erased and, therefore, programmed parts are only useful to a specific customer.

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

Revenue is recognized upon shipment of both programmed and unprogrammed parts to original equipment manufacturer (“OEM”) customers, provided that legal title and risk of ownership have transferred.

The Company also sells to distributors under agreements that allow for price adjustments and, in the case of unprogrammed parts, certain rights of return on unsold inventory.

Because programmed parts can only be used by a specific customer, it is the Company’s practice to agree upon any price adjustments with a distributor prior to shipment. Furthermore, distributors are not allowed any future price adjustments and have no rights of return on programmed parts. Accordingly, revenue is recognized upon delivery to a distributor since title and risk of ownership have transferred to the distributor, the price is fixed, no right of return exists, and collection of the resulting receivable is reasonably assured.

Unprogrammed parts shipped to distributors may be used by multiple end customers and distributors may have certain return and price adjustment privileges on unsold inventory. Accordingly, revenue associated with unprogrammed parts is deferred until resale to the end customer.

Software revenue from the sale of design tools 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 remain, the fee is fixed or determinable and collection is reasonably assured. Software revenue amounted to less than one percent of the Company’s revenue for the three and six months ended June 30, 2006 and 2005.

Long-lived Assets

The Company reviews the recoverability of its long-lived assets, such as property and equipment, prepaid wafer credits and investments, annually and when events or changes in circumstances occur that indicate that the

QUICKLOGIC CORPORATION

NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

carrying value of the asset or asset group may not be recoverable. The assessment of possible impairment is based on the Company’s ability to recover the carrying value of the asset or asset group from the expected future pretax cash flows, undiscounted and without interest charges, of the related operations. If these cash flows are less than the carrying value of the asset or asset group, an impairment loss is recognized for the difference between estimated fair value and carrying value, and the carrying value of the related assets is reduced by this difference. The measurement of impairment requires management to estimate future cash flows and the fair value of long-lived assets.

Comprehensive Income (Loss)

Comprehensive income (loss) includes all changes in equity (net assets) during a period from non-owner sources. Comprehensive income (loss) for the Company has included realized and unrealized holding gains or losses on Tower ordinary shares. See Note 5.

Stock-Based Compensation

Effective January 2, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 123 (revised 2004), “*Share-Based Payment*,” (“SFAS No. 123(R)”) which requires the measurement and recognition of expense related to the fair value of stock-based compensation awards. Accordingly, stock-based compensation is measured at the grant date and re-measured upon modification, as appropriate, based on the fair value of the award using the Black-Scholes option pricing model (“Black-Scholes”), and is recognized as expense over the requisite service period of the award. Black-Scholes requires the use of highly subjective, complex assumptions, including expected term and the price volatility of the Company’s stock. The Company elected to use the modified prospective transition method upon implementation and, therefore, has not restated its financial results for prior periods. The Company previously applied Accounting Principles Board Opinion No. 25, “*Accounting for Stock Issued to Employees*” (“APB 25”) and related interpretations and provided the required pro forma disclosures of SFAS No. 123, “*Accounting for Stock-Based Compensation*” (“SFAS No. 123”). In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (“SAB No. 107”) relating to SFAS No. 123(R). The Company has applied the provisions of SAB No. 107 in its adoption of SFAS No. 123(R). See Note 10.

Foreign Currency Transactions

All of the Company’s sales and cost of manufacturing are transacted in U.S. dollars. The Company conducts a portion of its research and development activities in Canada and India and has sales and marketing activities in various countries outside of the United States. Most of these international expenses are incurred in local currency. The functional currency of the Company’s subsidiaries is the U.S. dollar. Foreign currency transaction gains and losses are included in interest income and other, net, as they occur. The effect of foreign currency exchange rate fluctuations has not been significant to date. Operating expenses denominated in foreign currencies were

approximately 22% and 26% of total operating expenses for the six months ended June 30, 2006 and 2005, respectively. The Company incurred a majority of these foreign currency expenses in Canada. The Company has not used derivative financial instruments to hedge its exposure to fluctuations in foreign currency.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and cash equivalents and accounts receivable. Cash and cash equivalents 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.

One contract manufacturer, purchasing the Company's products for use in a telecom design for an OEM application, accounted for 22% of the Company's accounts receivable balance at June 30, 2006. In addition, one distributor of the Company's products accounted for 25% of the Company's accounts receivable balance at June 30, 2006.

QUICKLOGIC CORPORATION

NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Two distributors of the Company's products accounted for 25% and 13%, respectively, of the Company's accounts receivable balance at December 31, 2005. In addition, one OEM customer accounted for 18% of the Company's accounts receivable balance at December 31, 2005.

Warranty Costs

The Company generally warrants finished goods against defects in material and workmanship under normal use for twelve months from the date of shipment. The Company does not have significant product warranty related costs or liabilities. The one-time-programmable nature of QuickLogic's products minimizes warranty costs.

Recently Issued Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 123(R), "*Share-Based Payment*," which is a revision of SFAS No. 123 and supersedes APB 25. SFAS No. 123(R) requires all share-based payments ("SBPs") to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the requisite service period. Under SFAS No. 123(R), pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R), as amended, is effective for all stock-based awards granted in fiscal years beginning after June 15, 2005. In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123. Effective January 2, 2006, the first day of fiscal 2006, the Company adopted SFAS No. 123(R) on a modified prospective basis. As a result, the Company began to include stock-based compensation charges in its results of operations beginning in the quarter ended March 31, 2006. See Note 10.

In November 2005, the FASB issued Staff Position ("FSP") FAS123(R)-3, "*Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards*." This FSP requires an entity to follow either the transition guidance for the additional-paid-in capital pool as prescribed in SFAS No. 123(R), or the alternative transition method as described in the FSP. An entity that adopts SFAS No. 123(R) using the modified prospective application may make a one-time election to adopt the transition method described in this FSP. An entity may take up to one year from the later of its initial adoption of SFAS No. 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. The Company continues to evaluate the impact that the adoption of this FSP could have on its consolidated financial statements.

On March 29, 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 107, which provides guidance on the interaction between SFAS No. 123(R), "*Shared-Based Payment*," and certain SEC rules and regulations. SAB No. 107 provides guidance that may simplify some of the SFAS No. 123(R) implementation challenges and enhances the information that investors receive. Effective January 2, 2006, the first day of fiscal 2006, the Company adopted SFAS No. 123(R) on a modified prospective basis and applied the principles of SAB No. 107 in conjunction with the adoption of SFAS No. 123(R).

In June 2006, the FASB issued FASB interpretation No. 48 (FIN No. 48) "*Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*." FIN No. 48 requires that the Company recognize in the consolidated financial statements the impact of a tax position that is more likely than not to be sustained upon examination based on the technical merits of the position. The evaluation of a tax position in accordance with this interpretation is a two-step process. In the first step, recognition, the Company determines whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step addresses measurement of a tax position that meets the more-likely-than-not criteria. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be reversed in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109 is not an appropriate

substitute for the reversal of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on sufficiency of future taxable income is unchanged by this interpretation. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact FIN No. 48 will have on the Company's consolidated financial statements.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In July 2006, the FASB issued Emerging Issues Task Force ("EITF") Issue No. 06-3, "How Taxes Collected from Customers are Remitted to Governmental Authorities Should be Presented in the Income Statement (that is Gross versus Net Presentation)," ("EITF 06-3"). The adoption of EITF 06-3 did not have an impact on our consolidated financial position and results of operations. The Company's accounting policy has been to present the above mentioned taxes on a net basis, excluded from revenues.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB No. 108"). SAB No. 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. Traditionally, there have been two recognized methods for quantifying the effects of financial statement misstatements - the "rollover" method and the "iron curtain" method. The rollover method focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior period misstatements, but its use can lead to the accumulation of misstatements on the balance sheet. The iron curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. Prior to the application of the guidance in SAB No. 108, the Company used the rollover method for quantifying the materiality of financial statement misstatements.

In SAB No. 108, the SEC established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the Company's consolidated financial statements and the related financial statement disclosures. This model is commonly referred to as a "dual approach" because it requires quantification of errors under both the iron curtain and the rollover methods. SAB No. 108 permits public companies to initially apply its provisions either by (i) restating prior financial statements as if the "dual approach" had always been applied or (ii) recording the cumulative effect of initially applying the "dual approach" as an adjustment to the opening balance of the carrying values of assets and liabilities in the year of adoption with an offsetting adjustment recorded to the opening balance of retained earnings (accumulated deficit). SAB No. 108 is effective for fiscal years ending after November 15, 2006, and is encouraged in any report for an interim period in the year of adoption. The Company has elected early adoption of SAB No. 108 in relation to the results of its internal review of stock option grant practices and related accounting, and recorded the effects of applying SAB No. 108 using the cumulative effect transition method (see Note 3) in the second quarter of 2006.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements", ("SFAS No. 157"). SFAS No. 157 establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The changes to current practice resulting from the application of SFAS No. 157 relate to the definition of fair value, the methods used to measure fair value, and expanded disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the impact that SFAS No. 157 will have on the Company's consolidated financial statements.

Note 3— Cumulative Effect Adjustment under SAB No. 108

Under the direction of the Audit Committee of the Board of Directors, the Company voluntarily conducted an internal review of the Company's historical stock option granting practices and related accounting for the period from October 15, 1999, the date of its initial public offering, through July 28, 2006. The review was initiated by the Audit Committee in response to media attention about stock option practices at other companies. The internal review, conducted under the guidance of outside legal counsel and with the assistance of outside accountants, is complete and the findings of the review were presented to the Audit Committee on November 16, 2006 and December 6, 2006. The findings of the review included, among other things, the following:

- There was no systematic pattern of selecting an exercise price based on the lowest stock price over the period preceding the grant.
- There were no pervasive practices to account for stock options in a manner inconsistent with GAAP or the Company's stated policies and procedures.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

- The errors identified during the six year period covered by the review were errors committed in the process of documenting grants and accounting for stock options associated with measurement dates, grants prior to meeting the definition of an employee under GAAP, non-employee grants, modification of options and previously reported deferred stock compensation charges.

- There was no evidence that the errors were motivated by any intention to mislead investors or affect reported financial results.
- Less than \$50,000 of the identified adjustments to previously issued consolidated financial statements were due to errors that occurred after October 2002.

The Company should have recorded additional non-cash stock-based compensation expense in the cumulative pre-tax amount of approximately \$964,000 in its previously issued consolidated financial statements. This amount consists of the following:

1. From October 1999 through May 2004, the date used to determine the exercise price for certain stock option grants preceded the finalization of the approval process of those grants for accounting purposes due to administrative errors in documenting or approving the grants. The total intrinsic value (the difference between the exercise price and the price of the Company's stock on the measurement date) of these "in-the-money" grants, which should have been amortized over their vesting period in the Company's previously issued consolidated financial statements, was approximately \$787,000.
2. From October 1999 through July 2002, certain individuals were granted options prior to meeting all of the criteria of an employee under GAAP, as defined by APB 25 and related interpretations, due to errors in documenting the individuals' start of employment. The total intrinsic value of these grants, which should have been amortized over their vesting period in the Company's previously issued consolidated financial statements, was approximately \$449,000.
3. The Company found accounting errors related to non-employee option grants from January 2000 until October 2002 which resulted in total charges of \$328,000 that should have been recorded over their vesting period.
4. The Company found errors related to the modification of stock options to certain employees between March 2001 and August 2005, which resulted in \$132,000 of charges which should have been recorded. The errors were the result of unclear documentation and lapses in communication concerning employee termination agreements. Generally, these modifications were made in the context of separation agreements that permitted additional vesting and/or time to exercise options after the employee had ceased performing services.
5. In accordance with APB 25, the Company recorded deferred stock-based compensation in connection with grants of stock options to employees and directors prior to the Company's initial public offering if the fair market value of the Company's common stock determined for financial reporting purposes was greater than the fair value determined by the Board of Directors on the date of grant (commonly known as a "cheap stock" charge). As of October 15, 1999, the Company had approximately \$1.6 million of deferred stock-based compensation recorded in the stockholders' equity section of the balance sheets, which was amortized over the original vesting period of the stock options. During the review, the Company determined that the reported deferred stock-based compensation account was not properly adjusted to reflect forfeitures. If an option is forfeited, the deferred stock-based compensation balance related to unvested options should be reversed and no future expense recognized. As a result, total stock-based compensation expense was overstated by approximately \$732,000 from October 1999 to December 2003 due to this accounting error in the application of the provisions of APB 25.

Effective with the Company's second quarter of 2006 consolidated financial statements, the Company elected early adoption of SAB No. 108 (see Note 2). This accounting literature provides guidance on how to quantify the effects of prior year misstatements. At the time of the election, the Company had quantified the errors identified as a result of its stock option review and determined these errors to be individually and in the aggregate immaterial, considering all the quantitative and qualitative factors, to all fiscal years prior to fiscal 2006 under the rollover method, the method which was historically used by the Company. However, given that the effect of correcting these errors in 2006 would cause the 2006 consolidated financial statements to be materially misstated, the Company concluded that the cumulative effect adjustment method of initially applying the guidance of SAB No. 108 was appropriate.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Accordingly, the Company elected to record the effects of applying SAB No. 108 using the cumulative effect transition method, which resulted in an increase to the carrying amount of the opening balance of additional paid-in capital and an offsetting entry to accumulated deficit to correct these errors. The cumulative adjustment is not recorded in the statements of operations. The impact on the previously reported accounts as of December 31, 2005, adjusted effective January 1, 2006, is as follows (in thousands):

	December 31, 2005	SAB No. 108 cumulative effect adjustment	January 1, 2006
Additional paid-in capital	\$ 159,179	\$ 964	\$ 160,143
Accumulated deficit	(117,347)	(964)	(118,311)
Total stockholders' equity	42,237	—	42,237

The impact of the errors if they had been appropriately recorded in the Company's previously issued statements of operations is as follows (in thousands):

Fiscal Year	Net Income (Loss) (as previously reported)	Adjustment	Net Income (Loss) (as adjusted)
1999	\$ 3,161	\$ 45	\$ 3,206
2000	9,630	(233)	9,397

2001	(26,478)	(195)	(26,673)
2002	(31,287)	(148)	(31,435)
2003	(4,719)	(118)	(4,837)
2004	(8,832)	(230)	(9,062)
2005	2,350	(85)	2,265
		\$ (964)	

The tax effect of the identified adjustments is not significant since the Company has a deferred tax asset with a full valuation allowance due to the Company's net operating loss carryforwards.

Enacted in October 2004, Section 409A of the Internal Revenue Code significantly changed the rules for nonqualified deferred compensation plans. Section 409A imposes certain restrictions on stock awards that constitute deferred compensation. The Company believes that the implications of Section 409A on grants with intrinsic value that vested after December 31, 2004 and modifications made to existing grants after October 3, 2004 along with potential remedial actions is not material to the 2006 consolidated financial statements.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4—Net Income (Loss) 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 shares outstanding during the period plus 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,					
	2006			2005		
	Net Loss	Shares	Per Share Amount	Net Income	Shares	Per Share Amount
Basic	\$ (1,699)	28,519	\$ (0.06)	\$ 320	26,747	\$ 0.01
Effect of stock options	—	—	—	—	1,174	—
Diluted	\$ (1,699)	28,519	\$ (0.06)	\$ 320	27,921	\$ 0.01

	Six Months Ended June 30,					
	2006			2005		
	Net Loss	Shares	Per Share Amount	Net Income	Shares	Per Share Amount
Basic	\$ (2,927)	28,290	\$ (0.10)	\$ 1,184	26,566	\$ 0.04
Effect of stock options	—	—	—	—	1,112	—
Diluted	\$ (2,927)	28,290	\$ (0.10)	\$ 1,184	27,678	\$ 0.04

As of June 30, 2006, all vested and unvested options outstanding were not included in the calculation of diluted net loss per share, as they were considered antidilutive due to the net loss the Company experienced during the period. For the three and six months ended June 30, 2005, 4,437,000 and 4,783,000 shares, respectively, of common stock subject to outstanding options were antidilutive and, therefore, were not included in the calculation of diluted net income per share, as the per share exercise price for such options exceeded the average trading price of the Company's common stock during the respective period.

Note 5—Investment in Tower Semiconductor Ltd.

On December 12, 2000, the Company entered into several agreements with Tower, as amended, under which the Company agreed to make a strategic investment in Tower of up to \$25 million as part of Tower's plan to build and equip a new wafer fabrication facility. During 2001 and 2002, the Company paid a total of \$21.3 million to Tower to fulfill its investment requirements under the agreement. In partial consideration for the investment, the Company received 1,757,368 Tower ordinary shares with an original cost of \$16.6 million. Due to write-downs in fiscal years 2001, 2002, 2004 and 2005 as a result of "other than temporary" declines in market value, the adjusted cost of the Company's Tower ordinary shares is \$1.17 per share. The Company sold a portion of the Tower ordinary shares in fiscal 2003.

As of June 30, 2006, the Company held 1,344,543 available for sale Tower ordinary shares with an unrealized gain of \$309,000 recorded in accumulated other comprehensive income in the balance sheet, representing the difference between the adjusted cost per share and \$1.40 per share, their market value on the last trading day of the reporting period. The Company plans to continue to hold 450,000 of the Tower ordinary shares in order to receive competitive product pricing under the agreements with Tower and has recorded these shares as a long-term investment on the balance sheets. The remaining 894,543 shares are classified as a short-term investment on the balance sheets.

The Company also received \$4.7 million in prepaid wafer credits in partial consideration for the investment, \$4.2 million of which remained available as of June 30, 2006. The credits have no stated maturity and the Company has guaranteed capacity at Tower through

at least 2010. These credits are recorded within long-term other assets on the balance sheets and can be applied toward wafer purchases from Tower at 15% of the value of future purchases.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 6—Balance Sheet Components

	June 30, 2006	December 31, 2005
	(in thousands)	
Inventory:		
Raw materials	\$ 827	\$ 916
Work-in-process	6,115	6,314
Finished goods	491	600
	<u>\$ 7,433</u>	<u>\$ 7,830</u>
Other current assets:		
Prepaid expenses	\$ 1,016	\$ 1,064
Employee receivables	18	20
Other	172	181
	<u>\$ 1,206</u>	<u>\$ 1,265</u>
Property and equipment:		
Equipment	\$ 14,342	\$ 13,264
Software	9,340	8,610
Furniture and fixtures	827	825
Leasehold improvements	805	802
	<u>25,314</u>	<u>23,501</u>
Accumulated depreciation and amortization	<u>(19,295)</u>	<u>(17,804)</u>
	<u>\$ 6,019</u>	<u>\$ 5,697</u>
Other assets:		
Prepaid wafer credits	\$ 4,171	\$ 4,227
Other	214	188
	<u>\$ 4,385</u>	<u>\$ 4,415</u>
Accrued liabilities:		
Employee related accruals	\$ 1,450	\$ 2,026
Other	1,236	1,408
	<u>\$ 2,686</u>	<u>\$ 3,434</u>

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 7—Obligations

	June 30, 2006	December 31, 2005
	(in thousands)	
Debt and capital lease obligations:		
Notes payable to bank	\$ 1,668	\$ 1,443
Capital leases	1,790	1,510
	<u>3,458</u>	<u>2,953</u>
Current portion of debt and capital lease obligations	<u>(1,970)</u>	<u>(1,790)</u>
	<u>\$ 1,488</u>	<u>\$ 1,163</u>

Revolving Line of Credit and Notes Payable to Bank

Effective June 2006, the Company entered into a Second Amended and Restated Loan and Security Agreement with Silicon Valley

Bank. Terms of the agreement included a \$5.0 million revolving line of credit that is available through June 2008 and an additional \$2.0 million of borrowing capacity under the equipment line of credit that is available to be drawn against through June 2007. Advances under the equipment line of credit must be repaid in either 30 or 36 monthly equal installments, depending upon the nature of the items financed. Terms of the various advances under the agreement are as follows (in thousands):

	Original Balance	Balance at June 30, 2006	Available Credit	Interest Rate	Maturity Date
Revolving Line of Credit:					
Non-formula advances	n/a	—	5,000	Greater of Prime + 0.50% or 8.5%	June 28, 2008
Equipment Line of Credit:					
Notes payable	2,136	149	n/a	Prime + 2.00%	Multiple draws maturing on or before December 2006
Notes payable	859	342	n/a	Prime + 2.00%	Multiple draws maturing on or before December 2007
Notes payable	550	300	n/a	Prime + 2.00%	Multiple draws maturing on or before April 2008
Notes payable	932	877	n/a	Prime + 1.75%	Multiple draws maturing on or before April 2009
Notes payable	n/a	—	2,000	Prime +1.00% or Treasury +4.00%	30 or 36 months from date of advance
Total		<u>\$ 1,668</u>			

The bank has a first priority security interest in substantially all of the Company's tangible and intangible assets to secure any outstanding amounts under the agreement. Under the terms of the agreement, the Company must maintain a minimum tangible net worth and adjusted quick ratio. The agreement also has certain restrictions including, among others, on the incurrence of other indebtedness, the maintenance of depository accounts, the disposition of assets, mergers, acquisitions, investments, the granting of liens and the payment of dividends. The Company was in compliance with the financial covenants of the agreement as of June 30, 2006.

At June 30, 2006, the prime rate under the credit facility was 8.25%. As of June 30, 2006 and December 31, 2005, \$685,000 and \$387,000, respectively, of amounts outstanding under the equipment line of credit were classified as long-term obligations.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Capital Lease

In December 2005, the Company leased design software and related maintenance under a two-year capital lease at an imputed interest rate of 8.5% per annum. Terms of the agreement require the Company to make quarterly payments of approximately \$204,000 through November 2007. The Company recorded a capital asset for \$1.2 million that is being depreciated over the term of the agreement, prepaid maintenance of \$272,000 that is being amortized over the term of the agreement and a capital lease obligation of \$1.5 million. As of June 30, 2006, \$1.1 million was outstanding under the capital lease, \$396,000 of which was classified as a long-term obligation.

In January 2006, the Company leased design software tools and related maintenance under a three-year capital lease at an imputed interest rate of 9.0% per annum. Terms of the agreement require the Company to make semi-annual payments of approximately \$148,000 through July 2008. The Company recorded a capital asset for \$633,000 that is being depreciated over the term of the agreement, prepaid maintenance of \$158,000 that is being amortized over the term of the agreement and a capital lease obligation of \$791,000. As of June 30, 2006, \$649,000 was outstanding under the capital lease, \$407,000 of which was classified as a long-term obligation.

Note 8—Deferred Royalty Revenue

In October 2000, the Company entered into a technology license and wafer supply agreement with Aeroflex Incorporated (“Aeroflex”). Under the terms of the agreement, the Company received \$750,000 of prepaid royalties. In addition, Aeroflex receives a 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 a long-term liability and will be recognized as revenue when Aeroflex reports the sale of products incorporating the licensed technology to the Company. As of June 30, 2006 and December 31, 2005, the Company had recorded approximately \$1.5 million and \$1.4 million, respectively, of deferred royalty revenue under this agreement. As of June 30, 2006, no royalty revenue had

been earned under the agreement.

Note 9—Employee Stock Plans

1989 Stock Option Plan

The 1989 Stock Option Plan (the “1989 Plan”) provided for the issuance of incentive and nonqualified options for the purchase of up to 4.6 million shares of common stock. 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. In September 1999, the Company adopted the 1999 Stock Plan and no further stock option grants were made under the 1989 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, 2006, approximately 13.6 million shares were reserved for issuance under the 1999 Plan. In addition, each January an annual increase is added to the 1999 Plan equal to the lesser of (i) 5,000,000 shares, (ii) 5% of the Company’s outstanding shares on such date, or (iii) a lesser amount determined by the Board of Directors. Options that are canceled under the 1989 Plan also 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 has implemented a different vesting schedule in the past and may implement different vesting schedules in the future with respect to any new stock option grant.

QUICKLOGIC CORPORATION

NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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, 2006, approximately 4.1 million shares were reserved for issuance under the ESPP. In addition, each August an annual increase is added to the ESPP equal to the lesser of (i) 1,500,000 shares, (ii) 4% of the Company’s outstanding shares on such date, or (iii) a lesser amount determined by the Board of Directors.

Through the purchase period ending November 2005, the ESPP contained consecutive, overlapping, twenty-four month offering periods. Each offering period included four six-month purchase periods. The ESPP permitted participants to purchase shares through payroll deductions at 85% of the lower of the fair market value of the common stock at the beginning of an offering period or the end of a purchase period.

Effective November 2005, the Board of Directors amended the ESPP to provide for six-month offering periods. Participants purchase shares through payroll deductions of up to 20% of an employee’s total compensation (maximum of 20,000 shares per offering period). The amended ESPP permits the Board of Directors to determine whether participants purchase shares at: (i) 85% of the fair market value of the common stock at the end of the offering period; or (ii) 85% of the lower of the fair market value of the common stock at the beginning or the end of an offering period. The Board of Directors has determined that, until further notice, future offering periods will be made at 85% of the lower of the fair market value of the common stock at the beginning or the end of an offering period. As a result of the Company’s internal review of stock option grants and related accounting (see Note 3), employee contributions to the ESPP were suspended effective August 2006 and amounts previously withheld from employees were refunded in November 2006. In addition, the next offering period under the ESPP will commence once the Company has filed all required quarterly reports on Form 10-Q and will end on May 14, 2007, the next regularly scheduled purchase date.

Note 10—Stock-Based Compensation

Effective January 2, 2006, the Company adopted the provisions of SFAS No. 123(R), using the modified prospective transition method, which requires the measurement and recognition of expense related to the fair value of stock-based compensation awards made to employees and directors, over the requisite service period.

QUICKLOGIC CORPORATION

NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Periods Prior to Adoption of SFAS No. 123(R)

Prior to the adoption of SFAS No. 123(R), the Company applied APB 25 and related interpretations and provided the required pro forma disclosures of SFAS No. 123, as amended by SFAS No. 148, “Accounting for Stock-Based Compensation — Transition and

Disclosures.” The pro forma information in the following table illustrates the effect on net income (loss) and net income (loss) per share for the three and six months ended June 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123 (in thousands, except per share amounts):

	<u>Three Months Ended June 30, 2005</u>	<u>Six Months Ended June 30, 2005</u>
Net income – as reported	\$ 320	\$ 1,184
Less: Stock-based compensation expense related to stock option plans determined under the fair value based method, net of tax	(607)	(1,477)
Less: Stock-based compensation expense related to the stock purchase plan determined under fair value based method, net of tax	(336)	(336)
Net loss – as adjusted	<u>\$ (623)</u>	<u>\$ (629)</u>
Net income per share – as reported:		
Basic	<u>\$ 0.01</u>	<u>\$ 0.04</u>
Diluted	<u>\$ 0.01</u>	<u>\$ 0.04</u>
Net loss per share – as adjusted:		
Basic	<u>\$ (0.02)</u>	<u>\$ (0.02)</u>
Diluted	<u>\$ (0.02)</u>	<u>\$ (0.02)</u>

In the pro forma information required under SFAS No. 123 for the periods prior to fiscal 2006, the Company used the Black-Scholes option pricing model to value stock-based compensation awards and accounted for forfeitures as they occurred.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Impact of the Adoption of SFAS No. 123(R)

The Company adopted SFAS No. 123(R) using the modified prospective transition method beginning January 2, 2006, the first day of the Company’s fiscal year 2006. In accordance with the modified prospective transition method, the Company’s consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R). Effective with the adoption of SFAS No. 123(R), stock-based compensation expense is recognized in the Company’s consolidated statements of operations and includes (i) compensation expense for stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated and re-measured upon modification in accordance with the pro forma provisions of SFAS No. 123 and (ii) compensation expense for the stock-based compensation awards granted or modified subsequent to January 1, 2006, based on the grant-date fair value estimated and re-measured in accordance with the provisions of SFAS No. 123(R). The impact of SFAS No. 123(R) on the Company’s consolidated financial statements for the three and six months ended June 30, 2006 was as follows (in thousands, except per share amounts):

	<u>Three Months Ended June 30, 2006</u>	<u>Six Months Ended June 30, 2006</u>
Cost of revenue	\$ 53	\$ 102
Research and development	118	264
Selling, general and administrative	232	489
Total costs and expenses	<u>\$ 403</u>	<u>\$ 855</u>
Effect on net loss per share:		
Basic	<u>\$ (0.01)</u>	<u>\$ (0.03)</u>
Diluted	<u>\$ (0.01)</u>	<u>\$ (0.03)</u>

Stock-based compensation expense recorded in the three and six months ended June 30, 2006 had no effect on cash flows or the provision for income taxes.

Upon the adoption of SFAS No. 123(R), the Company has made an estimate of expected forfeitures and is recognizing compensation costs only for those equity awards expected to vest. The cumulative effect of forfeitures upon adoption of SFAS No. 123(R) was not material.

Valuation Assumptions

SFAS No. 123(R) requires companies to estimate the fair value of stock-based compensation awards on the grant date using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company’s consolidated statements of operations. The Company measures the fair value of stock-based compensation awards using the Black-Scholes option pricing model. Black-Scholes, as well as other currently accepted option valuation

models, was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions. These assumptions differ significantly from the characteristics of the Company's stock-based compensation awards. Black-Scholes also requires the use of highly subjective, complex assumptions, including expected term and the price volatility of the Company's stock.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following weighted average assumptions are included in the estimated fair value calculations for stock option grants:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Expected term (years)	5.75	4.02	5.75	4.05
Risk-free interest rate	4.95%	3.80%	4.87%	3.79%
Expected volatility	82%	92%	82%	92%
Estimated pre-vesting annual forfeiture rate	8.10%	—	8.10%	—
Dividend yield	—	—	—	—

The methodologies for determining the above values were as follows:

- *Expected term:* The expected term represents the period that the Company's stock-based awards are expected to be outstanding and is estimated based on historical experience.
- *Risk-free interest rate:* The risk-free interest rate assumption is based upon observed interest rate appropriate for the expected term of the Company's employee stock options.
- *Expected volatility:* The Company determines expected volatility based on historical volatility of the Company's common stock, and other factors.
- *Dividend yield:* The dividend yield assumption is based on the Company's intent not to issue a dividend under its dividend policy.
- *Estimated pre-vesting forfeitures:* When estimating pre-vesting forfeitures, the Company considers termination behavior based on actual historical information.

The weighted average estimated fair value for options granted during the three months ended June 30, 2006 and 2005 was \$4.11 and \$2.45 per option, respectively. The weighted average estimated fair value for options granted during the six months ended June 30, 2006 and 2005 was \$3.89 and \$2.44 per option, respectively. As of June 30, 2006, the fair value of unvested stock-based compensation awards, net of expected forfeitures, was \$1.1 million which is expected to be recognized over the next four years.

Employee Stock Purchase Plan

The offering periods ending in May 2006 and November 2006 under the ESPP provide that shares will be purchased at 85% of the fair market value of the common stock at the end of the offering period. Accordingly, the fair value of stock-based compensation awards under the ESPP was recognized based upon employee deductions and the purchase discount, rather than using a pricing model. In the three and six months ended June 30, 2006, stock-based compensation relating to the ESPP was \$34,000 and \$69,000, respectively.

The following weighted average assumptions are included in the estimated fair value calculations for rights to purchase stock under the ESPP during the three and six months ending June 30, 2005:

	Three Months	Six Months
	Ended	Ended
	June 30, 2005	June 30, 2005
Expected life (months)	6.0	6.0
Risk-free interest rate	3.13%	3.13%
Volatility	65%	65%
Dividend yield	—	—

The methodologies for determining the above values were as follows:

- *Expected term:* The expected term represents the six-month purchase period contained in the ESPP.
- *Risk-free interest rate:* The risk-free interest rate assumption is based upon observed interest rate appropriate for the six-month purchase period.

- *Expected volatility:* The Company determines expected volatility based on historical volatility of the Company's common stock, and other factors for the six-month purchase period.
- *Dividend yield:* The dividend yield assumption is based on the Company's intent not to issue a dividend under its dividend policy.

The purchase discount of rights issued pursuant to the Company's ESPP during the three and six months ended June 30, 2006 was \$0.84 per right, respectively. The weighted average estimated fair value, as defined by SFAS No. 123, of rights issued pursuant to the Company's ESPP during the three and six months ended June 30, 2005 was \$0.79 per right, respectively. During 2005, the fair value of rights granted was estimated on the date of grant using Black-Scholes.

Stock-Based Compensation Award Activity

The following table summarizes stock-based compensation award activity under the 1989 Plan and the 1999 Plan, and the related weighted average exercise price, for the six months ended June 30, 2006 and the year ended December 31, 2005:

	Shares Available for Grant (in thousands)	Options Outstanding	
		Number of Shares (in thousands)	Weighted Average Exercise Price
Balance at January 1, 2005	4,010	8,888	\$ 5.48
Authorized	1,316	—	—
Granted	(207)	207	3.77
Forfeited or expired	1,539	(1,539)	7.45
Exercised	—	(821)	2.20
Balance at December 31, 2005	6,658	6,735	5.37
Authorized	1,394	—	—
Granted	(187)	187	5.43
Forfeited or expired	139	(139)	7.49
Exercised	—	(687)	3.09
Balance at June 30, 2006	8,004	6,096	\$ 5.59

As of June 30, 2006 and December 31, 2005, options to purchase 5,571,000 and 5,830,000 shares were vested, respectively.

Significant exercise price ranges of options outstanding, related weighted average exercise prices, intrinsic value and contractual life information at June 30, 2006 was as follows:

Range of Exercise Prices	Options Outstanding				Options Exercisable			
	Options Outstanding (in thousands)	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Options Vested and Exercisable (in thousands)	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
\$0.97 — \$ 2.75	1,672	6.54	\$ 2.12	\$ 4,629	1,434	6.46	\$ 2.12	\$ 3,966
2.83 — 4.08	1,599	6.43	3.45	2,302	1,493	6.26	3.44	2,167
4.25 — 6.04	1,671	4.98	4.98	326	1,496	4.42	4.93	325
6.13 — 34.56	1,154	4.22	14.45	—	1,148	4.19	14.50	—
\$0.97 — \$34.56	6,096	5.64	\$ 5.59	\$ 7,257	5,571	5.39	\$ 5.78	\$ 6,458

QUICKLOGIC CORPORATION NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company's closing stock price of \$4.89 as of the end of the Company's current reporting period which would have been received by the option holders had all option holders exercised their options as of that date. The total number of shares of common stock underlying in-the-money options exercisable as of June 30, 2006 was 3,990,000.

The total intrinsic value of options exercised during the three and six months ended June 30, 2006 was \$700,000 and \$1.5 million, respectively. Total cash received from employees as a result of employee stock option exercises during the three and six months ended June 30, 2006 was approximately \$1.1 million and \$2.1 million, respectively. The Company settles employee stock option exercises with newly issued common shares. In connection with these exercises, there was no tax benefit realized by the Company due to the Company's current loss position.

The status of the Company's nonvested shares as of June 30, 2006 and changes during the six months ended June 30, 2006 and the year ended December 31, 2005 was as follows (in thousands, except per share amounts):

	Number of Shares	Weighted Average Grant Date Fair Value
--	---------------------	---

Nonvested at January 1, 2005	2,900	\$ 1.97
Granted	207	2.42
Vested	(1,870)	2.15
Forfeited	(332)	2.04
Nonvested at December 31, 2005	905	1.65
Granted	187	3.89
Vested	(506)	1.67
Forfeited	(61)	1.51
Nonvested at June 30, 2006	525	\$ 2.45

On December 21, 2005, the Compensation Committee of the Company's Board of Directors approved the vesting acceleration of unvested, "out-of-the-money" stock options awarded under its 1999 Stock Plan. The purpose of the accelerated vesting was to reduce future compensation expense associated with the accelerated stock options upon adoption of SFAS No. 123(R) by approximately \$380,000 and because the outstanding options were not fully achieving their original objective of incentive compensation and employee retention due to exercise prices which were in excess of the current market value. A total of 187,703 shares with exercise prices ranging from \$4.08 to \$8.70 were accelerated under the program. The accelerated stock options had a weighted average exercise price of \$5.45. On average, the accelerated options would otherwise have completed vesting over 1.6 years from the date of acceleration.

Note 11—Shelf Registration Statement

On July 12, 2005, the Company filed a shelf registration statement on Form S-3, which was declared effective on July 26, 2005 by the Securities and Exchange Commission. Under this filing, the Company has the ability to raise up to \$30.0 million, in one or more transactions, by selling common stock, preferred stock, depositary shares, or warrants. As of June 30, 2006, the Company had not raised any funds in connection with this filing.

Note 12—Rights Plan

In November 2001, the Board of Directors adopted a Rights Agreement, which provides for a dividend of one Preferred Stock Purchase Right (each a "Right" and collectively, the "Rights") for each share of common stock of the Company. Each Right will entitle stockholders to buy one ten-thousandth of a share of Series A Junior Participating Preferred Stock of QuickLogic at an exercise price of \$32.50, subject to adjustment. The Rights will become exercisable only if a person or group becomes the beneficial owner of 15% or more of the common stock, or commences a tender or exchange offer which would result in the offeror beneficially owning 15% or more of the common stock, without the approval of the Board of Directors. The Company is entitled to redeem the Rights at \$0.001 per Right up to ten business days after the public announcement of a 15% holder. If not earlier terminated or redeemed, the Rights will expire on November 27, 2011.

QUICKLOGIC CORPORATION

NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 13—Income Taxes

In the three months ended June 30, 2006 and 2005, the Company recorded income tax expense of \$21,000 and \$31,000, respectively, which consisted of income taxes on foreign operations. In the six months ended June 30, 2006 and 2005, the Company recorded income tax expense of \$23,000 and \$81,000, respectively, which consisted primarily of income taxes on foreign operations.

Due to the uncertainties surrounding the realization of the deferred tax assets resulting from the Company's accumulated deficit and net tax losses in previous years, the Company has provided a full valuation allowance against the associated deferred tax assets. The Company will continue to assess the realizability of the deferred tax assets in future periods.

At December 31, 2005, the Company had net operating loss carryforwards for federal and state income tax purposes of approximately \$74.0 million and \$17.0 million, respectively. These carryforwards, if not utilized to offset future taxable income and income taxes payable, will expire beginning in 2006 for federal and state purposes.

Under the Tax Reform Act of 1986, the amount of and the benefit from net operating losses that can be carried forward may be impaired in certain circumstances. Events which may cause changes in the Company's tax carryforwards include, but are not limited to, a cumulative ownership change of more than 50% over a three-year period. Since inception, the Company has had cumulative changes in ownership which will limit the loss carryforward deduction under IRC Section 382. However, the Company believes that such limitations will not have a material effect on the future utilization of the losses.

Note 14—Information Concerning Product Lines, Geographic Information and Revenue Concentration

The Company identifies its business segments based on business activities, management responsibility and geographic location. For all periods presented, the Company operated in a single business segment.

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following is a breakdown of revenue by product family (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
<i>Revenue by product family (1):</i>				
Mature products	\$ 4,092	\$ 7,575	\$ 9,174	\$ 16,123
Embedded standard products	2,473	3,441	4,981	5,828
Advanced embedded standard products	2,684	1,754	4,427	3,346
Total revenue	<u>\$ 9,249</u>	<u>\$ 12,770</u>	<u>\$ 18,582</u>	<u>\$ 25,297</u>

(1) The mature products family includes pASIC 1, pASIC 2 and pASIC 3 products. The embedded standard products family includes QuickRAM, QuickPCI, QuickDSP, QuickFC, and V3 products. The advanced embedded standard products family includes Eclipse, Eclipse II, QuickPCI II, PolarPro and QuickMIPS products, as well as programming hardware and software.

The following is a breakdown of revenue by shipment destination (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
<i>Revenue by geography:</i>				
United States	\$ 3,207	\$ 5,987	\$ 8,043	\$ 11,868
Europe	4,013	2,227	6,046	5,364
Japan	954	2,023	1,942	4,106
China	515	1,235	1,120	1,376
Rest of North America	344	1,011	938	1,725
Rest of Asia Pacific	216	287	493	858
Total revenue	<u>\$ 9,249</u>	<u>\$ 12,770</u>	<u>\$ 18,582</u>	<u>\$ 25,297</u>

Two distributors of the Company's products accounted for 23% and 12% of revenue, respectively, in the three months ended June 30, 2006 and for 28% and 13% of revenue, respectively, in the six months ended June 30, 2006. A contract manufacturer, purchasing the Company's products for use in a telecom design for an OEM application, and a domestic manufacturer accounted for 19% and 12% of revenue for the three months ended June 30, 2006, respectively, and each of these entities accounted for 12% of revenue for the six months ended June 30, 2006.

Three distributors of the Company's products accounted for 17%, 16% and 11% of revenue in the three months ended June 30, 2005. The same three distributors of the Company's products accounted for 20%, 16% and 12% of revenue in the six months ended June 30, 2005. For the three and six months ended June 30, 2005, one domestic manufacturer accounted for 10% and 11% of the Company's revenue, respectively.

As of June 30, 2006 less than 10% of the Company's long-lived assets, including property and equipment and other assets, were located outside the United States.

Note 15—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, 2006 and December 31, 2005, the Company had \$5.1 million and \$2.7 million, respectively, of outstanding commitments for the purchase of wafer inventory.

The Company leases, with an option to renew, its primary facility under a non-cancelable operating lease that expires in 2009. In addition, the Company rents development facilities in Canada and India as well as sales offices in Europe and Asia. Total rent expense, net of sublease income, for the three months ended June 30, 2006 and 2005

QUICKLOGIC CORPORATION
NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

was approximately \$250,000 and \$230,000, respectively, and for the six months ended June 30, 2006 and 2005 was approximately \$485,000 and \$490,000, respectively. The Company has subleased a portion of its primary facilities to a tenant until November 2007.

Note 16—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 certain investment banks that underwrote QuickLogic's initial public offering, QuickLogic and some of QuickLogic's officers and directors. 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. 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*. A stipulation of settlement for the claims against the issuer defendants, including the Company, has been signed and was submitted to the court. Under the stipulation of settlement, the plaintiffs will dismiss and release all claims against participating defendants in exchange for a contingent payment guaranty by the insurance companies collectively responsible for insuring the issuers in all the related cases, and the assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. Under the guaranty, the insurers will be required to pay the amount, if any, by which \$1.0 billion exceeds the aggregate amount ultimately collected by the plaintiffs from the underwriter defendants in all the cases. On February 15, 2005, the court preliminarily approved the settlement contingent on specified modifications. The settlement is still subject to court approval and a number of other conditions. There is no guarantee that the settlement will become effective.

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 Semiconductor Ltd. against Tower, several of its directors, and several of its investors, including QuickLogic. QuickLogic was named solely as an alleged control person. On August 19, 2004, the court dismissed the claims against all defendants, including QuickLogic, with prejudice. On September 29, 2004, one of the plaintiffs filed a notice of appeal from the judgment. On June 1, 2006, the court of appeals affirmed the dismissal.

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, including but not limited to intellectual property infringement and collection matters. 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 or other payments in the future which may adversely impact gross profit.

Note 17—Subsequent Events

SEC Inquiry

On July 26, 2006, the Company notified the Securities and Exchange Commission ("SEC") that it was conducting an internal review of its historical stock option practices and related accounting (see Note 3). On August 1, 2006, the Company received an informal inquiry from the SEC requesting certain documents and information relating to the Company's practices, procedures and disclosures regarding its stock option grants. The Company complied with this and subsequent requests made by the SEC and intends to cooperate fully with the SEC.

QUICKLOGIC CORPORATION

NOTES TO CONDENSED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Nasdaq Delisting

The Company has received two Nasdaq Staff Determination notices stating that it is not in compliance with Marketplace Rule 4310(c)(14) because the Company had not timely filed its Forms 10-Q for the quarters ended June 30, 2006 and September 30, 2006 and, therefore, that the Company's securities are subject to delisting from the NASDAQ Global Market.

On September 26, 2006, the Company attended a Nasdaq hearing at which it appealed the first Staff Determination notice and requested an extension of time to satisfy the filing requirement. On December 13, 2006, the Company received a decision from the Nasdaq Listing Qualifications Panel (the "Panel") stating that the Company's request for continued listing of its securities on the NASDAQ Global Market had been granted subject to the following conditions: (1) providing the Panel with an update of the internal review on or before December 22, 2006; (2) filing the Company's Form 10-Q for the second quarter of 2006 on or before December 22, 2006, and; (3) filing the Company's Form 10-Q for the third quarter of 2006 on or before January 12, 2007.

Shareholder Derivative Suits

On November 2, 2006 and November 29, 2006, purported shareholder derivative complaints were filed against certain of the Company's current and former officers and directors in the U.S. District Court for the Northern District of California. The complaints allege that the individual defendants violated the federal securities laws and breached their duties to the Company in connection with the granting and/or receipt of options for Company stock. The complaints name the Company as a nominal defendant and seek unspecified monetary damages against the individual defendants as well as various forms of injunctive relief.

Due to the preliminary status of these complaints and uncertainties related to litigation, the Company is unable to evaluate the likelihood of either a favorable or unfavorable outcome. Accordingly, the Company is unable at this time to estimate the effects of these complaints on its financial position, results of operations or cash flows.

Borrowing under Notes Payable to Bank

In September 2006, the Company borrowed \$1.6 million under the terms of its Second Amended and Restated Loan and Security Agreement with Silicon Valley Bank, and has \$0.4 million of borrowing capacity remaining under the equipment line of credit that is available to be drawn against through June 2007.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as information contained in "Risk Factors" in Part II, Item 1A 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. We intend that these forward-looking statements be subject to the safe harbors created by those provisions. 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 our revenue levels, our gross profit and factors that affect gross profit, our level of operating expenses, our research and development efforts, our liquidity, our partners and suppliers, industry trends, the competitive position and commercial success of our products, and the expenses and management attention associated with our stock option review, related inquiries and litigation. The following discussion should be read in conjunction with the attached condensed unaudited consolidated financial statements and notes thereto, with our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2005, found in our Annual Report on Form 10-K filed with the Securities and Exchange Commission, or SEC, on March 17, 2006, and with our condensed unaudited consolidated financial statements and notes thereto for the quarter ended March 31, 2006 found in our Quarterly Report on Form 10-Q filed with the SEC on May 12, 2006.

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 the decline in revenue from our pASIC® 1 and pASIC 2 products, the commercial and technical success of our new products such as PolarPro™, Eclipse™ II and QuickPCI® II, limited visibility into demand for our products including demand from significant customers or for new products, our dependence upon single suppliers to fabricate and assemble our products, our relationship with and the manufacturing of our products by Tower Semiconductor Ltd., and the liquidity required to support our future operating and capital requirements. 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 will be accurate. The risks, uncertainties and assumptions referred to above that could cause our results to differ materially from the results expressed or implied by such forward looking statements include, but are not limited to, those discussed under the heading "Risk Factors" in Part II, Item 1A hereto and the risks, uncertainties and assumptions discussed from time to time in our other public filings and public announcements. All forward-looking statements included in this document are based on information available to us as of the date hereof. 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. Furthermore, past performance in operations and share price is not necessarily indicative of future performance. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Overview

We operate in a single industry segment where we design and sell field programmable gate arrays, or FPGAs, embedded standard products, or ESPs, associated software and programming hardware. Our FPGA and ESP devices are standard products that can be programmed to perform desired logic functions or combined with intellectual property to provide customers with desired solutions. These products provide our customers with the opportunity to bring products to market quickly and the ability to differentiate their products from competitors. We design these devices based on our proprietary ViaLink technology. We believe that the underlying attributes of our ViaLink technology, including low power consumption, high reliability, design security and design efficiency enable us to differentiate our silicon solutions.

Under the direction of the Audit Committee of the Board of Directors, we voluntarily conducted an internal review of our historical stock option granting practices and related accounting for the period from October 15, 1999, the date of our initial public offering, through July 28, 2006. The review was initiated by the Audit Committee in response to media attention about stock option practices at other companies. We did not find any systematic or pervasive practices to account for stock options in a manner inconsistent with generally accepted accounting principles, or GAAP, or our stated policies and procedures. However, based on our results of the review and analysis of the facts, we determined that there were certain errors committed in the process of documenting grants and accounting for stock options associated with measurement dates, grants prior to meeting the definition of an employee under GAAP, non-

employee grants, modification of options and previously reported deferred stock compensation charges. A total pre-tax stock-based compensation charge of \$964,000 is associated with these identified errors that should have been reported in previously issued consolidated financial statements had they been identified in the proper period. After considering all the quantitative and qualitative factors in accordance with Staff Accounting Bulletin No. 99, “*Materiality*,” we determined that these adjustments were not material to any prior year and, thus, have not restated our consolidated financial statements for prior periods. However, given that the effect of correcting these errors in 2006 would cause our 2006 consolidated financial statements to be materially misstated, we concluded that the cumulative effect adjustment method of initially applying the guidance of SAB No. 108 was appropriate. Accordingly, the cumulative affect of the adjustment was reflected as an increase to the carrying amount of additional paid-in capital as of January 1, 2006, with an offsetting entry to accumulated deficit. In addition, less than \$50,000 of the adjustment to previously issued consolidated financial statements was due to errors that occurred after October 2002. As a result of our review and as part of our overall Sarbanes-Oxley compliance efforts, we are implementing enhanced controls and process improvements in connection with the issuance of stock option grants and modifications. See Note 3 of the consolidated financial statements in Item 1 of this report for additional information regarding our review conducted at the direction of the Audit Committee of the Board of Directors and the cumulative effect adjustment to previously issued consolidated financial statements. See also Item 4, Controls and Procedures.

Our objective is to be the leading provider of the lowest-power programmable logic solutions. In addition to offering the lowest-power, full-featured FPGAs, our products also provide:

- “*Bulletproof*” *Intellectual Property, or IP, Security*—we believe our products provide “bulletproof” design security, since it is virtually impossible to clone or reverse engineer designs implemented using our ViaLink technology;
- *Small Form Factor*—we can provide single chip full-featured solutions, in packages as small as 6x6 millimeters, since our products do not require an additional device to store configuration data;
- *Instant On*—our ViaLink based products require no configuration bit stream and thus are fully functional at power up. This is critical in applications that need to be active as soon as power is supplied; and
- *High Reliability*—our ViaLink-based devices are consistently more robust in harsh environments than SRAM-based FPGA products, since ViaLink-based products do not rely on an SRAM-cell that is susceptible to alpha particles, or brownouts, to define and maintain their functionality.

Competitively, our products can offer significant power, performance and design security benefits when compared to traditional FPGAs; lower cost of ownership, quicker time-to-market and increased system flexibility benefits when compared to the use of application specific integrated circuits, or ASICs; and increased system flexibility, product differentiation and design security benefits when compared to application specific standard products, or ASSPs. We believe that developing products around our ViaLink technology will continue to allow us to provide products that address the design flexibility, system power, performance, intellectual property security, time-to-market and price points demanded by our target markets.

It is our belief that important industry trends in our target markets include lower power consumption, higher performance, shorter time-to-market, increased intellectual property security, small form factor, higher ASIC development expenses and higher product development risks. We believe our products are designed to address many of these trends.

The market for programmable logic devices is expected to grow more quickly than the semiconductor industry, and we believe the FPGA programmable logic market will grow more quickly than the market for complex programmable logic devices, or CPLDs. One factor fueling this high growth is the migration from ASIC circuit designs to programmable logic circuit designs. System designers often choose programmable logic solutions over ASIC solutions, due to the relatively low development cost, low development risk, quick time-to-market and high adaptability or flexibility of programmable logic devices, and due to the ability of programmable logic suppliers to reduce the unit costs of their products over time.

Within the programmable logic device market, we believe that the market for low-power embedded applications will be a relatively high-growth market. We anticipate that original design manufacturers, or ODMs, and original equipment manufacturers, or OEMs, will expand their offering of consumer or professional portable products. These product offerings are expected to include smartphones, portable media players, personal video recorders, portable personal navigation products, handheld point of sale, or POS, terminals incorporating Wi-Fi and micro hard drive capabilities and cellular data cards interfacing a processor and a cellular radio. The adoption of new

features by embedded system designers is increasing the use of low-power programmable logic, to improve system performance by offloading the processor, or to interface to components such as Wi-Fi modules or micro hard disk drives. Designers are also implementing new features in their products using our devices. Our Eclipse II, QuickPCI II and PolarPro products offer compelling advantages against alternative solutions as customers benefit from their lowest power consumption, small form factor and high bandwidth.

In the fourth quarter of 2004, we completed the design of our Eclipse II and QuickPCI II products which provide a low-power solution for applications requiring small to medium amounts of programmable logic. These devices offered the lowest power consumption during all phases of operation – power-up, quiescent and dynamic operation – in the market.

Our PolarPro architecture and related products were announced in November 2005. These products improve on our Eclipse II and

QuickPCI II low-power leadership by providing lower power consumption and a more cost-effective architecture. Our PolarPro architecture combines the industry's lowest-power FPGA with embedded circuitry for implementing high-bandwidth bus-to-bus interfaces. All device circuitry is optimized for low power consumption through the innovative Very Low Power mode, or VLP, which provides an instant ability to lower power consumption when the device function is not needed. When put in VLP mode, we believe that our PolarPro products draw less than 10 microamps of quiescent current. PolarPro products also exhibit the FPGA industry's lowest dynamic power consumption, with operational power consumption up to three times lower than competing alternatives. Based on our engineering analysis of portable media players, we believe designers of handheld, battery-powered products using PolarPro products can now extend battery life by as much as four times as compared to a standard product implementation, setting a new standard for low power consumption through the use of our FPGAs. We have released four PolarPro products to production since March 2006.

We market a range of solutions to our customers, including:

- *complete solutions* incorporating our devices, intellectual property and software drivers. These complete solutions are targeted at specific low-power application segments that have similar connectivity and performance requirements. By providing solutions for customers we increase their ability to meet the time-to-market pressures associated with their markets;
- *Embedded Standard Products* incorporating a fixed function along with programmable logic in a low-power device. Our customers build on the fixed function or "known good starting point" by using our programmable logic to develop unique solutions required for their products. ESPs reduce the need to acquire and assemble industry standard IP, thus reducing design risk and improving time-to-market; and
- *FPGAs* which are general purpose devices used by customers who value the low power consumption, high intellectual property security, instant on and reliability of our FPGAs. These products give customers the ability to create a design specifically tailored to their needs.

Our new products are also being designed into applications in our traditional markets, such as data communications, instrumentation and test and military-aerospace, where customers value the low power consumption, instant-on, IP security, reliability and fast time-to-market of our products.

In addition to working directly with our customers, we partner with other technology companies to develop intellectual property, reference platforms and system software to provide application solutions. We work with processor manufacturers, such as Intel Corporation, Marvell Technologies, and Analog Devices, and companies that supply storage, networking or graphics components for embedded systems such as Seagate and Hitachi. The depth of these relationships varies depending on the partner and the dynamics of the end market being targeted, but is typically a co-marketing program that incorporates engineering collaboration, such as reference designs, joint account calls and promotional activities.

Our proprietary ViaLink programmable metal-to-metal technology is the core of our FPGA products and the foundation of our ESP products. Our ViaLink technology allows us to create devices smaller than competitors' products on comparable technology, thereby minimizing silicon area and cost. In addition, our ViaLink technology has lower electrical resistance and capacitance than other programmable technologies and, consequently, supports higher signal-speed and low power consumption. Our software design tools facilitate full utilization of a device's

logic cells, clocks and input/output pins. Our logic cells have been optimized to efficiently implement a wide range of logic functions at high speed, thereby enabling greater usable device density and design flexibility. Our architecture uses our ViaLink technology to maximize interconnects at every routing wire intersection, which allows more paths between logic cells. As a consequence, system designers are able to use our devices with smaller gate counts to implement their designs than if they had used competing FPGAs. The abundance of interconnect resources also provides a dense connection between the ASSP and the FPGA portions of ESPs.

Our ViaLink technology also provides our products with what we believe to be "bulletproof" intellectual property security, especially compared to SRAM-based FPGA and ASIC solutions, since it is virtually impossible to clone or reverse engineer designs implemented using our ViaLink technology. We believe intellectual property security is important to system designers who choose to implement proprietary algorithms and features in programmable logic.

We sell programmed and unprogrammed products through distributors and directly to system manufacturers. We recognize revenue at the time of shipment of products directly to system manufacturers. However, we sell the majority of our products through distributors who earn a negotiated margin on the sale of our products. We defer recognition of revenue from sales of unprogrammed products to distributors until after they have sold our products to systems manufacturers. We recognize revenue on programmed products at the time of shipment to our distributors. During the six months ended June 30, 2006 and 2005, approximately 51% and 73%, respectively, of the units shipped to our distributors were programmed by us and, accordingly, are not returnable. The percentage of sales derived through distributors was 57% and 69% in the six months ended June 30, 2006 and 2005, respectively.

Two distributors of our products accounted for 23% and 12% of our revenue in the three months ended June 30, 2006. The same two distributors of our products accounted for 28% and 13% of revenue in the six months ended June 30, 2006. Three distributors of our products accounted for 17%, 16% and 11% of our revenue in the three months ended June 30, 2005. The same three distributors of our products accounted for 20%, 16% and 12% of revenue in the six months ended June 30, 2005. One domestic manufacturer accounted for 12% and 10% of revenue for the three months ended June 30, 2006 and 2005, respectively. One European telecom original equipment manufacturer, or OEM, purchasing product through their contract manufacturer, accounted for 19% and zero percent of revenue in the

three months ended June 30, 2006 and 2005, respectively. The same OEM accounted for 12% and zero percent of revenue in the six months ended June 30, 2006 and 2005, respectively. We anticipate that a limited number of distributors and customers will continue to account for a significant portion of our revenue and that individual distributors could account for a larger portion of our revenue.

Our international sales were 57% and 53% of our revenue in the six months ended June 30, 2006 and 2005, respectively. We expect that revenue from sales to international customers will continue to represent a significant portion of our revenue. All of our sales originate in the United States and are denominated in U.S. dollars.

We outsource the wafer manufacturing, assembly and test of all of our products. We currently rely upon Taiwan Semiconductor Manufacturing Company Ltd., or TSMC, Tower Semiconductor Ltd., or Tower, Kawasaki Microelectronics, Inc. and Samsung Semiconductor, Inc. to manufacture our products, and we rely primarily upon Amkor Technology, Inc. to assemble, test and program our products. In 2001 and 2002, we made a \$21.3 million investment in Tower to obtain access to manufacturing capacity and favorable wafer pricing for our products. Our wafer suppliers' lead times are often as long as three months and sometimes longer. In addition, Tower requires us to provide them with a monthly wafer start forecast. Under the terms of our agreement with them, we are limited in the quantity that we can increase or decrease our wafer forecast and we are committed to take delivery of and pay for a minimum portion of the forecasted wafer volume. Our long manufacturing cycle times conflict with our customers' desire for short delivery lead times and we periodically negotiate price discounts on high volume wafer purchases. As a result, we typically purchase wafers based on our internal forecasts of customer demand.

Critical Accounting Policies and Estimates

The methods, estimates and judgments we use in applying our most critical accounting policies have a significant impact on the results we report in our consolidated financial statements. The U.S. Securities and Exchange Commission, or SEC, has defined critical accounting policies as those that are most important to the portrayal of our financial condition and results of operations and require us to make our most difficult and subjective judgments,

often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, our critical policies include revenue recognition including sales returns and allowances, inventory valuation including identification of excess quantities and product obsolescence, allowance for doubtful accounts, valuation of investments, valuation of long-lived assets, measurement of stock-based compensation, accounting for income taxes, and estimating accrued liabilities. We believe that we apply judgments and estimates in a consistent manner and that such consistent application results in consolidated 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 condition. For a detailed discussion of critical accounting policies and estimates, please see Item 7 in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the SEC on March 17, 2006, and Item 2 of our Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2006, filed with the SEC on May 12, 2006.

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,	
	2006	2005	2006	2005
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	45.6	36.1	43.0	37.6
Gross profit	54.4	63.9	57.0	62.4
Operating expenses:				
Research and development	25.5	18.3	25.6	18.9
Selling, general and administrative	49.7	31.7	49.6	33.0
Income (loss) from operations	(20.8)	13.9	(18.2)	10.5
Write-down of marketable securities	—	(11.5)	—	(5.8)
Interest expense	(1.1)	(0.4)	(0.9)	(0.4)
Interest income and other, net	3.7	0.7	3.4	0.7
Income (loss) before income taxes	(18.2)	2.7	(15.7)	5.0
Provision for income taxes	0.2	0.2	0.1	0.3
Net income (loss)	(18.4)%	2.5%	(15.8)%	4.7%

Three Months Ended June 30, 2006 and 2005

Revenue. Our revenue for the three months ended June 30, 2006 was \$9.2 million, representing a decline of approximately \$3.5 million, or 27.6%, from revenue of \$12.8 million in the three months ended June 30, 2005. Our Mature product family revenue declined by \$3.5 million as a result of a \$3.9 million decline in our pASIC 1 and pASIC 2 product revenue due to their end-of-life, partially offset by a \$450,000 increase in our pASIC 3 product revenue, primarily due to higher demand and customers migrating pASIC 2 designs to pASIC 3 products. Our Advanced ESP product family revenue increased by approximately \$930,000 due to a \$2.1 million increase in sales of our new products, including Eclipse II, QuickPCI II, QuickMIPS and PolarPro, partially offset by a \$1.0 million decline in our Eclipse product revenue as a result of lower demand from a Japanese customer purchasing product through a distributor. Our ESP product family revenue decreased by approximately \$970,000 year-over-year primarily as a result of \$990,000 in lower demand

from a Chinese customer purchasing QuickRAM product through a distributor.

Our revenue for the three months ended June 30, 2006 was 1% lower sequentially, declining by approximately \$80,000 to \$9.2 million from \$9.3 million in the three months ended March 31, 2006. This sequential revenue decrease was primarily due to a \$990,000 decline in Mature product family revenue, principally due to a \$1.1 million reduction in pASIC 1 and pASIC 2 revenue due to the end-of-life of these products, which was partially offset by a \$140,000 increase in pASIC 3 revenue due to higher demand and the conversion of customer pASIC 2 designs to pASIC 3 products. Advanced ESP revenue increased by \$940,000 sequentially due primarily to \$1.2 million higher demand for new products. New product sales to a European telecommunications OEM customer, purchasing product through their contract manufacturer, represented 19% and 6% of revenue in the three months ending June 30 and March 31, 2006, respectively.

Our foundry agreement with the supplier that fabricates our pASIC 1 and pASIC 2 products expired at the end of 2005. We announced an end-of-life for these products in 2004 and requested that our customers take delivery of lifetime buy orders before the end of 2005. These products contributed \$1.1 million and \$5.1 million of our revenue in the three months ended June 30, 2006 and 2005, respectively. A majority of our customers that use pASIC 1 and pASIC 2 products have either purchased sufficient quantities to satisfy their demand throughout the expected life of their products or have converted their designs to our other products, such as pASIC 3 which is pin compatible with pASIC 2. Because of the end-of-life of these products, we have experienced a significant reduction in pASIC 1 and pASIC 2 revenue since the third quarter of 2005. Further, we have stopped fabricating wafers for these products and our future revenue will be limited to inventory on hand. We currently are not forecasting significant revenue from pASIC 1 and pASIC 2 products after the fourth quarter of 2006.

In order to maintain or grow our revenue from its current level after the end-of-life period for our pASIC 1 and pASIC 2 products, we are dependent upon increased revenue from our existing products, especially our new PolarPro, Eclipse II and QuickPCI II products, and the development of additional products and solutions.

We continue to seek to expand our revenue, including the pursuit of high volume sales opportunities in the portable electronics market segment, by providing low-power solutions providing new features or incorporating industry standard interfaces such as Peripheral Component Interconnect, or PCI, Integrated Drive Electronics, or IDE, and Secure Digital Input/Output, or SDIO. Our industry is characterized by intense price competition and by lower prices as order volumes increase. While winning large volume sales opportunities will increase our revenue, we believe these opportunities are likely to decrease our average selling price and gross profit as a percentage of revenue.

Gross Profit. Gross profit was \$5.0 million and \$8.2 million in the three months ended June 30, 2006 and 2005, respectively, which represented 54.4% and 63.9% of revenue for those periods. The approximately \$3.1 million decline in gross profit was primarily due to a \$3.5 million decline in revenue which reduced gross profit by approximately \$2.4 million and changes in product mix contributing \$710,000 of lower gross profit. Cost of revenue for the three months ended June 30, 2006, includes \$53,000 related to the recognition of stock-based compensation in accordance with Statement of Financial Accounting Standard No. 123(R), "Share-Based Payment," or SFAS No. 123(R). In the three months ended June 30, 2006, we provided inventory reserves primarily for excess quantities in the amount of \$238,000 and sold \$300,000 of inventory that was previously reserved. In the three months ended June 30, 2005, we provided no new inventory reserves and sold \$370,000 of inventory that was previously reserved.

Research and Development Expense. Research and development expense was \$2.4 million and \$2.3 million in the three months ended June 30, 2006 and 2005, respectively, which represented 25.5% and 18.3% of revenue for those periods. The increase of approximately \$20,000 was primarily due to \$150,000 of higher project development expenses associated with the development of our new PolarPro devices and \$118,000 of stock-based compensation charges in accordance with SFAS No. 123(R), partially offset by lower other expenses including consulting expenses. We believe that continued or increased investments in product and solution development and process technology are essential for us to remain competitive in the markets we serve. We expect that these development efforts will allow us to expand our product and solution offering, increase our revenue and provide additional value to our customers and stockholders.

Selling, General and Administrative Expense. Selling, general and administrative expense was \$4.6 million and \$4.0 million for the three months ended June 30, 2006 and 2005, respectively, which represented 49.7% and 31.7% of revenue for those periods. The \$550,000 increase in selling, general and administrative expense was primarily the result of the recognition of stock-based compensation in accordance with SFAS No. 123(R) of \$232,000, higher legal expenses of \$200,000 associated with international operations and protection of our products against alleged patent infringement, and higher marketing expenses of \$170,000 associated with the introduction of our PolarPro products, partially offset by lower other expenses including travel and entertainment.

Write-down of Marketable Securities. In the second quarter of 2005, we determined that our investment in Tower stock suffered a decline in value that was determined to be "other than temporary." This determination included factors such as market value and the period of time that the market value had been below the carrying value. Accordingly, we recorded an impairment charge of \$1.5 million in the second quarter of 2005 based on the quoted market price of the stock on the last trading day of the reporting period.

Interest Expense. Interest expense increased to \$96,000 for the three months ended June 30, 2006 as compared to \$53,000 for the three months ended June 30, 2005. This \$43,000 increase was primarily due to higher average outstanding debt and capital lease balances and higher interest rates.

Interest Income and Other, Net. Interest income and other, net increased to \$341,000 of income for the three months ended June 30, 2006 as compared to \$90,000 of income for the three months ended June 30, 2005. The \$251,000 increase in interest income and other, net is primarily due to increased interest income received as a result of higher invested cash balances and higher interest rates and lower expense associated with foreign exchange rate fluctuations.

Provision for Income Taxes. For the three months ended June 30, 2006 we incurred a net loss of \$1.7 million and recorded a provision for income taxes of \$21,000, which consisted of income taxes on foreign operations. For the three months ended June 30, 2005 we realized net income of \$320,000 and recorded a provision for income taxes of \$31,000, which consisted of income taxes on foreign operations. Our ability to utilize our income tax loss carryforwards in future periods is uncertain and, accordingly, we have recorded a full valuation allowance against the related tax benefit. We will continue to assess the realizability of the deferred tax assets in future periods.

Stock-based Compensation. Effective January 2, 2006, we adopted the provisions of SFAS No. 123(R) which requires the measurement and recognition of expense related to the fair value of stock-based compensation awards. Accordingly, stock-based compensation is measured at the grant date and re-measured upon modification as appropriate, based on the fair value of the award using the Black-Scholes option pricing model, and is recognized as expense over the requisite service period of the award. Black-Scholes requires the use of highly subjective, complex assumptions, including expected term, forfeitures and the price volatility of our stock. We elected to use the modified prospective transition method as permitted by SFAS No. 123(R) and, therefore, we have not restated our financial results for prior periods. We previously applied Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," or APB 25, and related interpretations and provided the required pro forma disclosures of SFAS No. 123, "Accounting for Stock-Based Compensation." In March 2005, the SEC issued Staff Accounting Bulletin No. 107, or SAB No. 107, relating to SFAS No. 123(R). We have applied the provisions of SAB No. 107 in our adoption of SFAS No. 123(R).

In the second quarter of 2006 and 2005, stock-based compensation totaled \$403,000 and zero, respectively, and was included in the statement of operations as follows (in thousands):

	Three Months Ended June 30,	
	2006	2005
Cost of revenue	\$ 53	\$ —
Research and development	118	—
Selling, general and administrative	232	—
Total	<u>\$ 403</u>	<u>\$ —</u>

Six Months Ended June 30, 2006 and 2005

Revenue. Our revenue for the six months ended June 30, 2006 was \$18.6 million, representing a decline of \$6.7 million, or 26.5%, from revenue of \$25.3 million in the six months ended June 30, 2005. Our Mature product family revenue declined by \$6.9 million as a result of a \$8.1 million decline in our pASIC 1 and pASIC 2 product revenue due to their end-of-life, which was caused by the expiration of a wafer supply agreement, partially offset by a \$1.1 million increase in our pASIC 3 product revenue primarily due to higher demand and customers migrating pASIC 2 designs to pASIC 3 products. Our Advanced ESP product family revenue increased by approximately \$1.1 million due to a \$3.0 million increase in revenue from our new products, which include Eclipse II, QuickPCI II, QuickMIPS and PolarPro. Revenue from a European telecommunications OEM customer, purchasing Eclipse II product through their contract manufacturer, contributed 12% of revenue during the six months ended June 30, 2006

and no revenue in the first half of 2005. Our Eclipse product revenue declined by \$1.9 million year-over-year primarily due to lower demand from a Japanese customer purchasing product through a distributor. Our ESP product family revenue decreased by approximately \$850,000 year-over-year primarily as a result of lower demand from a Chinese customer purchasing QuickRAM product through a distributor.

Gross Profit. Gross profit was \$10.6 million and \$15.8 million in the six months ended June 30, 2006 and 2005, respectively, which represented 57.0% and 62.4% of revenue for those periods. The \$5.2 million decline in gross profit was primarily due to the decline in revenue which effected gross profit by approximately \$4.6 million, changes in product mix contributing \$470,000 to the lower gross profit and lower absorbed overhead of approximately \$510,000 which was partially offset by favorable production variances. Cost of revenue for the six months ended June 30, 2006, includes \$102,000 related to the recognition of stock-based compensation in accordance with SFAS No. 123(R). In the six months ended June 30, 2006, we provided inventory reserves primarily for excess quantities in the amount of \$470,000 and sold \$630,000 of inventory that was previously reserved. In the six months ended June 30, 2005, we provided inventory reserves primarily for excess quantities in the amount of \$205,000 and sold \$630,000 of inventory that was previously reserved.

Research and Development Expense. Research and development expense was \$4.8 million in each of the six months ended June 30, 2006 and 2005, which represented 25.6% and 18.9%, respectively, of revenue for those periods. Expenses were reduced by approximately \$30,000 year-over-year, primarily due to lower payroll and consulting expenses, partially offset by \$270,000 of higher

project development expenses associated with the development of our new PolarPro devices and \$264,000 of higher expense due to stock-based compensation in accordance with SFAS No. 123(R). We believe that continued or increased investments in product and solution development and process technology are essential for us to remain competitive in the markets we serve. We expect that these development efforts will allow us to expand our solution offering, increase our revenue and provide additional value to our customers and stockholders.

Selling, General and Administrative Expense. Selling, general and administrative expense was \$9.2 million and \$8.3 million for the six months ended June 30, 2006 and 2005, respectively, which represented 49.6% and 33.0% of revenue for those periods. The \$870,000 increase in selling, general and administrative expense was primarily the result of \$489,000 of 2006 expenses for stock-based compensation under SFAS No. 123(R), \$240,000 of higher legal expenses associated with international operations and protection of our products against alleged patent infringement, a \$240,000 increase in marketing expenses associated with the introduction of our PolarPro products, and a \$140,000 recovery of an account receivable in the first quarter of 2005 that did not repeat in 2006, partially offset by lower other expenses such as expenses for payroll and temporary contractors.

Write-down of Marketable Securities. In the second quarter of 2005, we determined that our investment in Tower stock suffered a decline in value that was determined to be "other than temporary." This determination included factors such as market value and the period of time that the market value had been below the carrying value. Accordingly, we recorded an impairment charge of \$1.5 million in the second quarter of 2005 based on the quoted market price of the stock on the last trading day of the reporting period.

Interest Expense. Interest expense increased to \$170,000 for the six months ended June 30, 2006 as compared to \$106,000 for the six months ended June 30, 2005. This \$64,000 increase was primarily due to higher average outstanding debt and capital lease balances and higher interest rates.

Interest Income and Other, Net. Interest income and other, net increased to \$633,000 of income for the six months ended June 30, 2006 as compared to \$170,000 of income for the six months ended June 30, 2005. The \$463,000 increase in interest income and other, net is primarily due to increased interest income received as a result of higher invested cash balances and higher interest rates and lower expense associated with foreign exchange rate fluctuations.

Provision for Income Taxes. For the six months ended June 30, 2006, we incurred a net loss of \$2.9 million and recorded a provision for income taxes of \$23,000, which consisted of income taxes on foreign operations. For the six months ended June 30, 2005, we realized net income of \$1.2 million and recorded a provision for income taxes of \$81,000, which consisted of income taxes on foreign operations of \$61,000 and federal alternate minimum income taxes of \$20,000. Our ability to utilize our income tax loss carryforwards in future periods is uncertain and, accordingly, we recorded a full valuation allowance against the related tax benefit. We will continue to assess the realizability of the deferred tax assets in future periods.

Stock-based Compensation. For the six months ended June 30, 2006 and 2005, stock-based compensation totaled \$855,000 and zero, respectively, and was included in the statement of operations as follows (in thousands):

	Six months Ended June 30,	
	2006	2005
Cost of revenue	\$ 102	\$ —
Research and development	264	—
Selling, general and administrative	489	—
Total	<u>\$ 855</u>	<u>\$ —</u>

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. As of June 30, 2006, our principal sources of liquidity consisted of our cash and cash equivalents of \$30.2 million, available credit under our revolving line of credit with Silicon Valley Bank of approximately \$5.0 million, available credit under our equipment line of credit of approximately \$2.0 million, and our investment in Tower with a market value of approximately \$1.9 million. In September 2006, we borrowed \$1.6 million under our equipment line of credit.

On July 12, 2005, we filed a shelf registration statement on Form S-3 with the SEC, which has been declared effective. Under this filing, we may raise up to \$30.0 million, in one or several transactions, by selling common stock, preferred stock, depositary shares, or warrants. As of June 30, 2006, we had not raised any funds in connection with this filing.

As of June 30, 2006, our interest-bearing debt consisted of \$1.7 million outstanding from Silicon Valley Bank and \$1.8 million outstanding under capital leases. As of June 30, 2006, our accumulated deficit was \$121.2 million. Capital expenditures, which are largely driven by the development of new products and manufacturing levels, could be up to \$5.5 million in the next twelve months.

In June 2006, we entered into a Second Amended and Restated Loan and Security Agreement with Silicon Valley Bank. Terms of the agreement include a \$5.0 million revolving line of credit available through June 2008 and an additional \$2.0 million of borrowing capacity under an equipment financing line of credit that is available to be drawn against through June 2007. As of June 30, 2006, we had no balances outstanding under the revolving line of credit. As of June 30, 2006, we had \$1.7 million outstanding under previous equipment lines of credit and \$2.0 million available to be drawn against future equipment purchases. Advances under the new equipment

line of credit must be repaid in either 30 or 36 equal monthly installments, depending upon the nature of the items financed. The bank has a first priority security interest on substantially all of our tangible and intangible assets to secure any outstanding amounts under the agreement. Under the terms of the agreement, we must maintain a minimum tangible net worth and an adjusted quick ratio. The agreement also has certain restrictions including, among others, on the incurrence of other indebtedness, the maintenance of depository accounts, the disposition of assets, mergers, acquisitions, the granting of liens and the payment of dividends. We were in compliance with all loan covenants as of June 30, 2006.

As of June 30, 2006, we had \$1.1 million outstanding under a capital lease obligation to finance design automation software and related maintenance. The capital lease obligation has an imputed interest rate of 8.5% per annum and is being repaid in quarterly amounts of \$204,000 through November 2007.

As of June 30, 2006, we also had \$649,000 outstanding under a capital lease obligation to finance design software tools and related maintenance. The capital lease obligation has an imputed interest rate of 9.0% per annum and is being repaid in semi-annual amounts of \$148,000 through July 2008.

Net cash from operating activities

Net cash provided by operating activities was \$830,000 in the six months ended June 30, 2006. The cash provided by operating activities resulted primarily from a net loss of \$2.9 million, adjusted for \$2.9 million of non-cash charges including depreciation and amortization of \$1.5 million, stock-based compensation of \$855,000 and reserves for excess inventory of \$470,000. In addition, changes in working capital accounts provided cash in the amount of \$885,000 primarily due to a \$1.1 million decrease in accounts receivable, net of allowances for doubtful accounts, due to a reduction in revenue levels and the timing of shipments in the period, a \$468,000 increase in accounts payable due to the timing of purchases and payments in the period, and a \$191,000 decrease in other assets due to the amortization of prepaid expenses. These sources of cash were partially offset by a \$748,000 decrease in accrued liabilities.

Net cash provided by operating activities was \$272,000 in the six months ended June 30, 2005. The cash provided resulted primarily from net income of \$1.2 million, adjusted for \$3.3 million of non-cash charges including a \$1.5 million write-down of marketable securities, depreciation and amortization of \$1.4 million, \$215,000 from the utilization of prepaid wafer credits and reserves for excess inventory of \$205,000. In addition, changes in working capital accounts used cash in the amount of \$4.2 million primarily as a result of a \$2.1 million increase in inventory due to wafer purchases of Eclipse II, QuickPCI II, and PolarPro products and of pASIC 1 and pASIC 2 under their end of life program and an increase of \$1.7 million in accounts receivable, net of allowances for doubtful accounts, due to an increase in revenue levels, a \$824,000 reduction in trade payables and a \$490,000 reduction in accrued liabilities, partially offset by a \$465,000 increase in deferred income and royalty revenue due primarily to higher inventories at distributors on which revenue is deferred and a \$452,000 reduction in other current assets due to the amortization prepaid expenses.

Net cash from investing activities

Net cash used for investing activities for the six months ended June 30, 2006 and 2005 was \$1.2 million and \$682,000, respectively, as a result of capital expenditures made primarily to acquire equipment and software used in the development and production of our products.

Net cash from financing activities

Net cash provided by financing activities was \$2.2 million for the six months ended June 30, 2006, resulting from \$2.5 million in proceeds related to the issuance of common shares under our employee stock purchase program and upon the exercise of stock options by employees and \$932,000 in proceeds from borrowings under our equipment line of credit, partially offset by scheduled repayments of \$1.2 million under the terms of our debt and capital lease obligations.

Net cash provided by financing activities was \$604,000 for the six months ended June 30, 2005 resulting from \$1.4 million in proceeds related to the issuance of common shares under our employee stock purchase program and upon the exercise of stock options by employees and \$550,000 in proceeds from debt and capital lease obligations, partially offset by scheduled repayments of \$1.4 million under the terms of our debt and capital lease obligations.

We require substantial working capital to fund our business, particularly to finance our operations, the acquisition of property and equipment, the repayment of debt and for working capital requirements. Our future liquidity will depend on many factors such as these, as well as our level of revenue and gross profit, market acceptance of our existing and new products, the decline in revenue from our pASIC 1 and pASIC 2 products under their end of life program, wafer purchase commitments, the amount and timing of research and development expenditures, the timing of new product introductions, production volumes, the quality of our products, our sales and marketing efforts, our ability to obtain debt financing and to remain in compliance with the terms of our credit facilities, our ability to raise funds from the sale of Tower shares and equity in the Company, the exercise of employee stock options and participation in our employee stock purchase plan, and other factors related to the uncertainties of the industry and global economics. However, we believe that our existing cash resources will be sufficient to fund operations, capital expenditures of up to \$5.5 million, and provide adequate working capital for at least the next twelve months. As our liquidity is affected by many factors as mentioned above and as discussed in

our “Risk Factors,” there can be no assurance that we will not seek additional capital during the next twelve months or that such capital will be available on terms acceptable to us. After the next twelve months, our capital and operating requirements will depend on many factors, including our level of revenue and gross profit, the market acceptance of our new products, the levels at which we maintain inventory and accounts receivable, costs of securing access to adequate manufacturing capacity, new product development efforts, 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, 2006 and the effect such obligations and commitments are expected to have on our liquidity and cash flows in future periods (in thousands):

	Payments Due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
<i>Contractual cash obligations:</i>					
Operating leases	\$ 2,158	\$ 714	\$ 1,365	\$ 79	\$ —
Wafer purchases (1)	5,132	5,132	—	—	—
Other purchase commitments	3,723	3,342	381	—	—
Total contractual cash obligations	11,013	9,188	1,746	79	—
<i>Other commercial commitments (2):</i>					
Notes payable to bank	1,668	983	685	—	—
Capital lease obligations	1,790	987	803	—	—
Total commercial commitments	3,458	1,970	1,488	—	—
Total contractual obligations and commercial commitments	\$ 14,471	\$ 11,158	\$ 3,234	\$ 79	\$ —

(1) Certain of our wafer manufacturers require us to forecast wafer starts several months in advance. We are committed to take delivery of and pay for a portion of forecasted wafer volume. Wafer purchase commitments of \$5.1 million include both firm purchase commitments and a portion of our forecasted wafer starts as of June 30, 2006.

(2) Other commercial commitments are included as liabilities on our balance sheet as of June 30, 2006.

Inflation

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

Off-Balance Sheet Arrangements

We do not maintain any off-balance sheet partnerships, arrangements or other relationships with unconsolidated entities or others, often referred to as structured finance or special purpose entities, which are established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Recently Issued Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (“FASB”), issued Statement of Financial Accounting Standards No. 123(R), “*Share-Based Payment*,” which is a revision of SFAS No. 123 and supersedes APB 25. SFAS No. 123(R) requires all share-based payments (“SBPs”) to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the requisite service period. Under SFAS No. 123(R), pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R), as amended, is effective for all stock-based awards granted in fiscal years

beginning after June 15, 2005. In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123. Effective January 2, 2006, the first day of fiscal 2006, we adopted SFAS No. 123(R) on a modified prospective basis. As a result, we began to include stock-based compensation charges in our results of operations beginning in the quarter ended March 31, 2006 (see Note 10 to the consolidated financial statements in Item 1 of this report).

In November 2005, the FASB issued Staff Position (“FSP”) FAS123(R)-3, “*Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards*.” This FSP requires an entity to follow either the transition guidance for the additional-paid-in capital pool as prescribed in SFAS No. 123(R), or the alternative transition method as described in the FSP. An entity that adopts SFAS No. 123(R) using the modified prospective application may make a one-time election to adopt the transition method described in this FSP. An entity may take up to one year from the later of its initial adoption of SFAS No. 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. We continue to evaluate the impact that the adoption of this FSP could

have on our consolidated financial statements.

On March 29, 2005, the Securities and Exchange Commission (“SEC”) issued Staff Accounting Bulletin (“SAB”) No. 107, which provides guidance on the interaction between SFAS No. 123(R), “*Shared-Based Payment*,” and certain SEC rules and regulations. SAB No. 107 provides guidance that may simplify some of the SFAS No. 123(R) implementation challenges and enhances the information that investors receive. Effective January 2, 2006, the first day of fiscal 2006, we adopted SFAS No. 123(R) on a modified prospective basis and applied the principles of SAB No. 107 in conjunction with the adoption of SFAS No. 123(R).

In June 2006, the FASB issued FASB interpretation No. 48 (FIN No. 48) “*Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*.” FIN No. 48 requires us to recognize in our consolidated financial statements the impact of a tax position that is more likely than not to be sustained upon examination based on the technical merits of the position. The evaluation of a tax position in accordance with this interpretation is a two-step process. In the first step, recognition, we determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step addresses measurement of a tax position that meets the more-likely-than-not criteria. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be reversed in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109 is not an appropriate substitute for the reversal of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on sufficiency of future taxable income is unchanged by this interpretation. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact FIN No. 48 will have on our consolidated financial statements.

In July 2006, the FASB issued Emerging Issues Task Force (“EITF”) Issue No. 06-3, “How Taxes Collected from Customers are Remitted to Governmental Authorities Should be Presented in the Income Statement (that is Gross versus Net Presentation),” (“EITF 06-3”). The adoption of EITF 06-3 did not have an impact on our consolidated financial position and results of operations. Our accounting policy has been to present the above mentioned taxes on a net basis, excluded from revenues.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,” or SAB No. 108. SAB No. 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. Traditionally, there have been two recognized methods for quantifying the effects of financial statement misstatements - the “rollover” method and the “iron curtain” method. The rollover method focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior period misstatements, but its use can lead to the accumulation of misstatements on the balance sheet. The iron curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with

less emphasis on the reversing effects of prior year errors on the income statement. Prior to the application of the guidance in SAB No. 108, we used the rollover method for quantifying the materiality of financial statement misstatements.

In SAB No. 108, the SEC established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of our consolidated financial statements and the related financial statement disclosures. This model is commonly referred to as a “dual approach” because it requires quantification of errors under both the iron curtain and the rollover methods. SAB No. 108 permits public companies to initially apply its provisions either by (i) restating prior financial statements as if the “dual approach” had always been applied or (ii) recording the cumulative effect of initially applying the “dual approach” as an adjustment to the opening balance of the carrying values of assets and liabilities in the year of adoption with an offsetting adjustment recorded to the opening balance of retained earnings (accumulated deficit). SAB No. 108 is effective for fiscal years ending after November 15, 2006, and is encouraged in any report for an interim period in the year of adoption. We elected early adoption of SAB No. 108 in relation to the results of our internal review of stock option grant practices and related accounting, and recorded the effects of applying SAB No. 108 using the cumulative effect transition method in the second quarter of 2006 (see Note 3 of the consolidated financial statements found in Item 1 of this report).

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements”, (“SFAS No. 157”). SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of SFAS No. 157 relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the impact that SFAS No. 157 will have on our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio and variable rate debt. We do not use derivative financial instruments to manage our interest rate risk. We are adverse to principal loss and ensure the safety and preservation of invested funds by limiting default, market and reinvestment risk. Our investment portfolio is generally comprised of investments that meet high credit quality standards. Since these securities are subject to interest rate risk, they could decline in value if interest rates fluctuate. Due to the short duration and conservative nature of our investment portfolio, we do not anticipate any material loss with respect to our investment portfolio. A 10% move in interest rates as of June 30, 2006 would have an immaterial effect on our financial position, results of operations and cash flows.

Foreign Currency Exchange Rate Risk

All of our sales and cost of manufacturing are transacted in U.S. dollars. We conduct a portion of our research and development activities in Canada and India and have sales and marketing offices in several locations outside of the United States. We use the U.S. dollar as our functional currency. Most of the costs incurred at these international locations are in local currency. If these local currencies strengthen against the U.S. dollar, our payroll and other local expenses will be higher than we currently anticipate. Since our sales are transacted in U.S. 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 26% of total operating expenses for the six months ended June 30, 2006 and 2005, respectively. A majority of these foreign expenses were incurred in Canada. A currency exchange rate fluctuation of 10% would have caused our operating expenses to change by approximately \$350,000 in the six months ended June 30, 2006.

Equity Price Risk

Our exposure to equity price risk for changes in market value relates primarily to our investment in Tower Semiconductor Ltd., or Tower. Tower's ordinary shares trade on the NASDAQ Global Market under the symbol "TSEM". Since these securities are publicly traded on the open market, they are subject to market fluctuations. Temporary market fluctuations are reflected by increasing or decreasing the presented value of the related securities and recording "other comprehensive income (loss)" in the equity section of the balance sheet. An "other than temporary" decline in market value is reflected by decreasing the adjusted cost of the related securities and recording a charge to operating expenses on the income statement. We wrote down the value of the Tower shares due to an "other than temporary" decline in their market value by \$1.5 million, \$1.5 million, \$3.8 million and \$6.8 million in fiscal 2005, 2004, 2002 and 2001, respectively. The determination that the decline in market value was "other than temporary" included factors such as the then current market value and the period of time that the market value had been below the carrying value in each of the respective periods. A market value fluctuation of 10% would have caused us to reduce accumulated other comprehensive income by approximately \$190,000 in the six months ended June 30, 2006.

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 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, as amended, is (i) recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, while no cost-effective control system will preclude all errors and irregularities, our current disclosure controls and procedures are effective to provide reasonable assurance that the consolidated financial statements and other disclosures in our SEC reports are reliable.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. As a result of our internal review of stock option practices and related accounting as described in more detail in Note 3 of the consolidated financial statements found in Item 1 of this report, we have identified and are implementing enhanced controls and process improvements in connection with the issuance of stock-based awards.

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 certain investment banks that underwrote QuickLogic's initial public offering, QuickLogic and some of QuickLogic's officers and directors. 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. 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*. A stipulation of settlement for the claims against the issuer defendants, including the Company, has been signed and was submitted to the court. Under the stipulation of settlement, the plaintiffs will dismiss and release all claims against participating defendants in exchange for a contingent payment guaranty by the insurance companies collectively responsible for insuring the issuers in all the related cases, and the assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. Under the guaranty, the insurers will be required to pay the amount, if any, by which \$1.0 billion exceeds the aggregate amount ultimately collected by the plaintiffs from the underwriter defendants in all the cases. On February 15, 2005, the court preliminarily approved the settlement contingent on specified modifications. The settlement is still subject to court approval and a number of other conditions. There is no guarantee that the settlement will become effective.

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 Semiconductor Ltd. against Tower, several of its directors, and several of its investors, including QuickLogic. QuickLogic was named solely as an alleged control person. On August 19, 2004, the court dismissed the claims against all defendants, including QuickLogic, with prejudice. On September 29, 2004, one of the plaintiffs filed a notice of appeal from the judgment. On June 1, 2006, the court of appeals affirmed the dismissal.

On November 2, 2006 and November 29, 2006, purported shareholder derivative complaints were filed against certain of our current and former officers and directors in the U.S. District Court for the Northern District of California. The complaints alleged that the individual defendants violated the federal securities laws and breached their duties to the Company in connection with the granting and/or receipt of options for Company stock. The complaints named the Company as a nominal defendant and seek unspecified monetary damages against the individual defendants as well as various forms of injunctive relief.

Due to the preliminary status of these complaints and uncertainties related to litigation, we are unable to evaluate the likelihood of either a favorable or unfavorable outcome. Accordingly, we are unable at this time to estimate the effects of these complaints on our financial position, results of operations or cash flows.

Item 1A. Risk Factors

This description includes any material changes to the description of the risk factors associated with our business previously disclosed in Item 1A of our 2005 Annual Report on Form 10-K, filed with the SEC on March 17, 2006, and our Quarterly Report on Form 10-Q for the period ended March 31, 2006, filed with the SEC on May 12, 2006. Because of the following risk factors, as well as other variables affecting our operating results, past financial performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends in future periods.

Risk Factors

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 obtain access to advanced fabrication capacity and dedicate significant resources to specify, design, develop, manufacture and sell new or enhanced products and solutions that provide increasingly higher levels of performance, low power consumption, new features, reliability and/or cost savings to our customers. We experience a long delay between the time when we expend these product definition and development resources and invest in related long-lived assets, and the time when we begin to generate revenue, if any, from these expenditures.

We are marketing our Eclipse II, QuickPCI II and PolarPro products to new customers and markets and expect a significant portion of our future revenues to be generated from these new products. We believe our low-power Eclipse II, QuickPCI II and PolarPro products have a compelling advantage in low-power applications, and that this business will provide long-term revenue growth for QuickLogic, but there is no assurance when this will occur, if at all. Some of the opportunities for our new products are in the rapidly changing consumer market, which typically has shorter product life cycles, higher volumes and greater price pressure than our traditional business. In order to react quickly to opportunities or to obtain favorable wafer prices, we have made significant investments in and commitments to purchase Eclipse II and PolarPro inventory. In addition, the nature of the consumer market and the customers that operate in this market may cause revenue to fluctuate significantly from quarter to quarter. For example, our new product revenue increased in each of the first three quarters of 2006. However, we believe that new product revenue may decline in the fourth quarter of 2006 due to the maturity and product life cycle of a significant customer for these products. If we are unable to design, produce and sell new products and solutions that meet design specifications, address customer requirements, and generate sufficient revenue and gross profit, if market demand for our products fails to materialize, if we are unable to obtain adequate capacity, or if our customers do not successfully introduce products incorporating our devices, our revenue and gross margin will be materially harmed, our liquidity and cash flows will be materially affected, we may be required to write-off related inventory and long-lived assets or have other adverse effects on our business or the price of our common stock.

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

We spend significant time and money to design and develop products and customer solutions around an industry standard, such as Peripheral Component Interconnect, or PCI, and Integrated Drive Electronics, or IDE, or emerging technologies, such as low-power programmable logic, advanced process technology or lead-free packaging. We intend to develop additional products and solutions and adopt new technologies in the future. We expect other programmable product companies to expand their low-power product offering and compete more directly with our lowest-power products. If system manufacturers adopt alternative standards or technologies, if an industry standard or emerging technology that we have targeted fails to achieve broad market acceptance, if customers choose low-power offerings from our competitors, or if we are unable to bring the technologies or solutions to market in a timely and effective manner, we may be unable to generate significant revenue from our research and development efforts. As a result, our business would be materially harmed and we may be required to write-off related inventory and long-lived assets.

44

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

We offer our customers a short delivery lead-time and a majority of our shipments during a quarter are ordered by customers in that quarter. As a result, we often have low visibility to the current quarter's revenue, and our revenue levels can change significantly in a short period of time. Furthermore, our ability to respond to increased demand is limited to inventory on hand or on order, the capacity available at our contract manufacturers and our capacity to program products to customer specifications. In addition, a significant portion of our revenue is deferred until our distributors ship unprogrammed parts to end customers since the price is not fixed or determinable until that time. Therefore, we are highly dependent on the accuracy and timeliness of resale and inventory reports from our distributors. Inaccurate distributor resale or inventory reports, as well as unanticipated changes in distributor inventory levels, could contribute to our difficulty in predicting and reporting our quarterly revenue and results of operations. If we fail to accurately estimate customer demand, record revenue, or if our available capacity is less than needed to meet customer demand, our results of operations could be harmed and our stock price could materially fluctuate.

The announced end-of-life of our pASIC 1 and pASIC 2 products has resulted in a decline in our revenue

Our foundry agreement with the supplier that fabricates our pASIC 1 and pASIC 2 products expired on December 31, 2005 and the supplier no longer has the necessary equipment to manufacture our products. We announced an end-of-life for these products in 2004 and asked our customers to take delivery of lifetime buy orders before the end of 2005. As a result, we have experienced a reduction in revenue from these products. Revenue from these products was \$6.4 million, \$5.1 million, \$6.0 million and \$3.5 million in the first, second, third and fourth quarters of 2005, respectively, and \$2.3 million and \$1.1 million in the first and second quarters of 2006. We believe that a majority of our customers that use pASIC 1 and pASIC 2 products have either purchased sufficient quantities to satisfy their demand throughout the expected life of their products or have converted their designs to our other products, such as pASIC 3 which is pin compatible with pASIC 2. We currently expect that these products will not contribute significant revenue after the fourth quarter of 2006. Our operating results and liquidity have been adversely affected by the end-of-life of our pASIC 1 and pASIC 2 products as we are currently operating at a net loss and expect negative cash flow at our current revenue level. To mitigate the affects of the end-of-life of our pASIC 1 and pASIC 2 products, we plan to develop customer demand for new products, such as PolarPro, Eclipse II and QuickPCI II, which have active customer designs but limited revenue history. The pASIC 1 and pASIC 2 revenue decline has been more rapid than the revenue growth from our PolarPro, Eclipse II, QuickPCI II and other products. While we expect revenue growth from PolarPro, Eclipse II, QuickPCI II, other products and new products will offset the decline in pASIC 1 and pASIC 2 revenue, there is no assurance when this will occur, if at all.

We depend upon third parties to fabricate, assemble, test and program our products, and they may discontinue manufacturing our products, fail to give our products priority, be unable to successfully manufacture our products to meet performance, volume or cost targets, or inaccurately report inventory to us

We contract with third parties to fabricate, assemble, test and program our devices. Our devices are generally fabricated, assembled and programmed by single suppliers, and the loss of a supplier, transfer of manufacturing to a new location, expiration of a supply agreement or the inability of our suppliers to manufacture our products to meet volume, performance and cost targets could have a material adverse effect on our business. Tower solely manufactures our Eclipse II, PolarPro, certain QuickPCI II, QuickMIPS and other new products currently under development. Furthermore, a single supplier fabricates our pASIC 1 and pASIC 2 products under an agreement that expired in December 2005. While we purchased limited quantities of pASIC 1 and pASIC 2 wafers in 2006, this supplier has since taken the equipment used to fabricate these products out of service. These products contributed 44% of 2005 revenue and we anticipate that these products will generate no significant revenue after 2006. In addition, demand for assembly capacity at one of our suppliers has increased. For this and other reasons, capacity available to us may be constrained. Identifying and qualifying an additional assembly supplier is a time consuming and costly process and may require volume commitments that we may not be unwilling or unable to make. Programming capacity at our suppliers is also dependent on our investment in sufficient programming hardware to meet fluctuating demand. Our relationship with our suppliers could change as a result of a merger or acquisition. If for any reason these suppliers or any other vendor becomes unable or unwilling to continue to provide services of acceptable quality, at acceptable costs and in a timely manner, our ability to operate our business or deliver our

45

products to our customers could be severely impaired. We would have to identify and qualify substitute suppliers, which could be time consuming, difficult and result in unforeseen operational problems, or we could announce an end-of-life program for these products, as we did with our pASIC 1 and pASIC 2 products. Alternate suppliers might not be available to fabricate, assemble, test and program our devices or, if available, might be unwilling or unable to offer services on acceptable terms.

In addition, if competition for wafer manufacturing capacity increases, if we need to migrate to more advanced wafer manufacturing technology, or if competition for assembly services increases, we may be required to pay or invest significant amounts to secure access to this capacity. For example, in the second quarter of 2006, we entered into an agreement with Amkor to secure assembly capacity that required a payment of \$1.0 million that is refundable if we meet certain volume commitments. The number of companies that provide these services is limited and some of them have limited operating histories and financial resources. In the event our current suppliers refuse or are unable to continue to provide these services to us, we may be unable to procure services from alternate suppliers in a timely manner, if at all. Furthermore, if customer demand for our products increases, we may be unable to secure sufficient additional capacity from our current suppliers on commercially reasonable terms, if at all. Moreover, our reliance on a limited number of suppliers subjects us to reduced control over delivery schedules, quality assurance and costs. This lack of control may cause unforeseen product shortages or may increase our cost to manufacture and test our products, which would adversely affect our operating results and cash flows.

We record a majority of our inventory transactions based on information from our subcontractors. If we do not receive prompt and accurate information from our vendors, we could misstate inventory levels, incorrectly record gross profit, be unable to meet our delivery commitments to customers or commit to manufacturing inventory that is not required to meet customer delivery commitments, which could materially harm our business.

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

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 cancel or change their product plans. In addition, customers may discontinue products incorporating our devices at any time or they may choose to replace our products with lower cost semiconductors. If customers cancel, reduce or delay product orders from us or choose not to release products that incorporate our devices after we have spent substantial time and resources in assisting them with their product design, our revenue levels may be less than anticipated and our business could be materially harmed.

We are expending substantial time and effort to develop solutions with partners that depend on the availability and success of technology owned by the partner

Our approach to developing system solutions for potential customers involves embedded processors developed by companies such as Marvell Semiconductor, Inc., who purchased the XScale business unit from Intel, and Analog Devices, Inc., peripheral devices developed by other parties such as micro hard disk drives, WI-FI devices and NAND flash memory and specific industry standards such as PCI, IDE and Secure Digital Input/Output, or SDIO. We have entered into informal partnerships with these other parties that involve the development of solutions that interface with their devices or standards. These informal partnerships also may involve joint marketing campaigns and sales calls. For example, we have developed a system solution incorporating a specific embedded processor, a micro hard disk drive and our Eclipse II device that lowers the overall power consumption of a system and improves system performance. Recently, one of our partners announced the sale of their embedded processor business to another company, and we are focused on building a relationship with the new owner. If our solution is not incorporated into customer products, if our partners discontinue production of or incorporate our solution into their product offerings, or if the informal partnerships are significantly reduced or terminated, our revenue and gross margin will be materially harmed and we may be required to write-off related long-lived assets.

We have significant customers and limited visibility into the long-term demand for our products from these customers

A few end customers can represent a significant portion of our total revenue in a given reporting period and the likelihood of this occurring will increase in the future as we target high-volume consumer applications. As in the past, future demand from these customers may fluctuate significantly. These customers typically order products with short requested delivery lead times, and do not provide 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 these customers, and we make significant inventory purchases and capital expenditures in anticipation of future demand. For example, a domestic manufacturer of instrumentation and test equipment accounted for 13% of revenue in fiscal 2005 and a European telecommunications OEM customer, purchasing product through their contract manufacturer, represented 19% of revenue in the second quarter of 2006. If revenue from any significant customer were to decline substantially, we may be unable to offset this decline with increased revenue from other customers and we may purchase excess inventory. These factors could severely harm our business.

In addition, we may make a significant investment in long-lived assets for the production of our products based upon historical and expected demand. If demand for or gross margin generated from our products does not meet our expectations or if we are unable to collect amounts due from significant customers, we may be required to write-off inventory, provide for uncollectible accounts receivable or incur charges against long-lived assets, which would materially harm our business.

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

Our cash and cash equivalents balance at June 30, 2006 was \$30.2 million. At June 30, 2006, our interest-bearing debt consisted of \$1.7 million outstanding from Silicon Valley Bank and \$1.8 million outstanding under capital leases. On June 30, 2006, we amended and restated our credit facility with Silicon Valley Bank. Terms of the agreement include a \$5.0 million revolving line of credit available through June 2008 and \$2.0 million of borrowing capacity under the equipment line of credit that is available to be drawn through June 2007. At June 30, 2006, we had approximately \$5.0 million available to borrow under our revolving credit facility and approximately \$2.0 million available to borrow under our equipment line of credit. In September 2006, we borrowed \$1.6 million under our equipment line of credit.

At the end of the second quarter of 2006, we held 1,344,543 Tower ordinary shares available for sale valued at approximately \$1.9 million based upon the market closing price of \$1.40 per share on such date. Our ability to obtain competitive pricing from Tower is tied to our ownership of at least 450,000 of these Tower shares.

Capital expenditures, which are largely driven by development activities and the introduction and initial manufacturing of new products, could be up to \$5.5 million in the next twelve months. As of June 30, 2006, we had commitments to purchase \$5.1 million of wafer inventory.

On July 12, 2005, we filed a shelf registration statement on Form S-3 with the SEC, which has been declared effective. Under this filing, we may decide to raise up to \$30.0 million, in one or several transactions, by selling common stock, preferred stock, depository shares, or warrants.

As a result of potential investments, the reduction in revenue from our pASIC 1 and pASIC 2 products, operating expenses, changes in working capital and interest and debt payments, we will need to generate significantly higher revenue and gross profit, especially from our new Eclipse II, QuickPCI II and PolarPro products and products currently under development, to generate positive cash flow. In addition, these new products have been generating lower gross margin as a percentage of revenue than the rest of our historical business due to the markets that we have targeted and the larger order quantities required to meet customer demand. Whether we can achieve cash flow levels sufficient to support our operations 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 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 competent personnel. Our employees are at-will and not subject to employment contracts. Hiring and retaining qualified sales, technical and financial personnel is difficult due to the limited number of qualified professionals, economic conditions and the size of our company. 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, finance and technical personnel. Failure to attract, hire, train and retain personnel could materially harm our business.

Our future results depend on our relationship with Tower

We have invested approximately \$21.3 million in Tower. In return for our investment, we received equity, prepaid wafer credits, favorable wafer pricing, and committed production capacity in Tower's foundry facility. We believe that Tower's long-term operation of this fabrication facility depends on its ability to attract sufficient customer demand, to obtain additional financing, to increase capacity, to obtain the release of grants and approvals for changes in grant programs from the Israeli government's Investment Center, and its ability to remain in compliance with the terms of its grant and credit agreements. The current political uncertainty and security situation in the Middle East where Tower's fabrication facility is located, the cyclical nature of the market for foundry manufacturing services, Tower's financial condition, or other factors may adversely impact Tower's business prospects and may discourage future investments in Tower from outside sources. If Tower is unable to obtain adequate financing and increase production output in a timely manner, the value of our investment in Tower may decline significantly or possibly become worthless, our wafer credit from Tower may decline in value or possibly become worthless, and we would have to identify and qualify a substitute supplier to manufacture our products. This could require significant development time, cause product shipment delays, impair long-lived assets and the value of our wafer credits, damage our liquidity and severely harm our business. In addition, Tower is the sole manufacturer of our Eclipse II, PolarPro, certain QuickPCI II, QuickMIPS and other new products currently under development.

The value of our investment in Tower and its corresponding wafer credits may also be adversely affected by a deterioration of conditions in the market for foundry manufacturing services and the market for semiconductor products. At June 30, 2006, the aggregated value of our Tower investment and wafer credits recorded on our balance sheets was \$6.1 million. If the fair value of our Tower investment or our wafer credits are deemed to be impaired, we will record charges to our statement of operations. For instance, the fair value of our Tower investment was \$2.26 per share at the end of 2004 as compared to \$1.17 per share at the end of the second quarter of 2005. Since the value of our Tower investment remained below \$2.26 per share for a period of time, we recorded a \$1.5 million write-down of marketable securities in the second quarter of 2005.

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

Our agreements with certain third-party manufacturers require us to provide forecasts of our anticipated manufacturing orders, and place binding manufacturing commitments in advance of receiving purchase orders from our customers. We are limited in our ability to

increase or decrease our forecasts under such agreements. Other manufacturers supply us product on a purchase order basis. The allocation of capacity is determined solely by our suppliers over which we have no direct control. Additionally, we may place orders on our vendors in advance of customer orders to allow us to quickly respond to changing customer demand or to obtain favorable product pricing. Furthermore, we provide our suppliers with equipment which is used to program our products to customer specifications. The programming equipment is manufactured to our specifications and has significant order lead-times. These factors may result in product shortages or excess product inventory. Obtaining additional supply in the face of product, programming equipment or capacity shortages may be costly, or not possible, especially in the short term since most of our products and programming equipment are supplied by a single vendor. Our failure to adequately forecast demand for our products could materially harm our business.

Fluctuations in our manufacturing processes, yields and quality, especially for new products, may increase our costs

Difficulties encountered during the complex semiconductor manufacturing process can render a substantial percentage of semiconductor devices nonfunctional. New manufacturing techniques or manufacturing fluctuations may change the performance distribution and yield of our products. We have, in the past, experienced manufacturing runs that have contained substantially reduced or no functioning devices, or that generated devices with below normal performance characteristics. In addition, manufacturing 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. Once corrected, our customers may be required to redesign or requalify their products. As a result, we may incur substantially higher manufacturing costs, inventory shortages or reduced customer demand.

Yield fluctuations frequently occur in connection with the manufacture of newly introduced products, with changes in product architecture, with manufacturing at new facilities, on new fabrication processes or in conjunction with new backend manufacturing processes. Newly introduced products and products that incorporate new intellectual property, such as our Eclipse II and PolarPro 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 achieve expected quality levels and manufacturing efficiencies. While we test our products, including our software development tools, they may still contain errors or defects that are found after we have commenced commercial production, that occur due to manufacturing variations or that are identified as new intellectual property is incorporated into our products. If our products contain undetected or unresolved defects, we may lose market share, experience delays in or loss of market acceptance, reserve or scrap inventory, or be required to issue a product recall. In addition, we would be at risk of product liability litigation if defects in our products were discovered. 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.

We have a history of losses and cannot assure you that we will again be profitable in the future

We incurred significant losses in 2004, 2003 and 2002. Our accumulated deficit as of June 30, 2006 was \$121.2 million. Although we recorded net income of \$2.4 million for the year ended December 31, 2005, we recorded a net loss of \$2.9 million in the first half of 2006 and we may not return to profitability in any future periods. Our profitability for the year ended December 31, 2005 cannot be relied upon as any indication of our future operating results or prospects.

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. We typically have only a few distributors serving each geographic market, and, in the future, we may have a single distributor covering a geographic market. Although we have contracts with our distributors, our agreements with them may be terminated on short notice by either party and, if terminated, we may be unable to recruit additional or replacement distributors. Additionally, distributors that we have contracted with may acquire, be acquired or merge with other distributors which may result in the termination of our contract or less effort being placed on the marketing, sale and support of our products. As a result, our future performance will depend in part on our ability to retain our existing distributors and to attract new distributors that will be able to effectively market, sell and support our products. The loss of one or more of our principal distributors, or our inability to attract new distributors, could materially harm our business.

Many of our distributors, including our principal distributors, market and sell products for other companies. Many of these products may compete directly or indirectly with our products. Also, 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 original equipment manufacturers 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 past operating results may not be an indicator of future operating results. 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:

- the effect of end-of-life programs;
- a significant change in sales to, or the collectibility of accounts receivable from, our largest customers;
- successful development and market acceptance of our products and solutions;
- our ability to accurately forecast product volumes and mix, and to respond to rapid changes in customer demand;
- changes in sales volume, product mix, average selling prices or production variances that affect gross profit;
- our ability to adjust our product features, manufacturing capacity and 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;
- timely implementation of efficient manufacturing technologies;
- changes in or errors in applying accounting and corporate governance rules;
- the issuance of stock options, or changes in the terms of our employee stock purchase plan;
- mergers or acquisitions;
- impact of import and export laws and regulations;
- 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, our business may be materially harmed.

We may encounter periods of industry-wide semiconductor oversupply, resulting in pricing pressure, 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 of and demand for semiconductors have been widely out of balance. An industry-wide semiconductor oversupply could result in severe downward pricing pressure from customers. In a market with undersupply of manufacturing capacity, we would have to compete with larger foundry and assembly customers for limited manufacturing resources. In such an environment, we may be unable to have our products manufactured in a timely manner, at a cost that generates adequate gross profit, or in sufficient quantities. Since we outsource all of our manufacturing and generally have a

single-source of wafer supply, test, assembly and programming for our products, we are particularly vulnerable to such supply shortages and capacity limitations. 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.

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. Contractually, our distributors are generally permitted to return unprogrammed products worth up to 10%, by value, of the products they purchase from us. If our distributors or customers cancel or defer significant purchase orders or return our products, our accounts receivable collections would decrease and inventories would increase, which would materially harm our business.

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 our new products and the products

that we currently have under development in Israel and to assemble these products in South Korea, the Philippines, Malaysia, or China. As a result, these 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, between South Korea and North 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 revenue in future periods. In addition, most of our domestic customers sell their products outside of North America, thereby indirectly exposing us to risks associated with foreign commerce and economic instability. In addition to overseas sales offices, we have significant research and development activities in Canada and India. Accordingly, our operations and revenue are subject to a number of risks associated with foreign commerce, including the following:

- managing foreign distributors;
- collecting amounts due;
- staffing and managing foreign offices;
- political and economic instability;
- foreign currency exchange fluctuations;
- changes in tax laws, import and export regulations, tariffs and freight rates;
- timing and availability of export licenses;
- supplying products that meet local environmental regulations; and
- inadequate protection of intellectual property rights.

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 their local currency. As a result, sales of our products in that foreign country may decline. To the extent any such risks materialize, our business could be materially harmed.

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

Many system 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 system 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 purchased for a lower price at 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 Freescale Semiconductor, 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 advanced manufacturing technologies;
- the quality, power characteristics, performance characteristics, price and availability of devices, programming hardware and software development tools;
- the ability to engage with companies that provide synergistic products and services;
- the incorporation of industry standards in our products;
- the diversity of product offerings available to customers; or
- the quality and cost effectiveness of design, development, manufacturing and marketing efforts.

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 requests 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 are currently 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. Additionally, matters that we initially consider not material to our business could become costly. 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.

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, our business could be materially harmed.

Because it is critical to our success that we continue 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 other third parties. However, these parties 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 the laws of the United States.

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

We have entered into and, in the future, intend to enter into agreements that have involved numerous risks, including the use of significant amounts of our cash; diversion of resources from other development projects or market opportunities; our ability to incorporate licensed technology in our products and solutions; our ability to introduce related products in a cost-effective and timely manner; our ability to collect amounts due under these contracts; 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 third-party companies. In the fourth quarter of 2004, we determined that the expected revenue and gross profit from these products would not be sufficient to recover the full carrying value of the related third party elements and other long-lived assets, and we recorded a \$3.2 million long-lived asset impairment charge. If we fail to recover the cost of these or other assets from the cash flow generated by the related products, our assets will become impaired and our financial results would be harmed.

Our business is subject to the risks of earthquakes, other catastrophic events and business interruptions for which we may maintain limited insurance

Our operations and the operations of our suppliers are vulnerable to interruption by fire, earthquake, power loss, flood, terrorist acts and other catastrophic events beyond our control. In particular, our headquarters is located near earthquake fault lines in the San Francisco Bay area. In addition, we rely on sole suppliers to manufacture our products and would not be able to qualify an alternate

supplier of our products for several quarters. Our suppliers often hold significant quantities of our inventory which, in the event of a disaster, could be destroyed. In addition, our business processes and systems are vulnerable to computer viruses, break-ins, and similar disruptions from unauthorized tampering. Any catastrophic event, such as an earthquake or other natural disaster, the failure of our computer systems, war or acts of terrorism, could significantly impair our ability to maintain our records, pay our suppliers, or design, manufacture or ship our products. The occurrence of any of these events could also affect our customers, distributors and suppliers and produce similar disruptive effects upon their business. If there is an earthquake or other catastrophic event near our headquarters, our customers' facilities, our distributors' facilities or our suppliers' facilities, our business could be seriously harmed.

We do not have a detailed disaster recovery plan. In addition, we do not maintain sufficient business interruption and other insurance policies to compensate us for all losses that may occur. Any losses or damages incurred by us as a result of a catastrophic event or any other significant uninsured loss could have a material adverse effect on our business.

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

Our officers, directors and principal stockholders together control a significant portion of our outstanding common stock. As a result, these stockholders, if they act together, will be able to significantly influence our operations, affairs 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 that is beneficial to stockholders

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.

The market price of our common stock may fluctuate significantly and could lead to securities litigation

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.

Changes to existing accounting pronouncements or taxation rules or practices may cause adverse revenue fluctuations, affect our reported results of operations or how we conduct our business

Generally Accepted Accounting Principles, or GAAP, are promulgated by, and are subject to the interpretation of the Financial Accounting Standards Board, or FASB, and the Securities and Exchange Commission, or SEC. New accounting pronouncements or taxation rules and varying interpretations of accounting pronouncements or taxation practice have occurred and may occur in the future. Any future changes in accounting pronouncements or taxation rules or practices may have a significant effect on how we report our results and may even affect our reporting of transactions completed before the change is effective. In addition, a review of existing or prior accounting practices may result in a change in previously reported amounts. This change to existing rules, future changes, if any, or the questioning of current practices may adversely affect our reported financial results, our ability to remain listed on the NASDAQ Global Market, or the way we conduct our business and subject us to regulatory inquiries or litigations.

For example, FASB has issued SFAS No. 123(R), "Share-Based Payment," which we adopted in the first quarter of 2006. SFAS No. 123(R) requires us to measure compensation costs for all stock-based compensation awards (including our stock options and our employee stock purchase plan, as currently constructed) at fair value and record compensation expense over the vesting period. If this accounting pronouncement had been in effect during fiscal 2005, we estimate that we would have reported a net loss.

Additionally, in July 2006 we initiated a review of our historical stock option practices and related accounting. This review identified accounting and administrative errors that, if they had been recorded at the time they occurred, would have resulted in total additional charges of approximately \$964,000 between October 1999 and December 2005.

Compliance with changing regulations related to corporate governance and public disclosure may result in additional expenses

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and the Nasdaq National Market rules, are creating uncertainty for companies such as ours. These new or changed laws, regulations and standards are subject to varying interpretations in many cases due to their lack of specificity and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in

continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we intend to invest resources to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from profit-generating activities. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed and the market price of our common stock could be affected.

While we believe that we currently have adequate internal control procedures in place, we are still exposed to potential risks from legislation requiring companies to evaluate controls under Section 404 of the Sarbanes-Oxley Act of 2002

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

As of December 2005, we have evaluated our internal control systems in order to allow management to report on, and our independent registered public accounting firm to attest to, our internal controls over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. As a result of our internal review of stock option granting practices and related accounting, we have identified and are implementing enhanced controls and process improvements in connection with the issuance of equity awards. However, our internal review has not identified any weaknesses in our existing internal control systems. We performed the system and process evaluation and testing required in an effort to comply with the management certification and independent registered public accounting firm attestation requirements of Section 404. As a result, we incurred additional expenses and a diversion of management's time. While we believe that our internal control procedures are adequate and we intend to continue to fully comply with the requirements relating to internal control and all other aspects of Section 404, our controls necessary for continued compliance with the Act may not operate effectively at all times and may result in a material control disclosure. The identification of a material weakness in internal controls over financial reporting, if any, could indicate a lack of proper controls to generate accurate consolidated financial statements. Furthermore, we cannot be certain as to the outcome of future evaluations, testing and remediation actions or the impact of the same on our operations. If we are not able to remain in compliance with the requirements of Section 404, we might be subject to sanctions or investigation by regulatory authorities, such as the SEC or the Nasdaq National Market. Any such action could adversely affect our financial results and the market price of our common stock.

We have implemented import and export control procedures to comply with United States regulations but we are still exposed to potential risks from import and export activity

Our products, technology and software are subject to import and export control laws and regulations which, in some instances, may impose restrictions on business activities, or otherwise require licenses or other authorizations from agencies such as the U.S. Department of State, U.S. Department of Commerce and U.S. Department of the Treasury. These restrictions may impact deliveries to customers or limit development and manufacturing alternatives. We have import and export licensing and compliance procedures in place for purposes

of conducting our business consistent with U.S. and applicable international laws and regulations, and we periodically review these procedures to maintain compliance with the requirements relating to import and export regulations. If we are not able to remain in compliance with import and export regulations, we might be subject to investigation, sanctions or penalties by regulatory authorities. Such penalties can include civil, criminal or administrative remedies such as loss of export privileges. We cannot be certain as to the outcome of an evaluation, investigation, inquiry or other action or the impact of these items on our operations. Any such action could adversely affect our financial results and the market price of our common stock.

As a result of our internal stock option review, the SEC has opened an informal inquiry into our stock option granting practices and related accounting that may not be resolved favorably and may require a significant amount of management time and attention and accounting and legal resources, which could adversely affect our business, results of operations, and cash flows

The SEC has opened an informal inquiry into our historical stock option practices and related accounting. The period of time necessary to resolve the SEC inquiry is uncertain and could require significant management and financial resources that could otherwise be devoted to the operation of our business. In addition, considerable legal and accounting expenses related to these matters may be incurred in the future. We cannot predict the outcome of the SEC inquiry. If we or any of our current or former officers or directors is subject to an adverse finding resulting from the SEC inquiry, we could be required to pay damages or penalties or have other remedies imposed upon us which could adversely affect our business, results of operations, financial position, cash flows and the trading price of our securities. In addition, if the inquiry continues for a prolonged period of time, this could have the same effects, regardless of the outcome.

If we do not maintain compliance with the listing requirements of the NASDAQ Global Market, our common stock could be delisted, which could, among other things, reduce the price of our common stock and the levels of liquidity available to our stockholders

In connection with the internal review of our stock option grants and related accounting, we were delinquent in filing certain of our periodic reports with the SEC, and consequently we were not in compliance with the listing requirements under the NASDAQ Global

Market's Marketplace Rules. As a result, we requested and participated in a hearing with the Nasdaq to determine our listing status. The Nasdaq ultimately permitted our securities to remain listed provided that the filing of our consolidated financial statements is current within a specified time frame. However, our securities could be delisted in the future if we do not file our consolidated financial statements in an acceptable time frame or if we do not maintain compliance with other applicable listing requirements. If our securities were delisted from the NASDAQ Global Market, they would subsequently be transferred to the National Quotation Service Bureau, or "Pink Sheets." The trading of our common stock on the Pink Sheets may reduce the price of our common stock and the levels of liquidity available to our stockholders. In addition, the trading of our common stock on the Pink Sheets will materially adversely affect our access to capital markets and our ability to raise capital through alternative financing sources on terms acceptable to us, or at all. Securities that trade on the Pink Sheets are no longer eligible for margin loans, and a company trading on the Pink Sheets cannot avail itself of federal preemption of state securities, or "blue sky," laws, which adds substantial compliance costs to securities issuances, including shares issued pursuant to employee option plans, stock purchase plans and private or public offerings of securities. If we are delisted in the future from the NASDAQ Global Market and transferred to the Pink Sheets, there may also be other negative implications, including the potential loss of confidence by suppliers, customers and employees and the loss of institutional investor interest in our company.

Our directors and management have been named parties to two lawsuits related to our historical stock option practices and related accounting, and we may be named in additional litigation in the future, all of which could result in an unfavorable outcome and have a material adverse effect on our business, financial condition, results of operations, cash flows and the trading price for our securities

Two lawsuits have been filed against the Company, our current directors and officers and certain of our former directors and officers relating to our historical stock option practices and related accounting. See Part I, Item 1, Note 17 "Subsequent Events" for a more detailed description of these proceedings. We may become the subject of additional private or government actions regarding these matters in the future. These actions are in the preliminary stages, and their ultimate outcome could have a material adverse effect on our business, financial condition, results of operations, cash flows and the trading price for our securities. Litigation may be time-consuming, expensive and disruptive to normal business operations, and the outcome of litigation is difficult to predict. The defense of these lawsuits will result in significant expenditures and the continued diversion of our management's time and attention from the operation of our business, which could impede our business. All or a portion of any amount we may be required to pay to satisfy a judgment or settlement, of any or all of these claims, if any, may not be covered by insurance.

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

The Annual Meeting of Stockholders of QuickLogic was held on April 25, 2006. The following matters were voted upon at the meeting:

- (i) The following nominee was elected to hold office as a Class I director until 2009:

<u>Nominee</u>	<u>Votes For</u>	<u>Votes Withheld</u>
Michael J. Callahan	24,261,170	9,342

Arturo Krueger, E. Thomas Hart and Christine Russell will continue to serve as directors. Additionally on May 26, 2006, the Board of Directors, upon recommendation by the Nominating and Corporate Governance Committee, appointed Nicholas Aretakis to serve as a director of the Company.

- (ii) The ratification of PricewaterhouseCoopers LLP as the independent registered public accounting firm of QuickLogic for the fiscal year ending December 31, 2006.

Votes For	24,262,817
Votes Against	1,835
Abstentions	5,860

Item 6. Exhibits

a. Exhibits

The following Exhibits are filed with this report:

<u>Exhibit Number</u>	<u>Description</u>
3.1(1)	Amended and Restated Certificate of Incorporation of Registrant.
3.2(2)	Bylaws of Registrant.
10.1	Second Amended and Restated Loan and Security Agreement between Silicon Valley Bank and the registrant effective June 30, 2006.
31.1	CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 31.2 CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32 CEO and CFO Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

-
- (1) Incorporated by reference to the Company's Registration Statement on Form S-1 declared effective October 14, 1999 (Commission File No. 333-28833).
(2) Incorporated by reference to the Company's Current Report on Form 8-K (Item 5.03) filed May 2, 2005.

58

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

Date: December 22, 2006

/s/ CARL M. MILLS
Carl M. Mills
Vice President, Finance and Chief Financial Officer
(as Principal Accounting and Financial Officer and on behalf of Registrant)

59

EXHIBIT INDEX

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60

SECOND AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT

between

SILICON VALLEY BANK

and

QUICKLOGIC CORPORATION

June 30, 2006

TABLE OF CONTENTS

		<u>Page</u>
1.	ACCOUNTING AND OTHER TERMS	1
2.	LOAN AND TERMS OF PAYMENT	2
3.	CONDITIONS OF LOANS	5
4.	CREATION OF SECURITY INTEREST	6
5.	REPRESENTATIONS AND WARRANTIES	6
6.	AFFIRMATIVE COVENANTS	9
7.	NEGATIVE COVENANTS	11
8.	EVENTS OF DEFAULT	13
9.	BANK'S RIGHTS AND REMEDIES	15
10.	NOTICES	17
11.	CHOICE OF LAW, VENUE, JURY TRIAL WAIVER AND JUDICIAL REFERENCE	17
12.	GENERAL PROVISIONS	18
13.	DEFINITIONS	20

This SECOND AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT (the "Agreement") dated June 30, 2006, 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

A. Borrower and Bank have previously entered into that certain Loan and Security Agreement dated as of June 28, 2002, as amended and restated by that certain Amended and Restated Loan and Security Agreement dated June 20, 2003, and as further amended by that certain Loan Modification Agreement dated as of June 28, 2004, and as further amended by that certain Loan Modification Agreement dated as of June 27, 2005 (collectively, the "Original Agreement").

B. Borrower and Bank desire to amend and restate the Original Agreement, as modified, as set forth herein.

C. Immediately prior to the amendment and restatement of the Original Agreement in accordance with the terms and conditions hereof, certain loans and advances remain outstanding under the Original Agreement, as modified (collectively, the "Outstanding Debt").

D. In connection with the Outstanding Debt, Bank made equipment advances in the amount of \$4,500,000, of which (i) \$148,928.62 is currently outstanding as of the Closing Date for the equipment line "B" advances; (ii) \$648,279.25 is currently outstanding as of the Closing Date for the equipment line "C" advances; and (iii) \$877,303.26 is outstanding as of the Closing Date for the equipment line "D" advances (collectively, the "Outstanding Equipment Advances"). The Outstanding Equipment Advances are payable in accordance with the terms and amortization schedules currently governing such Outstanding Equipment Advances, and no other advances thereunder may be made.

E. It is not the intention of the Bank or the Borrower that this Agreement constitute a novation of the indebtedness governed by the Original Agreement, as modified, and from and after the effective date of this Agreement, the Outstanding Debt and the Outstanding Equipment Advances shall remain owing to Bank on terms set forth under the Original Agreement, as modified, and the Original Agreement shall be further amended and restated in accordance with the terms and provisions hereof.

NOW, THEREFORE, Borrower and Bank hereby agree 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.

1

2. LOAN AND TERMS OF PAYMENT.

2.1 Promise to Pay.

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 Non-Formula Revolving Advances.

(a) Availability. Subject to the terms and conditions of this Agreement, Bank will make Advances on a non-formula basis (the "Non-Formula Advances") in an aggregate amount not to exceed the amount calculated as the Committed Non-Formula Revolving Line minus the sum of: (x) FX Reserve, plus, (y) the aggregate amounts deemed outstanding under the sublimit described in Section 2.1.5, plus, (z) the amount of all outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit). Amounts borrowed under this Section may be repaid and reborrowed during the term of this Agreement.

(b) Termination. The Committed Non-Formula Revolving Line terminates 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 Availability ("Letters of Credit").

(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 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 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 Prepayment.

Borrower may prepay any or all amounts owing under the Committed Non-Formula Revolving Line, without penalty or premium, by paying all principal and accrued interest as of the date of prepayment.

2.1.7 Equipment Advances.

(a) Availability. Between the effective date of this Agreement and June 28, 2007 (the “Equipment Availability End Date”), Bank will make advances (“Equipment Advance” and, collectively, “Equipment Advances”) not to exceed the Committed Equipment Line. The Equipment Advances may only be used to finance the acquisition of Eligible Equipment. Lender shall advance to Borrower 100% of the documented cost of Eligible Equipment. Unless otherwise agreed to by Bank, not more than 75% of the Committed Equipment Line may be used to finance Eligible Equipment comprised of software licenses, mask sets, foreign domiciled equipment, leasehold improvements, sales tax, shipping, warranty charges, freight, and installation expenses (“Soft Costs”). Unless otherwise agreed to by Bank, not less than 25% of the proceeds of the Committed Equipment Line shall be used to finance Eligible Equipment other than Soft Costs (“Hard Costs”). Eligible Equipment may include new and/or used equipment and furniture, purchased within 90 days (determined based upon the applicable invoice date of such Eligible Equipment) before the date of each Equipment Advance and may not exceed 100% of the Equipment invoice. Each Equipment Advance must be for a minimum of \$50,000 and only one Equipment Advance per month shall be available.

(b) Repayment. Interest accrues from the date of each Equipment Advance at the rate in Section 2.3(a). Each Equipment Advance for Soft Costs shall immediately amortize and be payable in 30 equal monthly installments of principal, plus accrued interest, beginning on the first day of each month following the date of the Equipment Advance of such Soft Costs. Each Equipment Advance for Hard Costs shall immediately amortize and be 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 for such Hard Costs. After repayment, no Equipment Advance may 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.

(d) Prepayment. Borrower may prepay any or all amounts owing under any Equipment Advance; provided that prepayments for any Fixed Rate Advances after the Closing Date are subject to a prepayment fee of 1% of the aggregate amount of principal outstanding on any such Equipment Advance.

(e) Prepayment Upon an Event of Loss. Borrower shall bear the risk of any loss, theft, destruction, or damage of or to the Financed Equipment. If, during the term of this Agreement, any item of Financed Equipment becomes obsolete or is lost, stolen, destroyed, damaged beyond repair, rendered permanently unfit for use, or seized by a governmental authority for any reason for a period equal to at least the remainder of the term of this Agreement (an “Event of Loss”), then, if no Event of Default has occurred or is continuing, within ten (10) days following such Event of Loss, at Borrower’s option, Borrower shall (i) pay to Bank on account of the Obligations all accrued interest to the date of the prepayment, plus all outstanding principal owing with respect to the Financed Equipment subject to the Event of Loss; or (ii) repair or replace any Financed Equipment subject to an Event of Loss provided the repaired or replaced Financed Equipment is of equal or like value to the Financed Equipment subject to an Event of Loss and provided further that Bank has a first priority perfected security interest in such repaired or replaced Financed Equipment.

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 the Committed Non-Formula

Revolving Line, Borrower must immediately pay Bank the excess.

2.3 Interest Rate, Payments.

(a) Interest Rate.

(i) Non-Formula Advances accrue interest on the outstanding principal balance at a per annum rate equal to the greater of (A) 50 basis points (.5%) above the Prime Rate or (B) 8.5%.

(ii) Equipment Advances after the Closing Date accrue interest on the outstanding principal balance at (y) a per annum rate of 100 basis points (1.00%) above the Prime Rate or (z) a fixed rate equal to 400 basis points (4%) above the Treasury Rate. After an Event of Default, Obligations accrue interest at 5% 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.

4

(b) Payments. Interest due on 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) Revolving Line of Credit Fee. On or before the Closing Date, a Committed Non-Formula Revolving Line fee equal to \$25,000 due, payable and fully earned on the Closing Date; and on the one year anniversary of the Closing Date, a fee equal to \$17,500 due, payable and fully earned on the such date.

(c) Equipment Line Fee. On or before the Closing Date, an equipment line fee (the "Equipment Line Fee") equal to \$5,000 due, payable and fully earned on the Closing Date; provided that the Equipment Line Fee shall be waived if 50% of the Committed Equipment Line is drawn 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, in form and substance satisfactory to Bank, such documents, and completion of such other matters, as Bank may reasonably deem necessary or appropriate, including, without limitation:

(a) Borrower shall have delivered duly executed original signatures to the Loan Documents to which it is a party;

(b) Borrower shall have delivered its Operating Documents and a good standing certificate of Borrower certified by the Secretary of State of the State of California as of a date no later than thirty (30) days after the effective date of this Agreement, unless waived by Bank; and

(c) Borrower shall have delivered duly executed original signatures to the completed Borrowing Resolutions for Borrower.

5

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.

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 Tax Returns and Payments; Pension Contributions.

To the best of Borrower's knowledge, Borrower has timely filed all required tax returns and reports, and Borrower has timely paid all federal, state and local taxes, assessments, deposits and contributions owed by Borrower. Borrower may defer payment of any contested taxes, provided that Borrower (a) in good faith contests its obligation to pay the taxes by appropriate proceedings promptly and diligently instituted and conducted, (b) notifies Bank in writing of the commencement of, and any material development in, the proceedings, (c) posts bonds or takes any other steps required to prevent the governmental authority levying such contested taxes from obtaining a Lien upon any of the Collateral that is other than a "Permitted Lien". Borrower is unaware of any claims or adjustments proposed for any of Borrower's prior tax years which could result in additional taxes becoming due and payable by Borrower. To the best of Borrower's knowledge, Borrower has paid all amounts necessary to fund all present pension, profit sharing and deferred compensation plans in accordance with their terms, and Borrower has not withdrawn from participation in, and has not permitted partial or complete termination of, or permitted the occurrence of any other event with respect to, any such plan which could reasonably be expected to result in any liability of Borrower, including any liability to the Pension Benefit Guaranty Corporation or its successors or any other governmental agency.

5.9 Use of Proceeds.

Borrower shall use the proceeds of the Credit Extensions to fund its equipment purchases and for general corporate purposes, and not for personal, family, household or agricultural purposes.

5.10 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) 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 Access to Collateral; Books and Records.

At reasonable times, on one Business Day's notice (provided no notice is required if an Event of Default has occurred and is continuing), Bank, or its agents, shall have the right, upon one week's notice to Borrower, to inspect the Collateral and the right to audit and copy Borrower's Books.

6.6 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.

6.7 Deposit and Investment Accounts.

Borrower will maintain 60% 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.

6.8 Financial Covenants.

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

(i) **Tangible Net Worth.** A Tangible Net Worth of at least \$31,000,000.

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

1.55 to 1.00.

6.9 Protection of Intellectual Property Right.

Borrower shall: (a) protect, defend and maintain the validity and enforceability of its material intellectual property; (b) promptly advise Bank in writing of material infringements of its intellectual property; and (c) not allow any intellectual property material to Borrower's business to be abandoned, forfeited or dedicated to the public without Bank's written consent. Notwithstanding anything to the contrary contained in this section, Borrower confirms that on June 28, 2004, Bank and Borrower entered into (i) a Negative Pledge Agreement in which Borrower agreed, subject to certain exceptions, not to encumber its Intellectual Property and (ii) a Loan Modification Agreement dated June 28, 2004 in which the definition of Collateral was amended to reflect that Intellectual Property created, modified acquired or obtained on or after June 28, 2004 (but not before such date) shall not be deemed as part of the Collateral.

6.10 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.

6.11 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 and Equipment 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, including guaranties of non-Borrower obligations, 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, or (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.

12

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.

13

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 Subordinated Debt.

A default or breach occurs under any agreement between Borrower and any creditor of Borrower that signed a subordination, intercreditor, or other similar agreement with Bank, or any creditor that has signed such an agreement with Bank breaches any terms of such agreement.

8.10 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, JURY TRIAL WAIVER AND JUDICIAL REFERENCE.

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; provided, however, that nothing in this Agreement shall be deemed to operate to preclude Bank from bringing suit or taking other legal action in any other jurisdiction to realize on the Collateral or any other security for the Obligations, or to enforce a judgment or other court order in favor of Bank. Borrower expressly submits and consents in advance to such jurisdiction in any action or suit commenced in any such court, and Borrower hereby waives any objection that it may have based upon lack of personal jurisdiction, improper venue, or forum non conveniens and hereby consents to the granting of such legal or equitable relief as is deemed appropriate by such court. Borrower hereby waives personal service of the summons, complaints, and other process issued in such action or suit and agrees that service of such summons, complaints, and other process may be made by registered or certified mail addressed to Borrower at the address set forth in Section 10 of this Agreement

and that service so made shall be deemed completed upon the earlier to occur of Borrower's actual receipt thereof or three (3) days after deposit in the U.S. mails, proper postage prepaid.

TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, BORROWER AND BANK EACH WAIVE THEIR RIGHT TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION ARISING OUT OF OR BASED UPON THIS AGREEMENT, 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.

WITHOUT INTENDING IN ANY WAY TO LIMIT THE PARTIES' AGREEMENT TO WAIVE THEIR RESPECTIVE RIGHT TO A TRIAL BY JURY, if the above waiver of the right to a trial by jury is not enforceable, the parties hereto agree that any and all disputes or

controversies of any nature between them arising at any time shall be decided by a reference to a private judge, mutually selected by the parties (or, if they cannot agree, by the Presiding Judge of the Santa Clara County, California Superior Court) appointed in accordance with California Code of Civil Procedure Section 638 (or pursuant to comparable provisions of federal law if the dispute falls within the exclusive jurisdiction of the federal courts), sitting without a jury, in Santa Clara County, California; and the parties hereby submit to the jurisdiction of such court. The reference proceedings shall be conducted pursuant to and in accordance with the provisions of California Code of Civil Procedure §§ 638 through 645.1, inclusive. The private judge shall have the power, among others, to grant provisional relief, including without limitation, entering temporary restraining orders, issuing preliminary and permanent injunctions and appointing receivers. All such proceedings shall be closed to the public and confidential and all records relating thereto shall be permanently sealed. If during the course of any dispute, a party desires to seek provisional relief, but a judge has not been appointed at that point pursuant to the judicial reference procedures, then such party may apply to the Santa Clara County, California Superior Court for such relief. The proceeding before the private judge shall be conducted in the same manner as it would be before a court under the rules of evidence applicable to judicial proceedings. The parties shall be entitled to discovery which shall be conducted in the same manner as it would be before a court under the rules of discovery applicable to judicial proceedings. The private judge shall oversee discovery and may enforce all discovery rules and order applicable to judicial proceedings in the same manner as a trial court judge. The parties agree that the selected or appointed private judge shall have the power to decide all issues in the action or proceeding, whether of fact or of law, and shall report a statement of decision thereon pursuant to the California Code of Civil Procedure § 644(a). Nothing in this paragraph shall limit the right of any party at any time to exercise self-help remedies, foreclose against collateral, or obtain provisional remedies. The private judge shall also determine all issues relating to the applicability, interpretation, and enforceability of this paragraph.

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 Limitation of Actions.

Any claim or cause of action by Borrower against Bank, its directors, officers, employees, agents, accountants, attorneys, or any other Person affiliated with or representing Bank based upon, arising from, or relating to this Loan Agreement or any other Loan Document, or any other transaction contemplated hereby or thereby or relating hereto or thereto, or any other matter, cause or thing whatsoever, occurred, done, omitted or suffered to be done by Bank, its directors, officers, employees, agents, accountants or attorneys, shall be barred unless asserted by Borrower by the commencement of an action or proceeding in a court of competent jurisdiction by (a) the filing of a complaint within one year from the earlier of (i) the date any of Borrower's officers or directors had knowledge of the first act, the occurrence or omission upon which such claim or cause of action, or any part thereof, is based, or (ii) the date this Agreement is terminated, and (b) the service of a summons and complaint on an officer of Bank, or on any other person authorized to accept service on behalf of Bank, within thirty (30) days thereafter. Borrower agrees that such one-year period is a reasonable and sufficient time for Borrower to investigate and act upon any such claim or cause of action. The one-year period provided herein shall not be waived, tolled,

or extended except by the written consent of Bank in its sole discretion. This provision shall survive any termination of this Loan Agreement or any other Loan Document.

12.4 Time of Essence.

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

12.5 Severability of Provision.

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

12.6 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.

12.7 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.

12.8 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.

12.9 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.

12.10 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 any Non-Formula Advance.

“**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

“**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 Resolutions**” of the Borrower shall be in substantially the form set forth as Exhibit D hereto.

“**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.

“**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 \$2,000,000.

“**Committed Non-Formula Revolving Line**” is Non-Formula Advances of up to \$5,000,000.

“**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 Non-Formula Advance, Equipment Advance, Letter of Credit, Exchange Contract, 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 of even date herewith.

“**Eligible Equipment**” is all present and future machinery, equipment, tenant improvements, furniture, fixtures, vehicles, tools, parts and attachments in which Lender has a valid security interest and Soft Costs.

“**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 2.1.7.

“**Equipment Availability End Date**” is defined in Section 2.1.7.

“**Equipment Advance(s)**” is defined in Section 2.1.7.

“**Equipment Line Fee**” is defined in Section 2.4(c).

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

“**Event of Loss**” is defined in Section 2.1.7(e).

“**Financed Equipment**” is all present and future Eligible Equipment in which Borrower has any interest, the purchase of which is financed by an Equipment Advance.

“**Fixed Rate Advance**” is any Equipment Advance subject to interest under the fixed Treasury Rate.

“**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.

“**Hard Costs**” is defined in Section 2.1.7(a).

“**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.

22

“**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;
- (e) 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.

“**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.

23

“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:

- (f) Borrower’s indebtedness to Bank under this Agreement or any other Loan Document;
- (g) Indebtedness existing on the Closing Date and shown on the Disclosure Letter;
- (h) Subordinated Debt including, but not limited to Subordinated Debt associated with Borrower’s future investment of up to \$3,666,900 in Tower Semiconductor;
- (i) Indebtedness to trade creditors incurred in the ordinary course of business;
- (j) Indebtedness secured by Permitted Liens;
- (k) 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);
- (l) Other Indebtedness not otherwise permitted by Section 7.4 not exceeding \$250,000 in the aggregate outstanding at any time;
- (m) 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; and
- (g) Indebtedness of Borrower to (i) finance directors’ and officers’ liability insurance and (ii) to finance Borrower’s “Cadence” and “Mentor Graphics” software licensing.

“Permitted Investments” are:

Investments shown on the Disclosure Letter and existing on the Closing Date; and

- (a) (i) marketable direct obligations issued or unconditionally guaranteed by the United States or its agency or any state maturing within one 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) certificates of deposit issued maturing no more than one year after issue.

- (b) Investments consisting of the endorsement of negotiable instruments for deposit or collection or similar transactions in the ordinary course of Borrower;
- (c) Investments accepted in connection with Transfers permitted by Section 7.1, 7.3 and 7.6;
- (d) 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.
- (e) 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;
- (f) 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;

(g) 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;

(h) Investments made pursuant to Borrower's investment policy, as approved by Bank from time to time;

(i) 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

(j) 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;

25

(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 (including Liens arising in connection with capital leases), 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 and capital leases of Equipment or software;

(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;

(j) Liens arising from Indebtedness of Borrower in connection with financing Borrower's directors' and officers' liability insurance and Borrower's "Cadence" or "Mentor Graphics" software licensing.

(k) Liens on insurance proceeds securing the payment of financed insurance premiums;

(k) 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.

26

"Prime Rate" is Bank's most recently announced "prime rate," even if it is not Bank's lowest rate.

"Quick Assets" is, on any date, the Borrower's consolidated, unrestricted and cash and cash equivalents, accounts receivable, investments with maturities of fewer than 12 months and long-term investments with maturities of more than 12 months held at Bank or its affiliates, 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, 2008.

“**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.

“**Soft Costs**” is defined in Section 2.1.7(a).

“**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.

“**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.

“**Treasury Rate**” is the per annum rate of interest (based on a year of 360- days) equal to the sum of the U.S. Treasury note yield to maturity for a term equal to the Treasury Note Maturity date as quoted in The Wall Street Journal on the date of the applicable Advance.

“**Treasury Note Maturity**” is the term of 36 months.

[Signature Page to Follow]

27

IN WITNESS WHEREOF, the undersigned parties have executed this Second Amended and Restated Loan and Security Agreement as of the date first set forth above.

BORROWER:

QUICKLOGIC CORPORATION

By: /s/ Carl M. Mills

Title: VP Finance and CFO

BANK:

SILICON VALLEY BANK

By: /s/ Rick Freeman

Title: Relationship Manager

28

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 mask work or similar rights available for the protection of semiconductor chips, 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 shall not include any of the following created, modified or amended (to the extent of the modification or amendment), acquired or obtained on or after June 28, 2004: Any copyrights, copyright applications, copyright registration and like protection in each work of authorship and derivative work thereof, whether published or unpublished, now owned or hereafter acquired; any patents, patent applications and like protections including without limitation improvements, divisions, continuations, renewals, reissues, extensions and continuations-in-part of the same, trademarks, servicemarks and applications therefor, whether registered or not, and the goodwill of the business of Borrower connected with and symbolized by such trademarks, any trade secret rights, including any rights to unpatented inventions, know-how, operating manuals, license rights and agreements and confidential information, now owned or hereafter acquired; or any claims for damage by way of any past, present and future infringement of any of the foregoing (collectively, the "Intellectual Property"), except that the Collateral shall include the proceeds of all the Intellectual Property that are accounts, (i.e. accounts receivable) of Borrower, or general intangibles consisting of rights to payment, if a judicial authority (including a U.S. Bankruptcy Court) holds that a security interest in the underlying Intellectual Property is necessary to have a security interest in such accounts and general intangibles of Borrower that are proceeds of the Intellectual Property, then the Collateral shall automatically, and effective as of the Closing Date, include the Intellectual Property to the extent necessary to permit perfection of Bank's security interest in such accounts and general intangibles of Borrower that are proceeds of the Intellectual Property.

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 # _____

<u>REQUESTED TRANSACTION TYPE</u>	<u>REQUESTED DOLLAR AMOUNT</u>
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 20 th	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; \$31,000,000	Yes	No
Quick Ratio (Adjusted)	1.55to 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

CORPORATE BORROWING RESOLUTION

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

Bank: **Silicon Valley Bank**
3003 Tasman Drive
Santa Clara, CA 95054-1191

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

I certify that at a meeting of Borrower's Board of 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
E. Thomas Hart	Chairman, President & CEO	
Carl M. Mills	Vice President, Finance & CFO	
David F. Peterson	Corporate Controller	
Timothy Saxe	Vice President, Engineering	

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.

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 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 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-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: December 22, 2006

/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 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 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-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: December 22, 2006

/s/ Carl M. Mills

Carl M. Mills

Chief Financial Officer

**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 quarter ended July 2, 2006, 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: December 22, 2006
Name: E. Thomas Hart
Title: *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 quarter ended July 2, 2006, 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: December 22, 2006
Name: Carl M. Mills
Title: *Chief Financial Officer*
