

GIGA TRONICS INC
Form 10QSB
August 04, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-QSB**

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the quarterly period ended **June 24, 2006**

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT
for the transition period from _____ to _____

**Commission File No. 0-12719
GIGA-TRONICS INCORPORATED**

(Exact name of small business issuer as specified in its charter)

California

94-2656341

(State or other jurisdiction of
incorporation or organization)

(IRS Employer Identification No.)

4650 Norris Canyon Road, San Ramon, CA 94583
(Address of principal executive offices)

Issuer's telephone number: (925) 328-4650

N/A

(Former name, former address an former fiscal year, if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15 (d) of the Exchange Act during the past 12 months (or for shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act).

Yes No

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

Common stock outstanding as of August 3, 2006: 4,809,021 shares

Transitional Small Business Disclosure Format (Check one) Yes No

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<u>(In thousands except share data)</u> <u>(Unaudited)</u>	June 24, 2006	March 25, 2006
Assets		
Current assets		
Cash and cash equivalents	\$ 3,726	\$ 3,412
Notes receivable	14	3
Trade accounts receivable, net	1,734	3,435
Inventories	5,066	4,813
Prepaid expenses and other assets	255	219
Total current assets	10,795	11,882
Property and equipment, net	412	337
Other assets	113	127
Total assets	\$ 11,320	\$ 12,346
Liabilities and shareholders equity		
Current liabilities		
Accounts payable	\$ 1,099	\$ 870
Accrued commissions	108	171
Accrued payroll and benefits	742	781
Accrued warranty	244	250
Customer advances	465	521
Other current liabilities	389	433
Total current liabilities	3,047	3,026
Deferred rent	198	222
Total liabilities	3,245	3,248
Shareholders equity		
Preferred stock of no par value; Authorized 1,000,000 shares; no shares outstanding at June 24, 2006 and March 25, 2006		
Common stock of no par value; Authorized 40,000,000 shares; 4,809,021 shares at June 24, 2006 and March 25, 2006 issued and outstanding		
	13,007	13,003
Accumulated deficit	(4,932)	(3,905)
Total shareholders equity	8,075	9,098
Total liabilities and shareholders equity	\$ 11,320	\$ 12,346

See accompanying notes to unaudited condensed consolidated financial statements.

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CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended	
	June 24, 2006	June 25, 2005
<u>(In thousands except per share data)</u>		
<u>(Unaudited)</u>		
Net sales	\$ 3,386	\$ 5,783
Cost of sales	2,187	3,138
Gross profit	1,199	2,645
Product development	961	966
Selling, general and administrative	1,297	1,453
Operating expenses	2,258	2,419
Operating (loss) income	(1,059)	226
Interest income, net	29	5
(Loss) income from continuing operations before income taxes	(1,030)	231
Provision for income taxes		4
(Loss) income from continuing operations	(1,030)	227
Income on discontinued operations, net of income taxes	3	6
Net (loss) income	\$ (1,027)	\$ 233
Basic net (loss) income per share:		
From continuing operations	\$ (0.21)	\$ 0.05
On discontinued operations	(0.00)	0.00
Basic net (loss) income per share	\$ (0.21)	\$ 0.05
Diluted net (loss) income per share:		
From continuing operations	\$ (0.21)	\$ 0.05
On discontinued operations	(0.00)	0.00
Diluted net (loss) income per share	\$ (0.21)	\$ 0.05
Shares used in per share calculation:		
Basic	4,809	4,731
Dilutive	4,809	4,912

See accompanying notes to unaudited condensed consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended	
	June 24, 2006	June 25, 2005
<u>(In thousands)</u>		
<u>(Unaudited)</u>		
Cash flows from operations:		
Net (loss) income	\$ (1,027)	\$ 233
Adjustments to reconcile net (loss) income to net cash provided by operations:		
Depreciation and amortization	69	141
Equity based compensation	4	
Changes in operating assets and liabilities	1,436	(195)
Net cash provided by operations	482	179
Cash flows from investing activities:		
Proceeds from sale of equipment	2	
Purchases of property and equipment	(146)	(49)
Net cash used in investing activities	(144)	(49)
Cash flows from financing activities:		
Issuance of common stock		15
Payments on capital lease obligations	(24)	(18)
Net cash used in financing activities	(24)	(3)
Increase in cash and cash equivalents	314	127
Cash and cash equivalents at beginning of period	3,412	2,540
Cash and cash equivalents at end of period	\$ 3,726	\$ 2,667

Supplementary disclosure of cash flow information:

(1) No cash was paid for income taxes and interest in the three month periods ended June 24, 2006 and June 25, 2005.

See accompanying notes to unaudited condensed consolidated financial statements.

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GIGA-TRONICS INCORPORATED

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The condensed consolidated financial statements included herein have been prepared by Giga-tronics (the Company), pursuant to the rules and regulations of the Securities and Exchange Commission. The consolidated results of operations for the interim periods shown in this report are not necessarily indicative of results to be expected for the fiscal year. In the opinion of management, the information contained herein reflects all adjustments (consisting of normal recurring entries) necessary to make the consolidated results of operations for the interim periods a fair statement of such operations. For further information, refer to the consolidated financial statements and footnotes thereto, included in the Annual Report on Form 10-KSB, filed with the Securities and Exchange Commission for the year ended March 25, 2006.

Certain prior period amounts have been reclassified to conform with the current period's presentation.

(2) Discontinued Operations

In the first quarter of 2004, Giga-tronics discontinued the operations at its Dymatix Division due to the substantial losses incurred over the previous two years. In the fourth quarter of fiscal 2004, Giga-tronics consummated the sale of its Dymatix Division and recognized a gain of \$53,000 in connection with the sale. The sales price was \$300,000. The Company received a \$50,000 cash payment from the buyer and a \$250,000 note receivable with \$50,000 due in May 2004 and quarterly installments of \$25,000 due beginning in July 2004. The Company agreed to reschedule the payment due in May 2004 to August 2004 and, to date, has not received payments due. The note is secured by collateral and in management's opinion this collateral deteriorated during fiscal 2005. Accordingly, the Company considers the note receivable to be impaired and has recorded a provision of loss of \$250,000 through discontinued operations in the 2005 fiscal year.

(3) Revenue Recognition

The Company records revenue in accordance with SAB 101 and 104, *Revenue Recognition in Financial Statements*. As such, revenue is recorded when there is evidence of an arrangement, delivery has occurred, the price is fixed and determinable, and collectability is assured. This occurs when products are shipped, unless the arrangement involves acceptance terms. If the arrangement involves acceptance terms, the Company defers revenue until product acceptance is received.

The Company provides for estimated costs that may be incurred for product warranties at the time of shipment. The Company's warranty policy generally provides four years for the 2400 family of Microwave Synthesizers and one year for all other products. The estimated cost of warranty coverage is based on the Company's actual historical experience with its current products or similar products.

(4) Inventories

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs* (FAS 151). FAS 151 requires that abnormal amounts of idle facility expense, freight, handling costs and spoilage be recognized as current-period charges. Further, FAS 151 requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. Unallocated overheads must be recognized as an expense in the period in which they are incurred. The Company adopted FAS 151 effective March 26, 2006, which did not have a material impact on the Company's financial statements and related disclosures.

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(In thousands)	June 24, 2006	March 25, 2006
Raw materials	\$ 3,007	\$ 3,025
Work-in-progress	1,589	1,309
Finished goods	244	246
Demonstration inventory	226	233
Total inventory	\$ 5,066	\$ 4,813

(5) Earnings Per Share

Basic earnings (loss) per share is calculated by dividing net income or loss by the weighted average common shares outstanding during the period. Diluted earnings (loss) per share (EPS) reflects the net incremental shares that would be issued if dilutive outstanding stock options were exercised, using the treasury stock method. In the case of a net loss, it is assumed that no incremental shares would be issued because they would be antidilutive. In addition, certain options are considered antidilutive because the options exercise price was above the average market price during the period. The shares used in per share computations are as follows:

(In thousands except per share data)	Three Months Ended	
	June 24, 2006	June 25, 2005
Net (loss) income	\$ (1,027)	\$ 233
Weighted average:		
Common shares outstanding	4,809	4,731
Potential common shares		181
Common shares assuming dilution	4,809	4,912
Net (loss) income per share of common stock	\$ (0.21)	\$ 0.05
Net (loss) income per share of common stock assuming dilution	(0.21)	0.05
Stock options not included in computation	467	124

The number of stock options not included in the computation of diluted EPS for the three month period ended June 24, 2006 is a result of the Company's loss from continuing operations and, therefore, the options are antidilutive. The number of stock options not included in the computation of diluted EPS for the three month period ended June 25, 2005 reflects stock options where the exercise prices were greater than the average market price of the common shares and are, therefore, antidilutive. The weighted average exercise price of excluded options was \$2.46 and \$5.32 as of June 24, 2006 and June 25, 2005, respectively.

(6) Stock Based Compensation

The Company established a 2005 Equity Incentive Plan which provided for the granting of options for up to 700,000 shares of Common Stock. Effective March 26, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), *Share Based Payment* (SFAS 123(R)), using the modified prospective application transition method, which requires recognizing expense for options granted prior to the adoption date equal to the fair value of the unvested amounts over their remaining vesting period, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 *Accounting for Stock Based Compensation*, and compensation cost for

all share based payments granted subsequent to January 1, 2006, based on the grant date fair values estimated in accordance with the provisions of SFAS 123(R). There were 60,000 grants made in the first quarter of fiscal 2007 and no grants in the same quarter for fiscal 2006. Results for prior periods have not been restated. Prior to March 26, 2006, the Company accounted for these plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations (APB 25). No stock-based compensation cost is reflected in net income prior to March 26, 2006, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

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As a result of adopting SFAS 123(R), the Company's loss before provision for income taxes and net income for the three months ended June 24, 2006 was \$4,000 higher than if the Company had continued to account for share-based compensation under APB 25. Basic and diluted loss per share for the quarter ended June 24, 2006 would have been \$0.21 without the adoption of SFAS 123(R) compared to \$0.21 as reported.

SFAS 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as a cash flow from financing in the statement of cash flows. These excess tax benefits were not significant for the Company, for the three months ended June 24, 2006.

In calculating compensation related to stock option grants, the fair value of each stock option is estimated on the date of grant using the Black-Scholes option-pricing model and the following weighted average assumptions:

	Three Months Ended June 24, 2006
Dividend yield	None
Expected volatility	.51%
Risk-free interest rate	4.73%
Expected term (years)	5

The computation of expected volatility used in the Black-Scholes option-pricing model is based on the historical volatility of our share price. The expected term is estimated based on a review of historical employee exercise behavior with respect to option grants.

A summary of the changes in stock options outstanding for the three months ended June 24, 2006 is presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at March 25, 2006	438,975	\$ 2.57	2.7	\$ 122,173
Granted	60,000	2.65		
Exercised				
Forfeited/Expired	32,250	4.31		
Outstanding at June 24, 2006	466,725	\$ 2.46	2.9	\$ 5,800
Exercisable at June 24, 2006	185,350	\$ 2.48	2.1	\$ 4,350

The weighted average grant date fair value of options granted during the three month period ended June 24, 2006 was \$2.65. There was no intrinsic value of options exercised during the three month period ended June 24, 2006.

As of June 24, 2006, there was \$40,000 of total unrecognized compensation cost related to nonvested options granted under the plans. That cost is expected to be recognized over a weighted average period of one year. The total fair value of options vested during the three month period ended June 24, 2006 was \$1,600. No cash was received from stock option exercises for the three month period ended June 24, 2006.

The following table illustrates the pro forma effect on net income and earnings per share if the fair value recognition provisions of SFAS 123 had been applied to the Company's stock option plans for the quarter ended June 25, 2005.

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	Three Months Ended June 25, 2005
(In thousands except per share data)	
Net income, as reported	\$ 233
Deduct:	
Stock-based compensation expense included in reported net income	
Add:	
Total stock-based employee compensation determined under fair value based method for all awards, net of related tax effect	(42)
Pro forma net income	\$ 191
Net income per share basic:	
As reported	\$ 0.05
Pro forma	0.04
Net income per share diluted:	
As reported	0.05
Pro forma	0.04

(7) Industry Segment Information

The Company has four reportable segments: Giga-tronics Instrument Division, ASCOR, Microsource and Corporate. Giga-tronics Instrument Division produces a broad line of test and measurement equipment used in the development, test and maintenance of wireless communications products and systems, flight navigational equipment, electronic defense systems and automatic testing systems. ASCOR designs, manufactures, and markets a line of switching devices that link together many specific purpose instruments that comprise automatic test systems. Microsource develops and manufactures a broad line of YIG (Yttrium, Iron, Garnet) tuned oscillators, filters and microwave synthesizers, which are used in a wide variety of microwave instruments and devices. Corporate handles the financing needs of each segment and lends funds to each segment as required and are eliminated in consolidation.

Information on reportable segments is as follows:

(In thousands)	Three Months Ended			
	June 24, 2006		June 25, 2005	
	Net Sales	Pre-tax Income (loss)	Net Sales	Pre-tax Income (loss)
Instrument Division	\$ 1,770	\$ (638)	\$ 2,878	\$ 49
ASCOR	602	(279)	1,277	32
Microsource	1,014	(447)	1,628	(104)
Corporate		334		254
Total	\$ 3,386	\$ (1,030)	\$ 5,783	\$ 231

(8) Warranty Obligations

The Company's warranty policy generally provides four years for the 2400 family of Microwave Synthesizers and one year for all other products. The Company records a liability for estimated warranty obligations at the date products are

sold. The estimated cost of warranty coverage is based on the Company's actual historical experience with its current products or similar products. For new products, the reserve is based on historical experience of similar products until such time as sufficient historical data has been collected on the new product. Adjustments are made as new information becomes available.

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The following provides a reconciliation of changes in the Company's warranty reserve. The Company provides no other guarantees.

(In thousands)	Three Months Ended	
	June 24, 2006	June 25, 2005
Balance at beginning of quarter	\$ 250	\$ 378
Provision for current quarter sales	42	75
Warranty costs incurred and adjustments	(48)	(108)
Balance at end of quarter	\$ 244	\$ 345

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Item 2

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF OPERATIONS AND FINANCIAL CONDITION**

The forward-looking statements included in this report including, without limitation, statements containing the words believes, anticipates, estimates, expects, intends and words of similar import, which reflect management's best judgment based on factors currently known, involve risks and uncertainties. Actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including but not limited to those listed in Giga-tronics' Annual Report on Form 10-KSB for the fiscal year ended March 26, 2005 Part I, under the heading Certain Factors Which May Adversely Affect Future Operations or an Investment in Giga-tronics, and Part II, under the heading Management's Discussion and Analysis of Financial Conditions and Results of Operations.

Overview

Giga-tronics produces instruments, subsystems and sophisticated microwave components that have broad applications in both defense electronics and wireless telecommunications. In 2005, our business consisted of four operating and reporting segments: Instrument Division, ASCOR, Microsource and Corporate.

Our business is highly dependent on government spending in the defense electronics sector and on the wireless telecommunications market. While the Company has seen some improvement in its international defense business, domestic spending remains sporadic. The commercial business environment has shown some improvement; however, commercial orders for the year declined slightly due to delays in new product introductions.

The Company continues to monitor costs, including reductions in personnel and other expenses, to more appropriately align costs with revenues. The Company's employees have been on salary reductions over the last three years.

Recently, the Company has reversed a portion of the prior salary reductions and anticipates reinstating previous salary levels contingent on the Company's financial condition stabilizing.

The Company has recently released the 2400B synthesizer (part of the 2400 family of products) during the 2006 fiscal year. These products are being accepted by the market and management believes there is significant room for growth. This release demonstrates the Company's commitment to new product development.

In an effort to improve results and make optimal use of its resources, Giga-tronics intends to take additional steps to restructure the company. The Company will continue to consolidate operations and functions among its divisions as the Company has done with sales and marketing. Further integration of product development efforts should enable Giga-tronics to achieve a better return on its substantial investment in R&D. New development programs will focus more on commercial products to reduce the Company's dependence on the domestic defense sector. Giga-tronics will look for any available opportunities to operate more efficiently and with greater focus on customer needs. The Company hopes to accomplish these changes in a business-like manner that is not overly disruptive to its very talented work force yet is decisive enough to yield meaningful improvements to the bottom line.

While the management at Microsource estimates that prospects for new orders will improve in this new fiscal year, its short-term growth will be limited as to customer delivery schedules associated with this new business.

Results of Operations

New orders received from continuing operations in the first quarter of fiscal 2007 decreased 47% to \$2,933,000 from the \$5,493,000 received in the first quarter of fiscal 2006. New orders decreased primarily due to a decline in new military orders.

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	New Orders		June 25, 2005
	June 24, 2006	Three Months Ended % change	
<u>(Dollars in thousands)</u>			
Instrument Division	\$ 1,898	(31%)	\$ 2,755
ASCOR	671	(65%)	1,915
Microsource	364	(56%)	823
Total new orders	\$ 2,933	(47%)	\$ 5,493

All three divisions experienced a decrease in new orders due to a decrease in military demand in the first quarter of fiscal 2007 as compared to the first quarter of fiscal 2006.

The following table shows order backlog and related information at the end of the respective periods.

	Three Months Ended		
	June 24, 2006	% change	June 25, 2005
<u>(Dollars in thousands)</u>			
Backlog of unfilled orders	\$9,876	(36%)	\$15,502
Backlog of unfilled orders shippable within one year	5,756	(30%)	8,216
Previous fiscal year (FY) quarter end backlog reclassified during quarter as shippable later than one year	64	392%	13
Net cancellations during quarter of previous FY quarter end one year backlog	38	100%	

Backlog at the end of the first quarter 2007 decreased 36% from the same quarter end last year primarily due to the decline in orders discussed above.

The allocation of net sales was as follows for the periods shown:

	Allocation of Net Sales		
	June 24, 2006	Three Months Ended % change	June 25, 2005
<u>(Dollars in thousands)</u>			
Instrument Division	\$ 1,770	(39%)	\$ 2,878
ASCOR	602	(53%)	1,277
Microsource	1,014	(38%)	1,628
Total net sales	\$ 3,386	(42%)	\$ 5,783

Fiscal 2007 first quarter net sales from continuing operations were \$3,386,000, a 42% decrease from the \$5,783,000 in the first quarter of fiscal 2006. The decrease in sales, and any other entity in which these persons (or the Employee or Consultant) own more than fifty percent of the voting interests, including any changes as may be made from time to time to the definition of "Family Member" as promulgated by the Securities and Exchange Commission in connection with the general instructions for Form S-8 promulgated under the Securities Act of 1933, as amended, or any successor form. (p) "INCENTIVE STOCK OPTION" means an Option granted pursuant to the Plan which is designated as an incentive stock option by the Board, and qualifies as an incentive stock option within the meaning of Section 422 of the Code and the regulations promulgated thereunder. (q) "INDEPENDENT STOCK APPRECIATION RIGHT" means a right granted under subsection 8(b)(iii) of the Plan. (r) "NON-EMPLOYEE

DIRECTOR" means a Director of the Company who either (i) is not a current Employee or Officer of the Company or its parent or a subsidiary, does not receive compensation (directly or indirectly) from the Company or its parent or a subsidiary for services rendered as a Consultant or in any capacity other than as a Director (except for an amount as to which disclosure would not be required under Item 404(a) of Regulation S-K promulgated pursuant to the Securities Act of 1933, as amended ("Regulation S-K")), does not possess an interest in any other transaction as to which disclosure would be required under Item 404(a) of Regulation S-K, and is not engaged in a business relationship as to which disclosure would be required under Item 404(b) of Regulation S-K; or (ii) is otherwise considered a "non-employee director" for purposes of Rule 16b-3. (s) "NON-STATUTORY STOCK OPTION" means an Option granted pursuant to the Plan which is not an Incentive Stock Option. (t) "OFFICER" means a person who is an officer of the Company within the meaning of Section 16 of the Exchange Act and the rules and regulations promulgated thereunder. (u) "OPTION" means an option to purchase Stock granted pursuant to the Plan. (v) "OPTION AGREEMENT" means a written agreement between the Company and an Optionee evidencing the terms and conditions of an individual Option grant. The Option Agreement is subject to the terms and conditions of the Plan. (w) "OPTION PRICE" shall mean the price per share of Stock to be paid by the Optionee upon exercise of the Option and as set forth in the Option Agreement. (x) "OPTIONEE" means an Employee, Director or Consultant who holds an outstanding Option. (y) "OUTSIDE DIRECTOR" means a Director of the Company who either (i) is not a current employee of the Company or an "affiliated corporation" (within the meaning of Treasury Regulations promulgated under Section 162(m) of the 3 Code), is not a former employee of the Company or an "affiliated corporation" receiving compensation for prior services (other than benefits under a tax qualified pension plan), was not an officer of the Company or an "affiliated corporation" at any time, and is not currently receiving direct or indirect remuneration from the Company or an "affiliated corporation" for services in any capacity other than as a Director or (ii) is otherwise considered an "outside director" for purposes of Section 162(m) of the Code. (z) "PARTICIPANT" means an Employee, Director or Consultant who receives a Stock Award. (aa) "PLAN" means this 1998 Incentive Stock Plan, as may be amended from time to time. (bb) "RULE 16B-3" means Rule 16b-3 of the Exchange Act or any successor to Rule 16b-3, as in effect when discretion is being exercised with respect to the Plan. (cc) "STOCK" shall mean the \$0.0001 par value common stock of the Company. (dd) "STOCK APPRECIATION RIGHT" means any of the various types of rights which may be granted under Section 8 of the Plan. (ee) "STOCK AWARD" means any right granted under the Plan, including any Option, any Stock Bonus, any Stock Purchase Right, and any Stock Appreciation Right. (ff) "STOCK AWARD AGREEMENT" means a written agreement between the Company and a Participant evidencing the terms and conditions of an individual Stock Award grant. The Stock Award Agreement is subject to the terms and conditions of the Plan. (gg) "TANDEM STOCK APPRECIATION RIGHT" or "TANDEM RIGHT" means a right granted under subsection 8(b)(i) of the Plan. 3. ADMINISTRATION. (a) The Plan shall be administered by the Board unless and until the Board delegates administration to a Committee or Committees, as provided in subsection 3(c). (b) The Board shall have the power, subject to, and within the limitations of, the express provisions of the Plan: (i) To determine from time to time which of the persons eligible under the Plan shall be granted Stock Awards; when and how Stock Awards shall be granted; whether a Stock Award will be an Incentive Stock Option, a Non-statutory Stock Option, a Stock Bonus, a Stock Purchase Right, a Stock Appreciation Right, or a combination of the foregoing; the provisions of each Stock Award granted (which need not be identical), including the time or times when a person shall be permitted to receive Stock pursuant to a Stock Award, whether a person shall be permitted to receive Stock upon exercise of an 4 Independent Stock Appreciation Right; and, subject to subsection 4(d), the number of shares with respect to which Stock Awards shall be granted to each such person. (ii) To construe and interpret the Plan and Stock Awards granted under it, and to establish, amend and revoke rules and regulations for its administration. The Board, in the exercise of this power, may correct any defect, omission or inconsistency in the Plan or in any Stock Award Agreement, in a manner and to the extent it shall deem necessary or expedient to make the Plan fully effective. (iii) To amend the Plan as provided in Section 14. (iv) Generally, to exercise such powers and to perform such acts as the Board deems necessary or expedient to promote the best interests of the Company. (c) The Board may delegate administration of the Plan to a Committee or Committees of one (1) or more members of the Board, and the term "Committee" shall apply to any person or persons to whom such authority has been delegated. If administration is delegated to a Committee, the Committee shall have, in connection with the administration of the Plan, the powers theretofore possessed by the Board, including the power to delegate to a subcommittee any of the administrative powers the Committee is authorized to exercise (and references in this Plan to the Board shall thereafter

be to the Committee or subcommittee), subject, however, to such resolutions, not inconsistent with the provisions of the Plan, as may be adopted from time to time by the Board. The Board may abolish the Committee at any time and reconstitute the Board the administration of the Plan. A Committee may consist solely of two (2) or more Outside Directors, and/or solely of two or more Non-Employee Directors. Within the scope of such authority, the Board or the Committee may (i) delegate to a committee of one (1) or more members of the Board who are not Outside Directors, the authority to grant Stock Awards to eligible persons who are either (a) not then Covered Employees and are not expected to be Covered Employees at the time of recognition of income resulting from such Stock Award or (b) not persons with respect to whom the Company wishes to comply with Section 162(m) of the Code and/or (ii) delegate to a committee of one (1) or more members of the Board who are not Non-Employee Directors the authority to grant Stock Awards to eligible persons who are not then subject to Section 16 of the Exchange Act.

4. SHARES SUBJECT TO THE PLAN. (a) Subject to the provisions of Section 13 relating to adjustments upon changes in Stock, the Stock that may be issued pursuant to Stock Awards shall not exceed in the aggregate six million one hundred sixty seven thousand eight hundred seventy two (6,167,872) shares. The number of shares available shall be adjusted as provided in Section 13. Stock issued under any other stock option plan of the Company shall not be counted against the maximum number of shares that can be issued under the Plan. If any Stock Award shall for any reason expire or otherwise terminate without having been exercised in full, the Stock not purchased under such Stock Award shall again become available for issuance under the Plan. Shares subject to Stock Appreciation Rights exercised in accordance with Section 8 of the Plan shall not be available for subsequent issuance under the Plan.

5 (b) The Stock subject to the Plan may be unissued shares or reacquired shares. (c) The number of shares of Stock available for issuance under the Plan shall automatically increase on the first trading day in each fiscal year during the term of the Plan, beginning with the fiscal year ending March 31, 2003, by an amount equal to the least of (i) 2% of the total number of shares of Stock outstanding on the last trading day of the immediately preceding fiscal year; (ii) 600,000 shares of Stock; or (iii) an amount determined by the Board. (d) No one person participating in the Plan may receive Stock Awards for more than 1,000,000 shares of Stock in the aggregate per calendar year.

5. ELIGIBILITY. (a) Incentive Stock Options and Stock Appreciation Rights appurtenant thereto may be granted only to Employees. Stock Awards other than Incentive Stock Options and Stock Appreciation Rights appurtenant thereto may be granted only to Employees, Directors or Consultants. (b) A Director or Officer shall in no event be eligible for the benefits of the Plan unless at the time discretion is exercised in the selection of the Director or Officer as a person to whom Stock Awards may be granted, or in the determination of the number of shares which may be covered by Stock Awards granted to the Director or Officer: (i) the Board has approved the grant of the Stock Awards; (ii) the Board has delegated its discretionary authority over the Plan to a Committee which consists solely of two or more Non-Employee Directors; or (iii) the grant otherwise complies with the requirements of Rule 16b-3. (c) No person shall be eligible for the grant of an Option if, at the time of grant, such person owns (or is deemed to own pursuant to Code Section 424(d)) Stock possessing more than ten (10%) percent of the total combined voting power of all classes of capital stock of the Company or of any of its Affiliates unless the exercise price of such Option is at least one hundred ten (110%) percent of the Fair Market Value of the Stock at the date of grant and the Option is not exercisable after the expiration of five (5) years from the grant date.

6. OPTION PROVISIONS. Each Option shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. The provisions of separate Options need not be identical, but each Option shall include (through incorporation of provisions of the Plan by reference in the Option or otherwise) the substance of each of the following provisions: (a) **TERM.** No Option shall be exercisable after the expiration of ten (10) years from the date it was granted; provided that an Option granted to a person possessing ten (10%) percent or more of the combined voting power of all classes of capital stock of the Company or its Affiliates shall have a term not exceeding five (5) years. (b) **PRICE.** The exercise price of each Incentive Stock Option shall be not less than one hundred percent (100%) of the Fair Market Value of the Stock subject to the Option on the date the Option is granted. The exercise price of each Non-statutory Stock Option shall be not less than eighty-five (85%) of the Fair Market Value of the Stock subject to the Option on the date the Option is granted. Despite the previous two sentences, the purchase price for Options granted to a person who possesses more than ten percent (10%) of the total combined voting power of all classes of capital stock of the Company or its Affiliates shall be at least one hundred ten percent (110%) of the Fair Market Value of the Stock at the date of grant. (c) **CONSIDERATION.** The Option Price of Stock acquired pursuant to an Option shall be paid, to the extent permitted by applicable statutes and regulations, either (1) in cash at the time the Option is exercised, or (2) at the discretion of the Board, either at the time of the grant or

exercise of the Option, (A) by delivery to the Company of other Stock of the Company, (B) according to a deferred payment or other arrangement (which may include, without limiting the generality of the foregoing, the use of other Stock of the Company valued at Fair Market Value as provided herein) with the person to whom the Option is granted or to whom the Option is transferred pursuant to subsection 6(d), or (C) an agreement with the Company whereby a portion of the Optionee's Options are terminated, and where the Built in Gain on any Options which are terminated as part of the agreement equals the aggregate Option Price of the Option being exercised. The Board may permit deemed or constructive transfer of shares in lieu of actual transfer and physical delivery of certificates. Except to the extent prohibited by applicable law, the Board may take any necessary or appropriate steps in order to facilitate the payment of the Option Price. The Board, in its sole and exclusive discretion, may require satisfaction of any rules or conditions in connection with paying the Option Price at any particular time, in any particular form, or with the Company's assistance. In the event the Board determines in its sole discretion to provide an Optionee with a deferred payment arrangement, interest shall be payable at least annually and shall be charged at the minimum rate of interest necessary to avoid the treatment as interest, under any applicable provisions of the Internal Revenue Code of 1986, of any amounts other than amounts stated to be interest under the deferred payment arrangement. "Built in Gain" means the excess of the aggregate Fair Market Value of Stock subject to an Option otherwise issuable on exercise of a terminated Option over the aggregate Option Price otherwise due the Company on such exercise. If Stock used to pay any Option Price is subject to any prior restrictions imposed in connection with any stock option or stock purchase plan or agreement of the Company (including this Plan), an equal number of the shares of Stock acquired on exercise shall be made subject to such prior restrictions in addition to any further restrictions imposed on the Stock by the terms of the particular Agreement or by the Plan. (d) TRANSFERABILITY. To the extent required by Code Section 422, Options, (or the rights of Optionees pursuant to the Agreement), shall not be transferable in any manner, whether voluntary or involuntary, except by will or the law of descent and distribution. A Non-Qualified Stock Option may be transferred: (i) by gift to a Family Member; (ii) under a domestic relations order in settlement of marital property rights; and (iii) to any entity in which more than fifty percent of the voting interests are owned by Family Members (or the Employee or Consultant) in exchange for an interest in that entity. An attempted non-permitted transfer shall be void and shall immediately terminate the Option. 7 (e) VESTING. The total number of shares of Stock subject to an Option may, but need not, be allotted in periodic installments (which may, but need not, be equal). The Option Agreement may provide that from time to time during each of such installment periods, the Option may become exercisable ("vest") with respect to some or all of the shares allotted to that period, and may be exercised with respect to some or all of the shares allotted to such period and/or any prior period as to which the Option became vested but was not fully exercised. The vesting provisions of individual Options may vary but in each case will provide for vesting of at least twenty percent (20%) of the total number of shares subject to the Option per year. During the remainder of the term of the Option (if its term extends beyond the end of the installment periods), the Option may be exercised from time to time with respect to any shares then remaining subject to the Option. The provisions of this subsection 6(e) are subject to any Option provisions governing the minimum number of shares as to which an Option may be exercised. (f) SECURITIES LAW COMPLIANCE. The Company may require any Optionee, or any person to whom an Option is transferred under subsection 6(d), as a condition of exercising any such Option, to give written assurances satisfactory to the Company, if any, that are necessary to ensure compliance with federal securities laws. These requirements, and any assurances given pursuant to such requirements, shall be inoperative if (i) the issuance of the shares upon the exercise of the Option has been registered under a then currently effective registration statement under the Securities Act of 1933, as amended, or (ii) as to any particular requirement, a determination is made by counsel for the Company that such requirement need not be met in the circumstances under the then applicable securities laws. (g) TERMINATION OF EMPLOYMENT OR RELATIONSHIP AS A DIRECTOR OR CONSULTANT. If an Optionee's Continuous Status as an Employee, Director or Consultant terminates (other than "for cause", or upon the Optionee's death or Disability), the Optionee may exercise his or her Option, but only within such period of time as is determined by the Board (which period shall not be less than three (3) months from the date of such termination), and only to the extent that the Optionee was entitled to exercise it at the date of termination (but in no event later than the expiration of the term of such Option as set forth in the Option Agreement). If, at the date of termination, the Optionee is not entitled to exercise his or her entire Option, the shares covered by the unexercisable portion of the Option shall revert to the Plan. If, after termination, the Optionee does not exercise his or her Option within the time specified in the Option Agreement, the Option shall terminate, and the shares covered by such Option

shall revert to the Plan. If an Optionee's Continuous Status as an Employee, Director or Consultant terminates "for cause," the right to exercise the Option shall immediately cease. (h) DISABILITY OF OPTIONEE. If an Optionee's Continuous Status as an Employee, Director or Consultant terminates as a result of the Optionee's Disability, the Optionee may exercise his or her Option, but only within such period of time as is determined by the Board (which period from the date of such termination shall not be less than one (1) year, and only to the extent that the Optionee was entitled to exercise it at the date of such termination (but in no event later than the expiration of the term of such Option as set forth in the Option Agreement). If, at the date of termination, the Optionee is not entitled to exercise his or her entire Option, the shares covered by the unexercisable portion of the Option shall revert to the Plan. If, after termination, the Optionee does not exercise his or her Option within the time specified herein, the Option shall terminate, and the shares covered by the Option shall revert to the Plan. (i) DEATH OF OPTIONEE. In the event of the death of an Optionee, the Option may be exercised, at any time within such period as is determined by the Board (which period shall not be less than twelve (12) months following the date of death) by the personal representative of the Optionee's estate or by a person who acquired the right to exercise the Option by bequest or inheritance, and only to the extent the Optionee was entitled to exercise the Option at the date of death (but in no event later than the expiration of the term of such Option as set forth in the Option Agreement). If, at the time of death, the Optionee was not entitled to exercise his or her entire Option, the shares covered by the unexercisable portion of the Option shall revert to the Plan. If, after death, the Optionee's estate or a person who acquired the right to exercise the Option by bequest or inheritance does not exercise the Option within the time specified herein, the Option shall terminate, and the shares covered by such Option shall revert to the Plan. (j) WITHHOLDING. To the extent provided by the terms of an Option Agreement, the Optionee may satisfy any federal, state or local tax withholding obligation relating to the exercise of such Option by any of the following means or by a combination of such means: (1) tendering a cash payment; (2) authorizing the Company to withhold shares from the shares of the Stock otherwise issuable to the Optionee as a result of the exercise of the Option; or (3) delivering to the Company unencumbered shares of Stock owned by Optionee. 7. TERMS OF STOCK BONUSES AND STOCK PURCHASES. Each Stock Bonus or Stock Purchase agreement shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. The terms and conditions of Stock Bonus or Stock Purchase agreements may change from time to time, and the terms and conditions of separate agreements need not be identical, but each Stock Bonus or Stock Purchase agreement shall include (through incorporation of provisions hereof by reference in the agreement or otherwise) the substance of each of the following provisions as appropriate: (a) PURCHASE PRICE. The purchase price under each Stock Purchase agreement shall be such amount as the Board shall determine and designate in such agreement (which purchase price shall in any event be not less than eighty-five (85%) percent of the Fair Market Value of the Stock on the date such award is made), provided that the purchase price shall be one hundred (100%) percent of the Fair Market Value of the Stock on the date the award is made, in the case of any person who owns Stock possessing more than ten (10%) percent of the total combined voting power of all classes of capital stock of the Company or its Affiliates. (b) TRANSFERABILITY. Rights under a Stock Bonus or Stock Purchase agreement shall not be transferable in any manner, whether voluntary or involuntary, except by will or the law of descent and distribution. Rights under a Stock Bonus or Stock Purchase agreement may be transferred: (i) by gift to a Family Member; (ii) under a domestic relations order in settlement of marital property rights; and (iii) to any entity in which more than fifty percent of the voting interests are owned by Family Members (or the Employee or Consultant) in exchange for an interest in that entity. An attempted non-permitted transfer shall be void and shall immediately terminate the rights. (c) CONSIDERATION. The purchase price of Stock acquired pursuant to a Stock Purchase agreement shall be paid either: (i) in cash at the time of purchase; (ii) at the discretion of the Board, according to a deferred payment or other arrangement with the person to whom the Stock is sold; or (iii) in any other form of legal consideration (including shares of previously owned Stock) that may be acceptable to the Board in its discretion. (d) VESTING. Shares of Stock sold or awarded under the Plan may, but need not, be subject to a repurchase option in favor of the Company in accordance with a vesting schedule to be determined by the Board. (e) TERMINATION OF EMPLOYMENT OR RELATIONSHIP AS A DIRECTOR OR CONSULTANT. In the event a Participant's Continuous Status as an Employee, Director or Consultant terminates, the Company may repurchase or otherwise reacquire any or all of the shares of Stock held by that person which have not vested as of the date of termination under the terms of the Stock bonus or Stock purchase agreement between the Company and such person. 8. STOCK APPRECIATION RIGHTS. (a) The Board shall have full power and authority, exercisable in its sole discretion, to grant Stock Appreciation Rights to Employees, Directors

or Consultants of the Company or its Affiliates under the Plan. Each such right shall entitle the holder to a distribution based on the appreciation in the Fair Market Value per share of a designated amount of Stock. (b) three types of Stock Appreciation Rights shall be authorized for issuance under the Plan: (i) TANDEM STOCK APPRECIATION RIGHTS. Tandem Rights will be granted appurtenant to an Option and will require the holder to elect between the exercise of the underlying Option for shares of Stock and the surrender, in whole or in part, of the Option for an appreciation distribution equal to the excess of (A) the Fair Market Value (on the date of Option surrender) of vested shares of Stock purchasable under the surrendered Option over (B) the aggregate exercise price payable for those shares. (ii) CONCURRENT STOCK APPRECIATION RIGHTS. Concurrent Rights will be granted appurtenant to an Option and may apply to all or any portion of the shares of Stock subject to the underlying Option and will be exercised automatically at the same time the Option is exercised for those shares. The appreciation distribution to which the holder of such Concurrent Right shall be entitled upon exercise of the underlying Option shall be in an amount equal to the excess of (A) the aggregate Fair Market Value (at date of exercise) of the vested shares purchased under the underlying Option with such Concurrent Rights over (B) the aggregate exercise price paid for those shares. 10 (iii) INDEPENDENT STOCK APPRECIATION RIGHTS. Independent Rights may be granted independently of any Option and will entitle the holder upon exercise to an appreciation distribution equal in amount to the excess of (A) the aggregate Fair Market Value (at the date of exercise) of a number of shares of Stock equal to the number of vested share equivalents exercised at such time (as described in subsection 8(c)(iii)(B)) over (B) the aggregate Fair Market Value of such number of shares of Stock at the date of grant. (c) The terms and conditions applicable to each Tandem Right, Concurrent Right and Independent Right shall be as follows: (i) TANDEM RIGHTS. (A) Tandem Rights may be tied to either Incentive Stock Options or Non-statutory Stock Options. Each Tandem Right shall, except as specifically set forth below, be subject to the same terms and conditions applicable to the particular Option to which it pertains. If Tandem Rights are granted appurtenant to an Incentive Stock Option, they shall satisfy any applicable Treasury Regulations so as not to disqualify the Option as an Incentive Stock Option under the Code. (B) The appreciation distribution payable on the exercised Tandem Right shall be in cash in an amount equal to the excess of (I) the Fair Market Value (on the date of the Option surrender) of the number of shares of Stock covered by that portion of the surrendered Option in which the Optionee is vested over (II) the aggregate exercise price payable for those vested shares. (ii) CONCURRENT RIGHTS. (A) Concurrent Rights may be tied to any or all of the shares of Stock subject to any Incentive Stock Option or Non-statutory Stock Option grant made under the Plan. A Concurrent Right shall, except as specifically set forth below, be subject to the same terms and conditions applicable to the particular Option grant to which it pertains. (B) A Concurrent Right shall be automatically exercised at the same time the underlying Option is exercised with respect to the particular shares of Stock to which the Concurrent Right pertains. (C) The appreciation distribution payable on an exercised Concurrent Right shall be in cash in an amount equal to such portion as shall be determined by the Board at the time of the grant of the excess of (I) the aggregate Fair Market Value (on the Exercise Date) of the vested shares of Stock purchased under the underlying Option which have Concurrent Rights appurtenant to them over (II) the aggregate exercise price paid for those shares. 11 (iii) INDEPENDENT RIGHTS. (A) Independent Rights shall, except as specifically set forth below, be subject to the same terms and conditions applicable to Non-statutory Stock Options as set forth in Section 6. They shall be denominated in share equivalents. (B) The appreciation distribution payable on the exercised independent Right shall be in an amount equal to the excess of (I) the aggregate Fair Market Value (on the date of the exercise of the Independent Right) of a number of shares of Company Stock equal to the number of share equivalents in which the holder is vested under such Independent Right, and with respect to which the holder is exercising the Independent Right on such date, over (II) the aggregate Fair Market Value (on the date of the grant of the Independent Right) of such number of shares of Company Stock. (C) The appreciation distribution payable on the exercised Independent Right may be paid, in the discretion of the Board, in cash, in shares of Stock or in a combination of cash and Stock. Any shares of Stock so distributed shall be valued at Fair Market Value on the date the Independent Right is exercised. (iv) TERMS APPLICABLE TO TANDEM RIGHTS, CONCURRENT RIGHTS AND INDEPENDENT RIGHTS. (A) To exercise any outstanding Tandem, Concurrent or Independent Right, the holder must provide written notice of exercise to the Company in compliance with the provisions of the instrument evidencing the right. (B) If a Tandem, Concurrent, or Independent Right is granted to an individual who is at the time subject to Section 16(b) of the Exchange Act (a "Section 16(b) Insider"), then the instrument of grant shall incorporate all the terms and conditions at the time necessary to assure that the subsequent exercise of the right shall qualify for the safe-harbor exemption from short-swing profit liability

provided by Rule 16b-3. (C) No limitation shall exist on the aggregate amount of cash payments the Company may make under the Plan in connection with the exercise of Tandem, Concurrent or Independent Rights. 9.

CANCELLATION AND RE-GRANT OPTIONS AND CANCELLATION AND RESCISSION OF AWARDS. (a) The Board shall have the authority to effect, at any time and from time to time, with the consent of the affected holders of Options and/or Stock Appreciation Rights, (i) the re-pricing of any outstanding Options and/or any Stock Appreciation Rights under the Plan and/or (ii) the cancellation of any outstanding Options and/or any Stock Appreciation Rights under the Plan and the grant in substitution therefor of new Options and/or Stock Appreciation Rights under the Plan covering the same or different numbers of shares of Stock, but having an exercise price per share not less than eighty-five (85%) percent of the Fair Market Value (one hundred (100%) percent of the Fair Market Value in the case of an Option or, in the case of a ten (10%) percent shareholder (as described in subsection 5(c)), not less than one hundred ten (110%) percent of the Fair Market Value) per share of Stock on the new grant date. (b) Unless the Stock Award Agreement specifies otherwise, the Board may cancel, rescind, suspend, withhold or otherwise limit or restrict any unexpired, unpaid, or deferred Stock Award at any time if the Participant is not in compliance with all applicable provisions of the Stock Award Agreement and the Plan, or if the Participant engages in any "Detrimental Activity." For purposes of this subsection 9(b), "Detrimental Activity" shall include: (i) the rendering of services for any organization or engaging directly or indirectly in any business which is or becomes competitive with the Company, or which organization or business, or the rendering of services to such organization or business, is or becomes otherwise prejudicial to or in conflict with the interests of the Company; (ii) the disclosure to anyone outside the Company, or the use in other than the Company's business, without prior written authorization from the Company, of any confidential information or material, as defined in the Company's confidential information or similar agreement, relating to the business of the Company, acquired by the Participant either during or after employment with the Company; (iii) the failure or refusal to disclose promptly and to assign to the Company, pursuant to the Company's confidential information or similar agreement, all right, title and interest in any invention or idea, patentable or not, made or conceived by the Participant during employment by the Company, relating in any manner to the actual or anticipated business, research or development work of the Company or the failure or refusal to do anything reasonably necessary to enable the Company to secure a patent where appropriate in the United States and in other countries; (iv) activity that results in termination of the Participant's employment for cause; (v) a violation of any rules, policies, procedures or guidelines of the Company, including but not limited to the Company's business conduct or similar guidelines; (vi) any attempt directly or indirectly to induce any employee of the Company to be employed or perform services elsewhere or any attempt directly or indirectly to solicit the trade or business of any current or prospective customer, supplier or partner of the Company; (vii) the Participant being convicted of, or entering a guilty plea with respect to, a crime, whether or not connected with the Company; or (viii) any other conduct or act determined to be injurious, detrimental or prejudicial to any interest of the Company. (c) In connection with subsection 9(b) herein, upon exercise, payment or delivery pursuant to a Stock Award, the Participant shall certify in a manner acceptable to the Company that he or she is in compliance with the terms and conditions of the Plan. In the event a Participant engages in a Detrimental Activity prior to, or during the six months after, any exercise, payment or delivery pursuant to a Stock Award, such exercise, payment or delivery may be rescinded within two years thereafter. In the event of any such rescission, the Participant shall pay to the Company the amount of any gain realized or payment received as a result of the rescinded exercise, payment or delivery, in such manner and on such terms and conditions as may be required, and the Company shall be entitled to set-off against the amount of any such gain any amount owed to the Participant by the Company. 13 10. **COVENANT OF THE COMPANY.** During the terms of the Stock Awards, the Company shall keep available at all times the number of shares of Stock required to satisfy such Stock Awards up to the number of shares of Stock authorized under the Plan 11. **USE OF PROCEEDS FROM STOCK.** Proceeds from the sale of Stock pursuant to Stock Awards shall constitute general funds of the Company. 12. **MISCELLANEOUS.** (a) Neither an Optionee nor any person to whom an Option is transferred under subsection 6(d) shall be deemed to be the holder of, or to have any of the rights of a holder with respect to, any shares subject to such Option unless and until such person has satisfied all requirements for exercise of the Option pursuant to its terms. (b) Throughout the term of any Option granted pursuant to the Plan, the Company shall make available to the holder of such Option, not later than one hundred twenty (120) days after the close of each of the Company's fiscal years during the Option term, such financial and other information regarding the Company as comprises the annual report to the stockholders of the Company provided for in the bylaws of the Company. (c) Nothing in the Plan or any instrument

executed or Stock Award granted pursuant thereto shall confer upon any Participant any right to continue in the employ of the Company or any Affiliate (or to continue acting as a Director or Consultant) or shall affect the right of the Company or any Affiliate to terminate the employment of any Employee, or the relationship as a Director or Consultant of any Director or Consultant with or without cause. (d) To the extent that the aggregate Fair Market Value (determined at the time of grant) of Stock with respect to which Incentive Stock Options are exercisable for the first time by any Optionee during any calendar year under all plans of the Company and its Affiliates exceeds one hundred thousand dollars (\$100,000), the Options or portions thereof which exceed such limit (according to the order in which they were granted) shall be treated as Non-statutory Stock Options. 13. ADJUSTMENTS UPON CHANGES IN

STOCK. (a) If any change is made in the Stock subject to the Plan, or subject to any Stock Award (through merger, consolidation, reorganization, recapitalization, stock dividend, dividend in property other than cash, stock split, liquidating dividend, combination of shares, exchange of shares, change in corporate structure or otherwise), the Plan and outstanding Stock Awards will be appropriately adjusted in the class(es) and maximum number of shares subject to the Plan and the class(es) and number of shares and price per share of Stock subject to outstanding Stock Awards.

14 (b) In the event of: (1) a merger or consolidation in which the Company is not the surviving corporation or (2) a reverse merger in which the Company is the surviving corporation but the shares of Stock outstanding immediately preceding the merger are converted by virtue of the merger into other property, whether in the form of securities, cash or otherwise, then, at the sole discretion of the Board and to the extent permitted by applicable law: (i) any surviving corporation shall assume any Stock Awards outstanding under the Plan or shall substitute similar Stock Awards for those outstanding under the Plan, or (ii) such Stock Awards shall continue in full force and effect. In the event any surviving corporation refuses to assume or continue such Stock Awards, or to substitute similar awards for those outstanding under the Plan, the Stock Awards shall be terminated if not exercised prior to such event. In the event of a dissolution or liquidation of the Company, any Stock Awards outstanding under the Plan shall terminate if not exercised prior to such event. 14. AMENDMENT OF THE PLAN. (a) The Board at any time, and from time to time,

may amend the Plan. However, except as provided in Section 13 relating to adjustments upon changes in Stock, any amendments shall be approved by the shareholders of the Company where required by law. (b) It is expressly contemplated that the Board may amend the Plan in any respect the Board deems necessary or advisable to provide Optionees with the maximum benefits provided or to be provided under the provisions of the Code and the regulations promulgated thereunder relating to Incentive Stock Options and/or to bring the Plan and/or Incentive Stock Options granted under it into compliance with the Code. (c) Rights and obligations under any Stock Award granted before amendment of the Plan shall not be altered or impaired by any amendment of the Plan unless (i) the Company requests the consent of the person to whom the Stock Award was granted and (ii) such person consents in writing. 15.

TERMINATION OR SUSPENSION OF THE PLAN. (a) The Plan shall terminate ten (10) years following its effective date. Despite the preceding sentence, the Board may suspend or terminate the Plan at any time. No Stock Awards may be granted under the Plan while the Plan is suspended or after it is terminated. (b) Rights and obligations under any Stock Award granted while the Plan is in effect shall not be altered or impaired by suspension or termination of the Plan, except with the consent of the person to whom the Stock Award was granted. 16.

EFFECTIVE DATE OF PLAN. The Plan shall become effective upon the later of the date it is first adopted by the Board or approved by the Company's shareholders. 15 PLAN HISTORY ----- October 5, 1998 Board adopts Plan. November 2, 1998 Shareholders approve Plan. August 18, 2000 Board adopts amended Plan. September 21, 2000 Shareholders approve amendments to Section 4 of Plan. March 1, 2001 Plan assumed by SVI Solutions, Inc. in reincorporation merger. August 27, 2002 Board adopts amended Plan. September 19, 2002 Shareholders approve amendments to Section 4 of Plan (pending). 16 SVI SOLUTIONS, INC. 5607 Palmer Way Carlsbad, CA 92008 (877) 784-7978 _____ PROXY

_____ ANNUAL MEETING OF STOCKHOLDERS TO BE HELD ON
SEPTEMBER 19, 2002 _____ THIS PROXY IS SOLICITED BY THE
BOARD OF DIRECTORS OF SVI SOLUTIONS, INC. _____ The

undersigned stockholder of SVI Solutions, Inc., a Delaware corporation, hereby appoints Barry M. Schechter, Chief Executive Officer and Chairman of the Board, or in his absence, Jackie O. Tran, Controller, my proxy to attend and represent me at the annual meeting of the stockholders of the corporation to be held on September 19, 2002 at 9 A.M. (PT), and at any adjournment thereof, and to vote my shares on any matter or resolution which may come before the meeting and to take any other action which I could personally take if present at the meeting. THE BOARD OF

DIRECTORS RECOMMENDS THAT THE STOCKHOLDERS VOTE FOR EACH OF THE NOMINEES FOR DIRECTOR AND FOR PROPOSALS 2 AND 3. 1. ELECTION OF DIRECTORS Management has nominated the following seven persons to stand for election. You may vote "for" or you may withhold your vote from any of those persons nominated. a. Barry M. Schechter For _____ Withhold _____ b. Arthur S. Klitofsky For _____ Withhold _____ c. Donald S. Radcliffe For _____ Withhold _____ d. Ivan M. Epstein For _____ Withhold _____ e. Michael Silverman For _____ Withhold _____ f. Ian Bonner For _____ Withhold _____ g. Robert P. Wilkie For _____ Withhold _____ 2. APPROVE AMENDMENTS TO 1998 INCENTIVE STOCK PLAN Amendments to the 1998 Incentive Stock Plan ("1998 Plan") to increase the number of shares reserved under the 1998 Plan by 1,000,000 shares, and to increase the number of stock awards that may be granted to any one participant in any calendar year under the 1998 Plan from 500,000 shares to 1,000,000 shares. For _____ Against _____ Abstain _____ 3. ENGAGEMENT OF INDEPENDENT PUBLIC ACCOUNTANTS Ratification of the continued engagement of Singer Lewak Greenbaum & Goldstein LLP as the Company's independent public accountants and auditors for the fiscal year ending March 31, 2003. For _____ Against _____ Abstain _____ Failure to check any of these boxes for each proposal will give Barry M. Schechter or Jackie O. Tran the authority to vote the proxy at his or her discretion. This Proxy gives discretionary authority to my proxy to vote for me on such other matters as may properly come before this meeting. Number of Shares Owned: _____ Dated: _____

----- SIGNATURE(S) Please sign exactly as your name appears hereon. If the stock is registered in the names of two or more persons, each should sign. Executors, administrators, trustees, guardians and attorneys-in-fact should add their titles. If signer is a corporation, please give full corporate name and have a duly authorized officer sign, stating title. If signer is a partnership, please sign in partnership name by authorized person. YOUR VOTE IS IMPORTANT. Please vote, date and promptly return this proxy in the enclosed return envelope which is postage prepaid if mailed in the United States