

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

(Mark One)
 ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended June 30, 2004;

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 0-23125

OSI SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

California
(State or Other Jurisdiction
of Incorporation or Organization)

12525 Chadron Avenue, Hawthorne, California
(Address of Principal Executive Offices)

33-0238801
(I.R.S. Employer
Identification No.)

90250
(Zip Code)

Registrant's Telephone Number, Including Area Code: (310) 978-0516

Securities registered pursuant to Section 12(b) of the Act: None

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

Common Stock, no par value
(Title of Class)

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

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

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

As of December 31, 2003 (the last day of the Registrant's second quarter of fiscal year 2004), the aggregate market value of the shares of the Registrant's Common Stock held by non-affiliates was approximately \$256,983,000, based on the last sales price of the Registrant's Common Stock on the NASDAQ National Market on such date. Shares of Common Stock held by each officer and director and by each person who owns more than 5% or more of the outstanding Common Stock of the Registrant have been excluded in that such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of the Registrant's Common Stock outstanding as of September 9, 2004 was 16,240,290.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement relating to the 2004 Annual Meeting of Stockholders (to be filed subsequently) are incorporated by reference into Part III.

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ITEM 1. BUSINESS

General

OSI Systems, Inc. and its subsidiaries is a vertically integrated, worldwide provider of security and inspection systems, medical monitoring and imaging systems, and optoelectronic devices and value-added subsystems. Our company was incorporated in 1987 in California. Our principal office is located at 12525 Chadron Avenue, Hawthorne, California 90250.

We design, manufacture and market security and inspection systems worldwide to end users under trade names including “Rapiscan,” “Ancore,” “PFNA,” “Eagle,” “Metor,” and “Secure.” These systems are used to inspect people, baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials.

In March 2004, we significantly enhanced our medical monitoring and imaging systems activities through the acquisition of Spacelabs Medical, Inc. (“Spacelabs Medical”), a global manufacturer and distributor of patient monitoring and clinical information systems for use primarily in hospitals. Spacelabs Medical’s principal products encompass patient monitoring systems, network and connectivity solutions, ambulatory blood pressure monitors and medical data services. As a result, in the medical field, we now design, develop, manufacture, and market patient monitoring products, network connectivity solutions, ambulatory blood pressure monitors, and related services under trade names including “Spacelabs,” “Ultracare,” and “Ultraview.” We also continue to design, develop, manufacture and market arterial hemoglobin saturation monitors and sensors, including hand-held and wireless monitoring tools under trade names including “Dolphin” and “NuCat,” and peripheral bone densitometers under trade names including “DTX-200” and “DTU-One.”

Our optoelectronic devices and value-added subsystems are used in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical diagnostics, fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. We design and manufacture optoelectronic devices and value-added subsystems for others through original equipment manufacturer arrangements, as well as for our own security and medical equipment businesses.

In fiscal year 2004, revenues from the sale of security and inspection systems amounted to \$117.8 million, or approximately 48% of our revenues. Revenues from the sale of medical imaging and monitoring systems amounted to \$60.7 million, or approximately 24% of our revenues. The revenues of Spacelabs Medical from March 19, 2004, the date of acquisition, amounting to \$47.2 million, are included in the medical imaging and monitoring systems revenues. Revenues from the sale of optoelectronic devices and value-added subsystems amounted to \$68.6 million, or approximately 28% of revenues. Additional information concerning reporting segments is available in Note 14 to our financial statements.

Industry Overview

We sell our security and inspection systems and medical monitoring and imaging systems primarily to end-users, while we design and manufacture our optoelectronic devices and value-added subsystems primarily for original equipment manufacturers.

Security and Inspection Systems. A variety of technologies are currently used worldwide in security and inspection applications, including: computed tomography systems, single energy x-ray equipment, dual energy x-ray equipment, metal detectors, x-ray machines employing backscatter detection technology, trace detection

products, and cargo inspection systems using x-rays, gamma rays, or thermal neutron analysis. We believe that the market for security and inspection products will continue to be affected by the threat of terrorist incidents and by new government mandates and appropriations for security and inspection products in the United States and internationally. We also anticipate a growing market for the use of our products in non-security applications such as customs manifest verification and agricultural products inspection.

In the 1970s, principally in response to civilian airline hijackings, the U.S. Government established security standards by setting guidelines for the screening of carry-on baggage for weapons. The United Nations later mandated these standards for adoption by all of its member states. We believe that to date the imposition of these standards has resulted in the installation of over 10,000 x-ray inspection systems in airports worldwide. Additionally, since 1998, the United Kingdom Department of Transport has required that the United Kingdom's commercial airports deploy systems for 100% screening of international checked baggage. The European Civil Aviation Conference, an organization of 41 member states, has also agreed to implement 100% screening of international checked baggage in the future.

In the United States, largely in response to the explosion of Pan Am Flight 103 in December 1988, Congress enacted the Aviation Security Improvement Act of 1990, which, among other initiatives, directed the air transportation regulatory authorities in the U.S. to establish and implement strict security measures and to deploy advanced technologies for the detection of explosives. Then, in July 1996, in response to a White House commission report on aviation safety and security, the U.S. Government enacted additional legislation appropriating \$144 million for the initial deployment of advanced security and inspection technology at major U.S. airports.

The September 11, 2001 terrorist attacks on the World Trade Center and the Pentagon using hijacked airliners has since led to nation-wide shifts in transportation and facilities security policies. Shortly following these attacks, Congress passed the Aviation and Transportation Security Act and integrated many U.S. security-related agencies, including the Federal Aviation Administration, into the U.S. Department of Homeland Security. As a result of these and other changes, sales of our security and inspection products have grown as compared to pre-September 11, 2001 levels.

Worldwide trends toward increased international trade and transportation of goods and people have resulted in a growing demand for cargo, port and border inspection technologies. Projects recently installed or currently underway include system installations in Hong Kong, Jamaica, Mexico, Romania, South Korea, Taiwan, the United Arab Emirates, and the United States. These sites contain various cargo inspection product offerings including fixed and relocatable high-energy x-ray, mobile gamma-ray, hybrid x-ray/thermo neutron analysis and pulsed fast neutron analysis scanning systems. We anticipate a growing demand from governments and commercial enterprises for increasingly sophisticated solutions to screening vehicles, trucks, ocean-going cargo, and air pallet containers.

Medical Monitoring and Imaging Systems. Though a well established market, healthcare is a rapidly growing sector of the U.S. and European economies. An aging population that is requiring a growing number of critical care beds is, in part, fueling this growth.

Many factors such as a severe nationwide nursing shortage, stricter government requirements affecting the staffing and accountability, and shrinking reimbursements from health insurance organizations are forcing healthcare providers to do more with less—improving patient safety and economic efficiencies with fewer resources. Our medical monitoring and imaging systems group designs, manufactures and markets products that respond to these new economic forces by helping hospitals reduce costs while maintaining or improving the quality of care their physicians and nurses are able to deliver.

In March 2004, we significantly enhanced our medical monitoring and imaging systems activities through the acquisition of Spacelabs Medical, a global manufacturer and distributor of patient monitoring and clinical information systems for use primarily in hospitals. As a result of the Spacelabs Medical acquisition, our total number of employees increased from approximately 1,450 to approximately 2,205, or 52%. Our Spacelabs Medical subsidiary designs, manufactures and markets patient monitoring solutions for critical care, emergency and perioperative areas of the hospital, wired and wireless networks and connectivity solutions, ambulatory blood pressure monitors and medical data services, all aimed at providing caregivers with instant patient information. By making critical patient information more readily accessible both inside and outside the hospital, delays in decision-making can be reduced, length of stay can be shortened, and treatment errors can be minimized.

Through our Dolphin Medical Inc. (“Dolphin Medical”) and Osteometer MediTech USA, Inc. (“Osteometer”) subsidiaries, we design, manufacture, and market next-generation pulse oximetry instruments and compatible pulse oximetry sensors as well as x-ray and ultrasound densitometers, which are used to diagnose osteoporosis as well as to provide follow-up bone density measurements. Our pulse oximetry technologies are used to non-invasively monitor oxygenation levels in a patient’s blood.

Optoelectronic Devices and Value-Added Subsystems. Our optoelectronic devices and value-added subsystems are used for a wide variety of applications ranging from complex monitoring, measurement and positioning functions, such as in industrial robotics where our optoelectronic devices and value-added subsystems are used to detect the exact position, motion or size of another object, to simple functions, such as the detection of paper in the print path of a laser printer. Because optoelectronic devices and value-added subsystems can be used in a wide variety of measurement control and monitoring applications, they are used in a broad array of industrial applications and are key components in the telecommunications and fiber optics industries.

We believe that in recent years, advances in technology and reductions in the cost of key components of optoelectronic systems, including computer processing power and memory, have broadened the market by enabling the use of optoelectronic devices in a greater number of applications. In addition, we see a trend among original equipment manufacturers to increasingly outsource the design and manufacture of optoelectronic devices and value-added subsystems to fully-integrated, independent manufacturers, like us, who may have greater specialization, broader expertise, and the flexibility to respond in shorter time periods than most original equipment manufacturers can accomplish in-house. We believe that our level of vertical integration, substantial engineering resources, expertise in the use and application of optoelectronic technology, and low-cost international manufacturing operations enable us to compete effectively in the market for optoelectronic devices and value-added subsystems. Our optoelectronic devices and value-added subsystems are also used in our security and inspection systems and medical monitoring and imaging products.

We have also penetrated several related markets that depend on our optoelectronic device and subsystem technologies. For example, we sell a series of high-speed photodetectors for use in fiber optic systems such as Gigabit Ethernet, Fiber Channel, and other telecommunication and data communication applications. Through system engineering, product development, rapid prototyping, and volume manufacturing, we develop, manufacture and market laser-based weapons simulation systems for the defense industry. Products include tactical engagement simulation systems, man worn laser detectors, small arms transmitters, controller guns and a variety of targeting systems. We also develop, manufacture, and sell laser-based remote sensing devices that are used in agricultural and mapping applications, as well as to detect and classify vehicles in toll and traffic management systems. Finally, our optoelectronic devices and subsystems group recently added “box build” manufacturing services and PC board assembly capabilities utilizing state-of-the-art automated surface mount technology lines for use by customers in the medical electronics, automotive diagnostic electronics, telecommunications, and digital audio systems industries, among others.

Growth Strategy

Our primary objectives are to be a leading provider of security and inspection products, cutting-edge medical monitoring and imaging systems and specialized optoelectronic products, to enhance our position in the

international inspection and detection marketplace, to capitalize on our research to provide reliable and cost-optimized medical devices, and to leverage our expertise in the optoelectronic technology industry by entering into new markets. Key elements of this strategy include:

Capitalizing on the Growing Market for Security and Inspection Systems. We believe that heightened attentiveness to terrorist and other security threats may continue to drive growth in the market for security and inspection systems, not only in transportation security, but in facilities security, event security and materials inspection as well. In addition, the trend toward increased international transportation of goods and people may result in growth in the market for cargo inspection systems. Package screening by freight forwarders also represents a potential growing sector, as new regulations in Europe require such screening, and awareness of the need for such screening grows in the U.S. We intend to continue to expand our sales and marketing efforts both domestically and internationally, and to capitalize on opportunities to replace service and upgrade existing security installations.

Developing New Security and Inspection Technologies. We intend to continue to develop new security and inspection systems such as our proprietary pulsed fast neutron analysis and real time tomography products. These and the other technological advances we make allow us to offer customers the broadest variety of advanced security solutions. In addition, through research and development and selective acquisitions, we may enhance and expand our current product offerings to better address new applications and security industry demands.

Improving Existing Medical Diagnostic Technologies. In March 2004, we significantly enhanced our medical monitoring and imaging systems activities through the acquisition of Spacelabs Medical, a global manufacturer and distributor of patient monitoring and clinical information systems for use primarily in hospitals. Spacelabs Medical develops medical monitoring and imaging systems aimed at lowering false alarm rates, thereby reducing time demands on physicians and nurses, and improving patient identification accuracy, thereby reducing physician and nursing errors. In connection with these efforts, Spacelabs Medical and our Dolphin Medical subsidiary are also pursuing cable-free medical sensors and other wireless solutions that will allow for medical monitoring, patient data, transmission, alarm notifications, and other information to be instantly transmitted at any time to any location. We also continue to improve and develop our medical diagnostic tools aimed at bone metabolic diseases, such as osteoporosis, and patient monitors and accessories that utilize pulse oximetry technologies. Overall, our efforts at improving our existing medical diagnostic technologies will continue to concentrate on the development of devices that make it possible for institutions from large hospitals to small clinics and physicians' offices to obtain accurate, precise, reliable and cost-effective results.

Leveraging the Optoelectronic Design and Manufacturing Expertise to Address New Applications. We believe that one of our primary competitive strengths is our expertise in designing and manufacturing, at cost-effective rates, specialized optoelectronic devices and value-added subsystems for our own end products both in security and medical businesses and for the products of our original equipment manufacturer customers. Our optoelectronic devices and subsystems group currently designs and manufactures devices and subsystems for numerous customers serving hundreds of applications.

Acquiring New Companies and Technologies. We have developed expertise in our various lines of business and other areas through internal research and development efforts and also through selective acquisitions.

In 1987, we formed Opto Sensors (Singapore) PTE Ltd. to manufacture optoelectronic devices and value-added subsystems.

In 1990, we acquired UDT Sensors, Inc. to broaden our expertise and capabilities in developing and manufacturing optoelectronic devices and value-added subsystems.

In 1993, we acquired Rapiscan Security Products Limited in the United Kingdom and, through Rapiscan Security Products (U.S.A.), Inc., commenced our operations as a provider of security and inspection systems in the United States.

In 1993, we acquired Ferson Optics, Inc. ("Ferson Optics") for its passive optic technologies.

In 1994, we commenced operations of Opto Sensors (Malaysia) Sdn. Bhd. to take advantage of lower manufacturing costs in Malaysia.

In 1994 we, together with an unrelated third party formed ECIL-Rapiscan Security Products Limited in India, for the purpose of the manufacture, assembly, service and testing of x-ray security and other products.

In 1997, we acquired Advanced Micro Electronics AS for its hybrid optoelectronic capabilities.

In 1998, we acquired Osteometer MediTech A/S, a Danish manufacturer of diagnostic scanners used for the early detection of symptoms of osteoporosis. In August 1999, we closed the operations of Osteometer in Denmark, and relocated certain of those operations to our Hawthorne, California facilities.

In 1998, we purchased the security products business of Metorex International Oy of Espoo, Finland. This acquisition brought a complete security metal detection product line to our security and inspection systems group.

In 1998, we acquired all the outstanding stock of Silicon Microstructures, Inc., a silicon pressure-sensor manufacturer, from Exar Corporation located in Fremont, California. On March 31, 2001, we sold all of the outstanding stock of Silicon Microstructures, Inc. to Elmos Semiconductor AG of Germany.

In 1998, we acquired substantially all of the assets and assumed certain liabilities of Corrigan Canada Ltd. in order to enhance the market presence of our security and inspection systems in Canada.

In 1998, we purchased a minority equity stake in Square One, Inc., a developer and manufacturer of infrared-based patient monitoring medical subsystems. In 2000, we acquired substantially all of Square One, Inc.'s assets.

In 1999, we acquired Aristo Medical Products, Inc. for its pulse oximeter probe technologies for use in the medical field.

In 1999, we formed OSI Medical, Inc., a developer of next generation pulse oximeter instruments and probes for use in the medical field.

In 2001, we contributed most of our medical monitoring and imaging systems to a newly formed subsidiary Dolphin Medical, for the purpose of consolidating our various medical devices into a single subsidiary. We merged OSI Medical, Inc. into Dolphin Medical in March 2002. In December 2003, we entered into a stock purchase and option agreement with Conmed Corporation, whereby Conmed Corporation purchased a 10% interest in, Dolphin Medical and an option to purchase all of the remaining assets and the business of Dolphin Medical. In addition, Conmed Corporation and Dolphin Medical entered into a distribution agreement, which provides Conmed Corporation with distribution rights for certain Dolphin Medical products within certain defined territories.

In July 2002, we acquired substantially all the assets of Thermo Centro Vision, Inc., an optoelectronic devices and value-added subsystems designer and manufacturer based in Ventura County, California. The acquisition was made through a newly formed, wholly owned subsidiary, Centro Vision, Inc.

In July 2002, we purchased a 6% interest in Imagis Technologies, Inc., a company that develops facial recognition software for security applications. Based on the continued trading of Imagis common stock below the original purchase price for a prolonged period of time, we recognized an other-than-temporary impairment of the carrying value of this investment.

In August 2002, we purchased a minority equity interest in CXR Limited, a United Kingdom based research and development company that develops real time tomography systems. In June 2004, we increased our equity interest in CXR Limited to approximately 75%.

In November 2002, we acquired all the outstanding capital stock of Ancore Corporation (“Ancore”), a Santa Clara, California based privately held high-technology developer and provider of advanced inspection systems for aviation security, port and border inspection and counter-terrorism. Consideration paid for the acquisition consisted of a combination of our Common Stock and cash of approximately \$10.4 million including professional fees associated with the acquisition. In addition, during the five years following the close, contingent consideration is payable based on sales of certain Ancore products. The contingent consideration is capped at \$34.0 million.

In August 2003, we acquired the military, laser-based training business of Schwartz Electro-Optics, Inc. in a bankruptcy-court supervised auction. At the close of the transaction we paid approximately \$3.7 million including professional fees associated with the acquisition. The acquisition was made through a newly formed, wholly owned subsidiary, OSI Defense Systems, LLC (“OSI Defense Systems”). The acquired business develops and manufactures tactical engagement simulation systems, man worn laser detectors, small arms transmitters, controller guns and a variety of targeting systems for the defense industry.

In October 2003, we acquired the assets of a manufacturing services company specializing in surface mount technology lines and PC board assembly operations for approximately \$4.5 million including professional fees associated with the acquisition. The acquisition was made through a wholly owned subsidiary, OSI Electronics, Inc.

In November 2003, we acquired substantially all remaining assets of Schwartz Electro-Optics, Inc. in a bankruptcy-court supervised auction. We paid approximately \$1.6 million, including the assumption of certain liabilities and bankers’ fees. The acquired assets comprise a business for the design, sales and manufacturing of laser-based systems used in traffic management, precision agricultural management, and precision mapping and surveying. The business, located in Orlando, Florida, now operates under the name OSI Laserscan. The acquisition was made through our wholly owned subsidiary, OSI Defense Systems.

In December 2003, we acquired substantially all of the assets of J&D Engineering (UK) Limited, a company registered in England and Wales. We paid approximately 367,000 pounds sterling (or approximately \$649,000) including acquisition costs. A further 93,000 pounds sterling (or approximately \$171,000) was paid during the quarter ended March 31, 2004. The acquired assets comprise a business for the design, manufacturing, and sale of, among other products, metal frames for x-ray scanners.

In January 2004, we completed the acquisition of Advanced Research & Applications Corp. (“ARACOR”), a privately held company located in Sunnyvale, California. Consideration for the acquisition consisted of an initial cash payment of approximately \$17.6 million (net of cash acquired), including acquisition costs. Furthermore, during the seven years following the close, contingent consideration is payable based on ARACOR’s net revenues, provided certain requirements are met. The contingent consideration is capped at \$30.0 million. The acquisition of ARACOR broadens our security product portfolio through ARACOR’s mobile x-ray inspection system, the Eagle, which is designed for container scanning at busy seaports.

In January 2004, minority shareholders of our RapiTec, Inc. (“RapiTec”) subsidiary accepted an offer by us to purchase all shares of RapiTec common stock held by them. As a result of the transaction, we now wholly own RapiTec. Consideration paid for the share purchase transaction consisted of an initial cash payment of approximately \$820,000, of which \$536,000 was allocated to goodwill. Subsequent to the year ended June 30, 2004, a second cash payment of approximately \$150,000 is due to the former minority shareholders of RapiTec, due to RapiTec meeting certain performance requirements. This amount will be recorded as goodwill.

In March 2004, we completed the acquisition of Spacelabs Medical, based in Issaquah, Washington, from Instrumentarium Corporation for approximately \$47.9 million in cash (net of cash acquired), including

acquisition costs. Spacelabs Medical is a leading global manufacturer and distributor of patient monitoring systems for critical care and anesthesia, wired and wireless networks, clinical information connectivity solutions, ambulatory blood pressure monitors, and medical data services. These are areas in which we have considerable interest as they represent a natural extension of our engineering and manufacturing expertise and will add to our presence in the medical device industry. The installed base of Spacelabs Medical's patient monitoring systems consists of approximately 100,000 units worldwide, with 60,000 in the United States, 30,000 in Europe and 10,000 in Asia. In June 2004, we notified Instrumentarium Corporation's parent, GE Medical Systems, of a working capital and retention bonus adjustment resulting in what we believe to be a downward adjustment of the purchase price in the amount of \$25.9 million. In September 2004, GE Medical Systems responded that it believes the amount of the downward adjustments to be approximately \$7.8 million. No amounts have been recorded in the financial statements in relation to the expected reduction in the purchase price. The amount of the final adjustment will be resolved by way of a process established in the purchase agreement.

Capitalizing on Vertical Integration. Our vertical integration provides several advantages in our security and inspection, medical monitoring and imaging and optoelectronic devices and value-added subsystem product lines. These advantages include reduced manufacturing and delivery times, lower costs due to our access to competitive international labor markets, direct sourcing of raw materials and quality control. We also believe that we offer significant added value to our original equipment manufacturer customers by providing a full range of vertically-integrated services including component design and customization, subsystem concept design and application engineering, product prototyping and development, efficient pre-production, and short-run and high volume manufacturing. We believe that our vertical integration differentiates us from many of our competitors and provides value to our original equipment manufacturer customers who can rely on us to be an integrated supplier of optoelectronic devices and value-added subsystems. We intend to continue to leverage our vertically integrated services to create greater value for our customers in the design and manufacture of our products. We believe that this strategy better positions us for penetration into other end markets.

Capitalizing on Global Presence. We operate from locations in North America, Europe and Asia. We view our international operations as providing an important strategic advantage over competitors in each of the security inspection, medical monitoring and imaging systems, and optoelectronic devices and subsystems market for three primary reasons. First, international manufacturing facilities allow us to take advantage of competitive labor rates in order to be a low cost producer. Second, our international offices strengthen our sales and marketing efforts and our ability to service and repair our systems by providing direct access to growing foreign markets and to our existing international customer base. Third, multiple manufacturing locations allow us to reduce delivery times to our global customer base. In the future, we intend to develop new sources of manufacturing and sales capabilities to maintain and enhance the benefits of our international presence.

Selectively Entering New Markets. We intend to selectively enter new markets that complement our existing capabilities in the design, development and manufacture of security systems, medical products, and optoelectronic devices and value-added subsystems. We believe that by manufacturing other end products that rely on our existing technological capabilities, we will leverage our integrated design and manufacturing infrastructure to capture greater margins and to build a larger presence in those new end markets that present attractive competitive dynamics. We intend to achieve this strategy through internal growth and through selective acquisitions of end-product manufacturers.

Products and Technology

We design, develop, manufacture and sell products ranging from complex security and inspection systems to medical imaging and monitoring systems to discrete optoelectronic devices and value-added subsystems.

Security and Inspection Systems. We design, manufacture and market security and inspection systems worldwide to end users under trade names including "Rapiscan," "Ancore," "PFNA," "Eagle," "Metor," and "Secure." These products are used to inspect people, baggage, cargo, vehicles and other objects for weapons,

explosives, drugs and other contraband. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials.

In recent years, and especially after the terrorist attacks of September 11, 2001, security and inspection products have increasingly been used at a wide range of facilities other than airports. Moreover, the non-security use of such equipment, such as manifest verification by customs agencies at border crossings, or agricultural products inspection, has also grown. As a result of the additional markets, we have successfully diversified sales channels for our security and inspection products. Of our security and inspection revenues, the percentage derived from the sale of inspection products to airlines and airports was approximately 24.5% in fiscal year 2002, 28.8% in fiscal year 2003 and 16.5 % in fiscal year 2004, and the balance of such revenues were derived from all other sales.

Many of our inspection and detection products combine the use of x-ray technology with our optoelectronic capabilities. Such products include dual- or multi-energy x-ray technology with computer enhanced imaging technology to facilitate the detection of materials such as explosives, narcotics, currency or other contraband. While all x-ray systems produce a two-dimensional image of the contents of the inspected object, the dual-energy x-ray systems also measure the x-ray absorption of the inspected object's contents at two x-ray energies to determine the atomic number, mass and other characteristics of the object's contents. The various organic and non-organic substances in the inspected object appear to operators of the inspection systems in various colors and this visual information can be used to identify and differentiate the inspected materials. These inspection systems range in size from compact tabletop systems to large cargo, port and border inspection systems comprising entire buildings through which trucks, shipping containers or pallets are transported.

Some of our inspection products require an operator to monitor the images produced by the inspection equipment. Depending on the model, our products permit the operator to inspect the contents of packages at varying image modes and magnifications. The images range from the monochrome and pseudo-color images produced by single energy x-ray imaging systems, to high resolution, multi-color images produced by our computer enhanced dual-energy models. We believe that our Rapiscan 500 and 600 series machines provide one of the highest quality images currently available in the x-ray security and inspection industry.

We also manufacture inspection products that automatically and non-invasively detect explosives and other contraband through the use of pulsed fast neutron and thermal neutron technologies. Such technologies permit the operator to inspect cargo, vehicles, and small parcels based on the distinctive chemical composition of various forms of contraband. Our Pulsed Fast Neutron Analysis ("PFNA") systems use a penetrating beam of fast neutrons to measure the elemental contents (oxygen, nitrogen, etc.) within scanned objects (cargo containers, trucks, etc.) and identify elemental signatures of explosives, drugs or other contraband. The PFNA system then displays to the system operator a three-dimensional image of the scanned object, identifying the location and type of contraband found. Our Thermal Neutron Analysis systems use a similar technology to detect bulk quantities of explosives and drugs concealed in trucks or cargo containers.

Our cargo, vehicle, port, and border screening applications utilize high-energy x-ray as well as gamma-ray and neutron technologies along with computer-enhanced imaging. Such cargo inspection product configurations currently include fixed-site, relocatable, rail, and mobile systems. These products are primarily used to verify the contents of trucks or cargo containers, and to detect the presence of contraband. They offer significant improvements over past methods of cargo screening, such as manual searches, as our cargo systems are faster, more thorough, and do not subject the cargo to pilferage. Entire shipping containers or trucks can be screened in seconds.

Our cargo inspection systems currently include fixed site, relocatable, and mobile systems. Fixed-site systems consist of a permanent structure in which trucks or containers are subjected to high-energy x-ray, gamma-ray, or neutron inspection. Fixed site projects installed or currently under construction include systems in the United States, Hong Kong, Mexico, and Taiwan. Relocatable systems use similar technologies, but consist of

structures that can be relocated among pre-positioned pads. Several relocatable systems were recently delivered to the Korean Customs Service. Mobile systems are truck-mounted systems using high-energy x-ray or gamma-ray for the inspection of vehicles or cargo containers. The mobile systems can be quickly deployed where needed. Mobile systems have been sold or are currently under production for customers including government agencies in the United States, Malaysia, and Romania.

Our security and inspection systems group also offers a line of walk-through metal detection and hand-held examination products for screening people in airports, amusement parks, banks, courthouses, government buildings, sports arenas, and other venues. Our walk-through metal detection systems utilize pulse induced magnetic fields combined with microprocessor based electronics, which provide uniform detection of ferrous and non-ferrous metallic objects. The technologies range from dual-channel crossed magnetic fields to multi-zone coil configurations. Our “Secure” brand product line, also for hands-off examination, uses extremely low dose backscatter x-ray imaging to detect contraband and weapons concealed underneath clothing and hair. The system provides enhanced screening compared to metal detectors as it displays anomalies caused by very small amounts of metal as well as non-metallic items. As a result, our “Secure” products can simultaneously locate and detect conventional metal weapons, as well as ceramic knives, explosives, illicit drugs, precious metals, cameras, recording devices and other contraband or security threats.

The following table sets forth certain information related to the standard security and inspection products that we currently offer. We do, however, also customize our standard products to suit specific applications and customer requirements:

MODEL (Technology)	APPLICATIONS	LIKELY INSTALLATIONS
ARACOR Eagle	Inspection of cargo containers and vehicles	Border crossings High-security facilities Seaports
Ancore Cargo Inspector	Material-specific PFNA inspection of cargo and vehicles	Seaports Airports/Air cargo terminals Border crossings
Rapiscan 500 Series -Large Tunnel (single view and dual view 320-450 kV x-ray source)	Large pallet inspections Cargo, port and border inspections	Airports Border crossings Freight shippers Seaports
Rapiscan Series 2000 Cargo Inspection Systems	Fixed-site cargo inspection systems	Border crossings Customs facilities Seaports
Rapiscan Series 3000 Cargo Inspection System	Relocatable and mobile cargo inspection	Border crossings Customs facilities High-security facilities Seaports
Rapiscan Series 4100 Gamma Ray Truck Validation System	Validation of truck, shipping container and railroad car manifests	Border crossings Railroad cars
Rapiscan Series 4200 Gamma Ray Mobile Detection Systems	Inspection of vehicles, cargo containers, and air pallets	Airports Border crossings High-security facilities Seaports

MODEL (Technology)	APPLICATIONS	LIKELY INSTALLATIONS
Vehicular Explosive Detection System	Non-invasive material-specific detection of explosives in cars or trucks	Border crossings High-security events Seaports Security checkpoints
Rapiscan 519	Inspection of incoming packages Mail inspection	Courthouses Embassies Post offices
Rapiscan 500 and 600 Series -Standard Tunnel (single view and dual view 140 kV x-ray source, single energy and dual energy)	Airport hand carried and checked baggage Pallet inspections Customs inspections Agriculture inspection Facilities security Events security	Airports Border crossings Cruise ships Freight carriers Nuclear facilities Prisons
Rapiscan 500 Series -Mobile Systems (x-ray van or trailer)	Mobile x-ray inspections of luggage or small parcels	Airports Customs inspections Border crossings
Small Parcel Explosive Detection System	Non-invasive material-specific detection of explosives in hand-carried items and packages	Airport lobbies Government facilities Post offices
Threat Image Projection	Operator performance monitoring	Available for a majority of Rapiscan 500 Series Systems
Metor 100 Series	Walk-through metal detection	Airports Courthouses Government buildings
Metor 200 Series	Multi-zone walk-through metal detection	Airports Prisons Nuclear facilities Government buildings Courthouses
Secure 1000 (non-intrusive personal screening system)	High-security “hands-off” personnel inspection	Airports Border crossings Customs Military facilities Prisons

Medical Monitoring and Imaging Systems. In the medical field, we design, develop, manufacture, and market patient monitoring systems, network connectivity solutions, ambulatory blood pressure monitors, and related services under trade names including “Spacelabs,” “Ultracare” and “Ultraview.” We also design, develop, manufacture and market arterial hemoglobin saturation monitors and sensors, including hand-held and wireless monitoring tools under trade names including “Dolphin” and “NuCat” and peripheral bone densitometers under trade names including “DTX-200” and “DTU-One.”

Our “Ultraview” patient monitors are used in perioperative, critical care and emergency ward environments. We also offer patient monitors for virtually all applications in the hospital, including neonatal, pediatric and adult critical and emergency care, as well as anesthesia and sub-acute care. WinDNA, based on Citrix application server technology, is a feature of many of these products which allows clinicians to view and control Microsoft

Windows applications on the patient monitor’s display, eliminating the need for separate terminals in the patient’s room. Attending nurses can thereby check laboratory results and other reports, enter orders, review protocols, and do charting right at the patient’s bedside. Inputs can be made using a mouse, keyboard, and touchscreen.

For electrocardiograph monitoring or multiparameter monitoring of ambulatory patients, we offer a digital telemetry system. The system operates between 608 and 614 MHz, a band not used for private land mobile radio, business radio services or broadcast analog and digital television. The “Ultraview” Digital Telemetry solution comprises a lightweight and compact transmitter that enables monitoring of heart rate, ST segment, arrhythmia and continuous SpO2 (Pulse Oximetry). The multiparameter transmitter also integrates with our “Ultralite” ambulatory blood pressure monitor for the transmission of non-invasive blood pressure values to a central station or a multi-disclosure and information system.

We are also a world leader in ambulatory blood pressure monitoring, which is a routine procedure in many European countries and is increasingly being used in the United States. Many physicians are using ambulatory blood pressure monitoring to detect “white coat” hypertension, a condition in which people experience elevated blood pressure in the doctor’s office but not in their daily lives. Hypertension affects approximately 50 million Americans and is particularly prevalent in the Medicare population. Ambulatory blood pressure monitoring is also used to adjust drug therapies for hypertensive patients. It is estimated that as many as 20% of the persons diagnosed with hypertension based on blood pressure measurements taken in their physicians’ offices are not actually hypertensive. Ambulatory blood pressure monitoring helps improve diagnostic accuracy and minimize the associated costs of treatment.

Our medical monitoring and imaging systems group also manufactures and distributes the “DTX-200”, a dual energy x-ray forearm densitometer, which is used to diagnose osteoporosis as well as to provide follow-up bone density measurements and the “DTU-One”, a calcaneus ultrasound scanner. The “DTU-One” is the first commercially available ultrasound scanner using imaging capability for the diagnosis of osteoporosis.

We develop next-generation pulse oximetry instruments and compatible pulse oximetry sensors under the “Dolphin One” product line. “Dolphin One” products include the “Voyager”, “Dolphin 2100” and “Dolphin 2150”. The Voyager is the first personal data assistant-based pulse oximetry product on the market. Our medical monitoring and imaging systems group also manufactures and distributes, under the “Dolphin 2000”, “Aristo” and “NuCat” product lines, sensors that are compatible with products made by other manufacturers of pulse oximetry technologies.

Finally, we believe that a substantial market exists for disposable supplies such as patient electrodes, specialty graph paper, sensors and connecting lead wires that are used with medical devices. As a result, we sell a broad line of such supplies as an adjunct to our medical device sales. In most cases, these products are obtained from original equipment manufacturers and are manufactured to our specifications.

The following table sets forth certain information related to the standard medical products we currently offer:

MODEL (Technology)	APPLICATIONS	LIKELY INSTALLATIONS
DTX-200 DEXA Bone Densitometer	Detection, diagnosis, and follow up of treatment of osteopenia and osteoporosis	Physician offices Integrated practice groups Medical clinics Small hospitals
DexaCare G4 DEXA Bone Densitometer	Detection, diagnosis, and follow up of treatment of osteopenia and osteoporosis	Physician offices Integrated practice groups Medical clinics Small hospitals

MODEL (Technology)	APPLICATIONS	LIKELY INSTALLATIONS
DTU-One Ultrasound Scanner	Detection of osteopenia and osteoporosis	Physician offices Integrated practice groups Medical clinics Small hospitals
Intesys Clinical Suite ICS	Solutions to make patient data available anytime, anywhere, even from outside the hospital	All hospital care areas
Model 2100 Pulse Oximeter	Vital signs monitoring of critically ill patients	Critical care units within hospitals of all sizes
Maternal Obstetrical Monitor	Monitoring of mother and fetus, as well as newborn	Labor and delivery areas within hospitals
Ultraview SL 2400	Patient monitoring at the bedside and in transport	All hospital care areas
Ultraview SL 2700	Patient monitoring at the bedside	All hospital care areas
Ultraview SL 2800	High-end patient monitoring at the bedside	All hospital care areas
Ultraview SL 3800	Centralized, real-time monitoring surveillance of patients	Central nurses' stations within hospitals
Voyager Pulse Oximeter	Spot check assessment of critically ill patients	Critical care units within hospitals of all sizes

Optoelectronic Devices and Value-Added Subsystems. Optoelectronic devices generally consist of both active and passive components. Active components sense light of varying wavelengths and convert the light detected into electronic signals, whereas passive components amplify, separate or reflect light. The active components we manufacture consist of silicon, Gallium Arsenide, and Indium Gallium Arsenide photodetectors. Passive components include lenses, prisms, filters, mirrors and other precision optical products that are used by us in the manufacture of our optoelectronic products or are sold to others for use in telescopes, laser printers, copiers, microscopes and other detection and vision equipment. The devices we manufacture are both standard products and products customized for specific applications and are offered either as components or as subsystems.

In addition to the manufacture of standard and original equipment manufacturer products, we also specialize in designing and manufacturing customized optoelectronic devices and value-added subsystems for use in a wide range of products and equipment. An optoelectronic subsystem typically consists of one or more optoelectronic devices that are combined with other electronic components and packaging for use in an end product. The composition of a subsystem can range from a simple assembly of various optoelectronic devices that are incorporated into other subsystems (for example, a printed circuit board containing our optoelectronic devices) to complete end-products (for example, medical pulse oximeter probes that we manufacture and package on behalf of an original equipment manufacturer customer and then ship directly to the customer or the customer's distributors). We manufacture subsystems for a variety of applications, such as fiber optics, imaging electronics for medical CT scanners, disposable and reusable medical probes for use with medical pulse oximetry equipment, components and subsystems for laser gyroscopes used in military and commercial aviation, optoelectronic subsystems for slot machines, laser subsystems in military helicopter gun sighting equipment, positioning subassemblies for computer peripheral equipment, alignment subsystems for laser heads in optical disc drives, and detection subsystems for submarines.

We have recently developed two-dimensional back-illuminated detector technology for security, medical, and other industrial applications. This technology overcomes the limitations of conventional detectors by providing finer detector pitch density. We expect that this technology will be used in high-resolution multi-slice CT scanners and other applications requiring improved image resolution.

Markets, Customers and Applications

Security and Inspection Products. Since entering the security and inspection products market in 1993, we have shipped over 10,000 x-ray systems and over 40,000 metal detectors to over 75 countries. The following is a representative list of certain customers and/or installations that have purchased our security and inspection products:

OVERSEAS

Domodedova Airport, Moscow, Russia
Gatwick Airport, United Kingdom
Heathrow Airport, United Kingdom
TNT Freight, United Kingdom
Japanese Embassies, worldwide
Malaysian Airport Board, Malaysia
Dubai Airport, United Arab Emirates
United Kingdom Prison System, United Kingdom
INFRAERO, airports, Brazil
Chek Lap Kok Airport, Hong Kong
Pudong Shanghai International Airport, China
Kremlin, Russia
New Zealand Customs, New Zealand
Vatican City
Narita Airport, Japan
CKS International Airport, Taiwan
Korean Customs Service, South Korea

DOMESTIC

Department of Homeland Security
Transportation Security Administration
U.S. Marshals Service
Federal Reserve Banks
Federal Protective Service
United States Customs and Border Protection
California Department of Corrections
Federal Bureau of Prisons
United States Department of Agriculture
New York City Police Department
Royal Caribbean Cruises
United States Department of Corrections
Cunard Line
United States Air Force

The market for most security and inspection products developed in response to civilian airline hijackings. Consequently, a significant portion of our security and inspection products was sold and continues to be sold for use at airports. Recently, however, our security and inspection products have been used for security purposes at locations in addition to airports, such as courthouses, office buildings, mailrooms, schools, prisons and high-profile locations such as Buckingham Palace, the Kremlin, and the Vatican. In addition, our security and inspection products are increasingly being used for non-security purposes, such as for cargo inspection to detect narcotics and contraband and to verify manifests, prevention of pilferage at semiconductor manufacturing facilities, quality assurance, and the detection of gold and currency. The September 11, 2001 terrorist attacks on the World Trade Center and the Pentagon using hijacked airliners likely will continue to cause increasing levels of airport security measures, which have resulted in an increase in sales of our security and inspection products as compared to previous levels.

In September 1998, we entered into an agreement with what was then known as the Federal Aviation Administration, now the Transportation Security Administration, for advanced contraband detection systems with threat image projection features. The systems began to ship to Category X airports (designated due to their high security priority) in the United States during fiscal year 1999. Systems were shipped each year since fiscal year 2000 and will continue to be shipped during fiscal year 2005. In addition, the Transportation Security Administration ordered Rapiscan shoe scanning x-ray technology to supplement airport checkpoint screening.

In April 2000, the U.S. Government awarded us a contract to provide x-ray screening systems at selected airports throughout the United States. Under the contract, the U.S. Government has the right to purchase from us

up to 800 systems, for which the aggregate purchase price would be approximately \$40 million. In fiscal years 2001 through 2004 our installed-base totaled approximately 750 systems under this contract. We expect to ship additional systems during fiscal year 2005.

Since 2001, we have completed the delivery of fixed site, relocatable, or mobile cargo inspection systems to governments and government agencies in Hong Kong, Malaysia, Romania, South Korea, Taiwan, and other locations.

Medical Monitoring and Imaging Systems. Our medical monitoring and imaging systems are manufactured and distributed globally for use in critical care, emergency and perioperative areas within hospitals. We also provide wired and wireless networks and clinical information access solutions, ambulatory blood pressure monitors and medical data services. Our Spacelabs Medical subsidiary has an installed base of approximately 100,000 patient monitoring units and 30,000 ambulatory blood pressure monitors worldwide. Our medical monitoring and imaging systems business has distributors in over 70 countries and subsidiary or branch offices in the United States and internationally in Austria, Canada, Finland, France, Germany, Greece, India, Italy, Singapore, Malaysia, and the United Kingdom.

In March 2004, our medical monitoring and imaging systems group was awarded a contract to supply over 100 monitors to the Chi Mei Liu-Ying hospital in Liu-Ying, Taiwan. Chi Mei Liu-Ying is a branch hospital located approximately 60 kilometers from Chi Mei main hospital. The contract was awarded to us, in part, because our monitoring systems allowed these two hospitals to easily share data and information between their sites.

In June of 2004 we were awarded a contract to become the major supplier of patient monitoring equipment for the Shanghai SARS Center in Shanghai, China. The center is a new, approximately 500-bed facility, that will serve as a reference standard for communicable disease control hospitals engaged in the treatment and monitoring of SARS (Severe Acute Respiratory Syndrome) cases in China.

Also in June 2004, Spartanburg Regional Medical Center, located in Spartanburg, South Carolina, agreed to standardize its institution-wide patient monitoring equipment with our monitors as part of its ongoing commitment to patient care and safety. The new monitors, which can be customized for each patient's needs, will enable clinicians to securely access live patient data when and where they need it. This means clinicians will be able to obtain a complete patient profile, including other information available through the central information system such as lab and radiology reports, and medical records, from multiple sources without leaving the patient.

The following is a representative list of certain customers and/or installations that have purchased our medical monitoring and imaging products:

OVERSEAS

Diaconessenhuis Meppel, Netherlands
Evangelisches Krankenhaus Bethesda, Germany
Klinik St. Josef, Belgium
LKW Villach, Austria
Ramguiel University Hospital, France
Schüchtermannklinik, Germany
St Vincent's Hospital, Australia
St. Elisabeth Ziekenhuis, Netherlands
Ullevål Sjukhus, Norway
Universitätsspital Zürich, Switzerland

DOMESTIC

Albany Medical Center, Albany, NY
Condell Medical Center, Liberty, IL
Duke Univ. Medical Center, Durham, NC
Harborview Medical Center, Seattle, WA
Lakeland Regional Medical Center, Lakeland, FL
Methodist Hospital, Houston, TX
Northside Hospital, Atlanta, GA
Spartanburg Reg. Healthcare System, Spartanburg, SC
Tulane Univ. Hospital and Clinic, New Orleans, LA
Women & Infants Hospital, Providence, RI

Optoelectronic Devices and Value-Added Subsystems. Our optoelectronic devices and value-added subsystems are used in a broad range of products by a variety of customers. The following table illustrates the

major product categories for which we provide optoelectronic products and certain representative customers in each category. We expect that the list of product categories, the amount of business derived from each such product category, and the composition of our major customers will vary from period to period.

<u>PRODUCT CATEGORY</u>	<u>REPRESENTATIVE MAJOR CUSTOMERS</u>
Aerospace and Avionics	Honeywell Avionics Northrop Grumman
Analytical, Medical Diagnostics and Particle Analyzers	Johnson & Johnson Beckman Coulter
Bar Code Scanners	Symbol Technologies Mettrologic Instruments NCR
Construction and Industrial Automation	Spectra Physics Dr. Johannes Heidenhain Baumer Electric
Fiber Optics/Telecommunications	JDS Uniphase Bookham Technology
Gaming Industry	Bally Gaming
Homeland Security	InVision Technologies Bio-Imaging Research Gilardoni
Medical Monitoring	Datascope BCI Invivo Research
Military/Defense and Weapons Simulations	Cubic Defense Systems Lockheed Martin Raytheon Norsk Forsvarstekmol
Office Automation and Computer Peripherals	Xerox Eastman Kodak
Toll and Traffic Management Systems	TransCor Florida Department of Transportation Computer Sciences Corporation

Marketing, Sales and Service

We market and sell our security and inspection products worldwide through a direct sales and marketing staff of approximately 60 employees located in the United States, Canada, Finland, Malaysia, Singapore, and the United Kingdom, in addition to a global network of independent sales representatives. This sales staff is supported by a service organization of approximately 90 persons located primarily in the United States, Finland, Malaysia, and the United Kingdom and a global network of independent distributors. We also support these sales and customer relations efforts by providing operator training, computerized training and testing equipment, in-country service, software upgrades, service training for customer technicians and a newsletter on security issues.

We market and sell and our medical monitoring and imaging products through a direct sales and marketing staff of approximately 225 sales personnel and 170 service personnel worldwide located in the United States, Austria, Canada, Finland, France, Germany, Greece, Italy, and Singapore, in addition to a global network of

independent distributors. We also support these sales and customer service efforts by providing operator in service training, software updates and upgrades, and service training for customer biomedical staff and distributors.

We market and sell our optoelectronic devices and value-added subsystems, through both a direct sales and marketing staff of approximately 25 employees located in the United States, Singapore, Malaysia, and Norway and indirectly through a global network of independent sales representatives and distributors. Most of our in-house sales staff is based in the United States while most of our independent sales representatives and distributors are located abroad. This sales staff is supported by an applications engineering group whose members are available to provide technical support. This support includes designing applications, providing custom tooling and process integration, defining solutions for customers and developing products that meet customer defined specifications.

We consider our maintenance service operations to be an important element of our business. After the expiration of our standard product warranty periods, we are sometimes engaged by our customers to provide maintenance services for our security and inspection products through annual maintenance contracts. We provide a variety of service and support options for our medical monitoring and imaging systems customers, ranging from complete on-site repair and maintenance service and telephone support to parts exchange programs for customers with the internal expertise to perform a portion of their own service needs. We believe that our international maintenance service capabilities allow us to be competitive in selling our security and inspection products as well as our medical monitoring and imaging products. Furthermore, we believe that as our installed base of both our security and inspection and medical monitoring and imaging products increase, revenues generated from such annual maintenance service contracts and from the sale of replacement parts will increase.

Research and Development

Our security and inspection systems are designed at our facilities in Hawthorne, Santa Clara, and Sunnyvale, California and internationally in Finland, Malaysia, India and the United Kingdom. These products include mechanical, electrical, electronic, digital electronic and software subsystems, which are all designed by us. In addition to product design, we provide system integration services to integrate our products into turnkey systems at the customer site. We support cooperative research projects with government agencies and, on occasion, provide contract research for our customers and government agencies.

Our medical monitoring and imaging systems are designed and engineered at our facilities in Issaquah, Washington while our medical diagnostic and imaging systems are designed and engineered at our facilities in Hawthorne, California. Such systems include mechanical, electrical, digital electronic and software subsystems, all of which are designed by us. We are also currently involved, both in the U.S. and abroad, in several research projects aimed at improving our medical systems and at expanding our current product line.

Our optoelectronic devices and value-added subsystems are primarily designed and engineered at our facilities in Camarillo, Hawthorne, Newbury Park, and Upland, California, Orlando, Florida, and Ocean Springs, Mississippi and internationally in India, Malaysia, and Norway. We engineer and manufacture subsystems to solve the specific application needs of our original equipment manufacturer customers. In addition, we offer entire subsystem design and manufacturing solutions. We consider our engineering personnel to be an important extension of our core sales and marketing efforts.

In addition to close collaboration with our customers in the design and development of our current products, we maintain an active program for the development and introduction of new products, enhancements and improvements to our existing products, including the implementation of new applications of our technology. We seek to further enhance our research and development program and consider such program to be an important element of our business and operations. As of June 30, 2003, in addition to the engineers that we employed in

manufacturing, process design and applications development, we engaged approximately 255 full-time engineers, technicians and support staff in research and development. During fiscal year 2002, our research and development expenses were \$6.4 million, in 2003 they were \$8.9 million, in 2004 they were \$14.6 million. The increase in 2004 reflects increased research and development spending for our security and inspection side of our business and inclusion of research and development expenses of our recent acquisitions of Spacelabs Medical and OSI Laserscan. In order to fulfill our strategy of enhancing our security and inspection product lines and of improving the capabilities of our existing products, we intend to continue to invest in our research and development efforts in the future.

Manufacturing and Materials Management

We currently have manufacturing facilities for our security and inspection systems in Hawthorne, Santa Clara, and Sunnyvale California and internationally in Canada, Finland, Malaysia, Singapore, and the United Kingdom. We have manufacturing facilities for our medical monitoring and imaging systems in Hawthorne, California and Issaquah, Washington and internationally in India, Malaysia, and Singapore. We have manufacturing facilities for our optoelectronic devices and value-added subsystems in Camarillo, Hawthorne, Newbury Park, and Upland, California and Ocean Springs, Mississippi and internationally in Malaysia, Singapore, and Norway. Our principal manufacturing facility is in Hawthorne, California. However, most of our high volume, labor intensive manufacturing and assembly is performed at our facility in Malaysia. Since most of our customers currently are located in Asia, Europe and the United States, our ability to assemble products in these markets and provide follow-on service from offices located in these regions is an important component of our global strategy.

Our global manufacturing organization has expertise in optoelectronic, microelectronic, and integrated value-added assemblies for commercial, medical, aerospace, and defense industry applications. Our manufacturing includes silicon wafer processing and fabrication, optoelectronic device assembly and screening, thin and thick film microelectronic hybrid assemblies, and surface mounted and thru-hole PCB electronic assemblies, and value-added services including complete turn-key and box-build manufacturing. We outsource certain manufacturing operations including our sheet metal fabrication and certain plastic components. The manufacturing process for components and subsystems consists of manual tasks performed by skilled and semi-skilled workers as well as automated tasks.

The principal raw materials and subcomponents used in producing our security and inspection systems consist primarily of x-ray generators, linear accelerators, detectors, data acquisition and computing devices, conveyor systems and video monitors. Substantially all of the optoelectronic devices, subsystems, and circuit card assemblies used in our inspection and detection systems are manufactured in-house. The x-ray generators used in our passenger and baggage screening inspection and detection systems are also manufactured in-house, while the x-ray generators and linear accelerators used in our large cargo screening inspection and detection systems are purchased from unaffiliated third party providers. We purchase the metal enclosures of the x-ray systems, x-ray tubes, computer hardware and certain standard mechanical parts from unaffiliated third party providers.

The principal raw materials and subcomponents used in producing our medical monitoring and imaging systems consist of printed circuit boards, housings, cables, filters and packaging materials. We purchase certain devices, including computers, peripheral accessories and remote displays from unaffiliated third party providers.

The principal raw materials and subcomponents used in producing our optoelectronic devices and value-added subsystems consist of silicon wafers, ceramics, electronic subcomponents, light emitting diodes, phototransistors, printed circuit boards, headers and caps, housings, cables, filters and packaging materials. The silicon-based optoelectronic devices manufactured by us are critical components in most of our subsystems. Since 1987, we have purchased substantially all of the silicon wafers we use to manufacture our optoelectronic devices from Wacker Siltronic Corp.

Although to date none of our groups has experienced any significant shortages or material delays in obtaining any of its raw materials or subcomponents, there can be no assurance that they will not face such shortages or delays in one or more materials in the future. For cost, quality control and efficiency reasons, we generally purchase raw materials and subcomponents only from single vendors with whom we have ongoing relationships. We do, however, qualify second sources for most of our raw materials and critical components, or have identified alternate sources of supply. We purchase the materials pursuant to purchase orders placed from time to time in the ordinary course of business. Although to date we have not experienced any significant shortages or material delays in obtaining any of our raw materials or subcomponents, there can be no assurance that we will not face such shortages or delays in one or more of these materials in the future.

Patents, Trademarks, and Licenses

Trademarks. We have used, registered, and applied to register certain trademarks and service marks to distinguish our products, technologies and services from those of our competitors in the U.S. and in foreign countries. We enforce our trademark, service mark, and trade name rights in the U.S. and abroad.

Patents. We hold a number of U.S. and foreign patents relating to various aspects of our security and inspection products, medical imaging and monitoring systems, and optoelectronic devices and subsystems. Our current patents will expire at various times between 2006 and 2021. There can be no assurance that pending patent applications or other applications that may be filed will result in issued patents, or that any issued patents will survive challenges to their validity. Although we believe that our patents have value, there can be no assurance that our patents, or any additional patents that may be issued in the future, will provide meaningful protection from competition.

Licenses. In June 1999, as part of an arbitration settlement, we entered into a fully paid-up, nonexclusive patent license agreement with PerkinElmer, Inc., formerly known as EG&G, Inc. (“EG&G”) for U.S. Patent No. 4,366,382. The patent expired in September 2000. Subsequent to the end of the patent term, we have been free to use the technology without patent or license restriction. Under the license, for which we paid \$450,000, we were permitted to make, use and sell or otherwise dispose of security and inspection products that use an x-ray line scan system for baggage inspection purposes covered by EG&G’s patent.

In December 1998, as part of the settlement of certain litigation, we and Lunar Corporation (“Lunar”) entered into a license agreement pursuant to which we were granted a fully paid up worldwide, nonexclusive license under U.S. Patent Nos. 4,626,688 (the “688 patent”) and 5,138,167 (the “167 patent”) in the non-medical field. Prior to our acquisition of Osteometer in September 1998, Osteometer had also been involved in litigation with Lunar regarding the 688 and 167 patents. In December 1998, the parties to this litigation entered into a settlement agreement. As a part of the settlement, the parties entered into a license agreement pursuant to which Osteometer was granted a worldwide, nonexclusive license under the 688 and 167 patents for certain bone densitometers. We make royalty payments on sales of the licensed products.

We believe that our patents, trademarks, and licenses are important to our business. The loss of some of our patents, trademarks, or licenses might have a negative impact; however, we operate in a competitive environment with a known customer base and rely mainly on providing value for money with quality products and services to ensure continuing business.

Environmental Regulations

We are subject to various federal, state and local environmental laws, ordinances and regulations relating to the use, storage, handling, and disposal of certain hazardous substances and wastes used or generated in the manufacturing and assembly of our products. Under such laws, we may become liable for the costs of removal or remediation of certain hazardous substances that have been or are being released on or in our facilities or that have been or are being disposed of off site as waste. Such laws may impose liability without regard to whether we knew of, or caused, the release of such hazardous substances. We have conducted Phase I environmental site assessments for each of our properties in the United States at which we manufacture products. The purpose of each such report is to identify, as of the date of such report, potential sources of contamination of the property from past and present activities or from nearby operations. In certain cases, we have conducted further environmental assessments consisting of soil and groundwater testing and other investigations deemed appropriate by independent environmental consultants. We believe that we are currently in compliance with all material environmental regulations in connection with our manufacturing operations, and that we have obtained all material environmental permits necessary to conduct our business. The amount of hazardous substances and wastes produced and generated by us may increase in the future depending on changes in our operations. Any failure by us to comply with present or future regulations could subject us to the imposition of substantial fines, suspension of production, alteration of manufacturing process or cessation of operations, any of which could have a material adverse effect on our business, financial condition and results of operations.

During one such investigation, we discovered soil and groundwater contamination at our Hawthorne, California facility. We filed the requisite reports concerning this problem with the appropriate environmental authorities in fiscal year 2001. We have not yet received any response to such reports, and no agency action or litigation is presently pending or threatened. We also have notified the prior owners of the facility and the present owners and tenants of adjacent properties concerning the problem and have requested from such parties agreements to toll of the statute of limitations with respect to actions against such parties with respect to the contamination in order that we may focus our attention on resolution of the contamination problem. Our site was previously used for semiconductor manufacturing similar to that presently conducted on the site by us, and it is not presently known who is responsible for the contamination and the remediation. The groundwater contamination is a known regional problem, not limited to our premises or our immediate surroundings.

We recently were informed of soil and groundwater remediation efforts at a facility that our Ferson Optics subsidiary previously leased in Ocean Springs, Mississippi. Ferson Optics occupied the facility until October 2003. We believe that the owner and previous occupants of the facility have primary responsibility for such remediation and have an agreement with the facility's owner under which the owner is responsible for remediation of pre-existing conditions. However, we are unable at this time to ascertain whether Ferson Optics bears any exposure for remediation costs under statutes or regulations.

Competition

The markets in which we operate are highly competitive and characterized by evolving customer needs and rapid technological change. We compete with a number of other manufacturers, some of which have significantly greater financial, technical and marketing resources than we have. In addition, these competitors may have the ability to respond more quickly to new or emerging technologies, adapt more quickly to changes in customer requirements, have stronger customer relationships, have greater name recognition, and may devote greater resources to the development, promotion and sale of their products than we do. There can be no assurance that we will be able to compete successfully against any current or future competitors in the security and inspection systems, medical imaging and monitoring, or optoelectronic devices and subsystems markets or, that future competitive pressures will not materially and adversely affect our business, financial conditions and results of operations.

In the security and inspection market, competition is based primarily on such factors as product performance, functionality and quality, the overall cost effectiveness of the system, prior customer relationships,

technological capabilities of the products, price, local market presence, and breadth of sales and service organization. We believe that our principal competitors in the market for security and inspection products are the Security and Detection Systems division of L-3 Communications Corporation, the Smiths Detection division of Smiths Group plc, American Science and Engineering, Inc., Science Applications International Corporation, Control Screening L.L.C., CEIA SpA, Garrett Electronics, Inc., and Nuctech Company Limited. Competition could result in price reductions, reduced margins, and loss of our market share. In the airline and airport security and inspection market, particularly in the upgrade and replacement market, we also compete for potential customers based on existing relationships between our competitors and the customers. Certain of our competitors have been manufacturing inspection systems since the 1980s and have established strong relationships with airlines and airport authorities. We believe that the image quality and resolution of certain of our security and inspection products is superior to the image quality offered by most of our competitors' x-ray based inspection products. Additionally, our true multi-zone metal detection technology provides the ability to detect small metallic objects and offer higher levels of discrimination in weapons-screening applications. Although we also have established relationships with a number of airport and airline customers, we can provide no assurance that we will be able to successfully compete in the future with existing competitors or with new entrants. In the large cargo inspection systems market, we compete for potential customers based on price, performance and the ability to design both standard and customized products. Several of our competitors have operated in this area for longer than we have. However, due to our recent successes in designing and delivering high-energy x-ray systems, we believe we have demonstrated our ability to compete effectively. Additionally, although our competitors in the large cargo inspection market each offer products in competition with one or more of our products, our ability to supply high-energy x-ray, gamma-ray, pulsed fast neutron analysis, and thermal neutron analysis systems means that we offer among the widest array of solutions available from a single supplier.

In the patient monitoring and imaging systems market, competition is also based on a variety of factors including product performance, functionality, value, and breadth of sales and service organization. We believe that our principal competitors in the market for patient monitoring and imaging systems are Criticare Systems, Inc., Philips Medical Systems, GE Medical Systems, Drägerwerk AG, Datascope Corp., Nihon Kohden Corporation and Nellcor, a division of Tyco International, Inc. Competition could result in price reductions, reduced margins, and loss of our market share. We believe that our patient monitoring products are easier to use than the products of many of our competitors because we offer a consistent user interface throughout many of our product lines. Furthermore, the monitors of our Spacelabs Medical subsidiary are backward/forward compatible, meaning that new Spacelabs Medical monitors can interface with existing Spacelabs Medical monitor models, thus offering investment protection to our customers. While some of our competitors are just now introducing portal technology, which allows remote access to data from the bedside monitor, central station or other point of care, we believe that our version is superior in bringing instant access to labs, radiology and charting at the point of care. Although we have established relationships with a number of large hospitals, there can be no assurance that we will be able to successfully compete in the future with existing competitors or with new entrants.

In the optoelectronic devices and subsystems market, competition for optoelectronic devices and value-added subsystems is based primarily on such factors as expertise in the design and development of optoelectronic devices, product quality, timeliness of delivery, price, customer technical support, and on the ability to provide fully integrated services from application development and design through production. We believe that our major competitors in the optoelectronic device and subsystem market are PerkinElmer, Inc. and Hamamatsu Corporation. Because we specialize in custom subsystems requiring a high degree of engineering expertise, we believe that we generally do not compete to any significant degree with any other large United States, European or Asian manufacturers of standard optoelectronic components.

Backlog

We measure our backlog as orders for which purchase orders or contracts have been signed, but which have not yet been shipped and for which revenues have not yet been recognized. We typically ship our security and

inspection products, optoelectronic devices and value-added subsystems, and medical imaging and monitoring systems within one to several months after receiving an order. However, such shipments may be delayed for a variety of reasons including any special design or engineering requirements of the customer. In addition, large orders (more than ten machines) of security and inspection products typically require more lead-time.

Large cargo scanning machines may require several months to several years lead-time. The only significant shipping delays we have experienced are with large cargo scanners. Such delays for many reasons, including: (i) additional time necessary to conduct large cargo system inspections at the factory before shipment; (ii) the customer's need to engage in timely special site preparation to accommodate such a scanner, over which we have no control or responsibility; (iii) additional fine tuning of such scanners once they are installed; (iv) design or specification changes by the customer; and (v) delays originating from other contractors on the project.

At June 30, 2004, our backlog totaled approximately \$84.9 million, compared to approximately \$53.0 million at June 30, 2003 and approximately \$89.6 million at June 30, 2002. The increase in the backlog from June 30, 2003 to June 30, 2004 is primarily due to the acquisition of Spacelabs Medical in March 2004. Excluding Spacelabs Medical, the backlog as of June 30, 2004 was \$63.0 million. We expect to ship most of our backlog as of June 30, 2004, during the fiscal year ending June 30, 2005. Sales orders underlying our backlog are firm orders. Any failure by us to meet an agreed-upon schedule could lead to the cancellation of the related order. Moreover, from time to time, we may agree to permit the cancellation of an order on a negotiated basis. Variations in the size of the order, the product mix, and delivery requirements of the customer order may result in substantial fluctuations in backlog from period to period. Backlog as of any particular date should not be relied upon as indicative of our revenues for any future period and cannot be considered a meaningful indicator of our performance on an annual or quarterly basis.

Employees

As of June 30, 2004, we employed approximately 2,205 people, of whom 1,070 were employed in manufacturing, 255 were employed in research and development, 250 were employed in finance and administration, 310 were employed in sales and marketing, and 320 were employed in our service organization. Of the total employees, approximately 1,470 were employed in the United States and Canada, 250 were employed in Europe, and 485 were employed in Asia. Twelve employees of our Advanced Microelectronics AS subsidiary in Norway and 11 of our Metorex Security Products, Oy subsidiary employees in Finland are union members and have collective bargaining rights; none of our other employees are unionized. We have never experienced a work stoppage or strike, and management believes that its relations with employees are good.

Available Information

Our Internet address is: <http://www.osi-systems.com>. We make available, free of charge through our Internet website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, and reports filed pursuant to Section 16 of the Exchange Act. We do so as soon as reasonably practicable after electronically filing such material with, or furnishing it to, the Securities and Exchange Commission.

ITEM 2. PROPERTIES

We own three buildings (approximately 88,000 square feet), which comprise our principal facility in Hawthorne, California. We use this facility for manufacturing, engineering, sales and marketing.

As of June 30, 2004, we leased all of our other facilities. The following table lists our principal physical properties:

Location	Description of Facility	Approximate Square Footage	Expiration
Camarillo, California	Manufacturing, engineering, sales and marketing and service	60,000	2010
Hawthorne, California	Manufacturing, engineering, sales and marketing and service	41,600	2006
Newbury Park, California (1)	Manufacturing, engineering, sales and marketing	18,400	2004
Santa Clara, California	Manufacturing, engineering, sales and marketing	36,000	2006
Sunnyvale, California	Manufacturing, engineering, sales and marketing	28,300	2007
Upland, California	Manufacturing, engineering, sales and marketing	22,000	2008
Orlando, Florida	Manufacturing, engineering, sales and marketing and service	19,300	2008
Ocean Springs, Mississippi (2)	Manufacturing, engineering sales and marketing	10,000	2004
Issaquah, Washington	Manufacturing, engineering, sales and marketing and service	95,600	2013
Issaquah, Washington	Manufacturing, engineering, sales and marketing and service	107,000	2013
Espoo, Finland	Manufacturing, engineering, sales and marketing	18,500	2006
Secunderabad, India (3)	Manufacturing and engineering	13,400	2004-2010
Johor Bahru, Malaysia (4)	Manufacturing, sales and service	99,000	2004-2005
Horten, Norway	Manufacturing, engineering, sales and marketing	19,800	2008
Crawley, United Kingdom (5)	Manufacturing, engineering, sales and marketing	30,300	2009-2011

- (1) This lease expires in November 2004. We are currently negotiating to renew this lease on similar terms.
- (2) This lease expires in October 2004, but contains options to extend the lease for up to two additional years. We currently intend to exercise one or more of such options.
- (3) The lease of the 13,400 square foot facility in Secunderbad, India is composed of four leases in the same or in a nearby facility: (i) a 5,500 square foot facility lease that will terminate in October 2004, (ii) a 3,700 square foot facility lease that will terminate in July 2010, (iii) a 2,200 square foot facility lease that will terminate in October 2005, (iv) and a 2,000 square foot facility lease that will terminate in June 2005. We expect the 5,500 square foot facility lease that will terminate in 2004 to be renewed on similar terms or we will relocate to a similar facility nearby.
- (4) The lease of the 99,000 square foot facility in Johor Bahru Malaysia is composed of three leases: (i) a 76,000 square foot facility lease that will terminate in December 2004, (ii) a 16,000 square foot facility lease that will terminate in January 2005, and (iii) a 7,000 square foot facility lease that will terminate in September 2004. We expect that each of such leases will be renewed on similar terms.
- (5) The lease of the 30,300 square foot facility in Crawley, United Kingdom is composed of three leases: (i) a 13,900 square foot facility lease that will terminate in March 2011, (ii) a 10,000 square foot facility lease that will terminate in February 2009, and (iii) a 6,400 square foot facility lease that will terminate in March 2011.

We believe that our facilities are in good condition and are adequate to support our operations for the foreseeable future. We currently anticipate that we will be able to renew the leases that are scheduled to expire in the next few years on terms that are substantially the same as those currently in effect. However, even if we were not able to renew one or more of the leases, we believe that suitable substitute space is available to relocate any of the facilities. Accordingly, we do not believe that our failure to renew any of the leases that are scheduled to expire in the next few years will have a material adverse effect on our operations.

ITEM 3. LEGAL PROCEEDINGS

In March 2000, certain individuals filed a class action suit in Los Angeles Superior Court naming our Rapiscan Security Products (U.S.A.), Inc. (“Rapiscan”) subsidiary and others as defendants. The named plaintiffs are the wives of men incarcerated in California prisons. The plaintiffs allege that while attempting to visit their husbands in prison, as a condition to such visits, prison personnel have subjected them, and other members of the putative class, to scans by Rapiscan’s Secure 1000 product, as well as strip searches, and body cavity searches, all of which plaintiffs allege to have been illegal searches and have caused them emotional injuries. The other defendants in the action include the State of California, the California Department of Corrections, its Director and other Department of Corrections personnel. The complaint asserts, among other things, that these types of searches are illegal and intrusive and have caused emotional injury to the plaintiffs. In addition to alleging that we are responsible for illegal searches conducted by prison personnel, the complaint alleges that we were negligent, that the Secure 1000 product is defective in design and manufacture, that we have failed to properly train the prison personnel in using the Secure 1000 product, that we have failed to warn subjects that they might be subjected to illegal searches using the Secure 1000 product, and that the scans are more intrusive than manual searches. Plaintiffs seek general, special and punitive damages in unspecified amounts and declaratory relief against illegal searches. We believe that these claims against us have no merit and we intend to vigorously defend this suit.

In November 2002, L-3 Communications Corporation (“L-3”) brought suit against us for a declaratory judgment that L-3 had not breached its obligations to us concerning the acquisition of PerkinElmer, Inc’s Security Detection Systems Business. In February 2003, we answered and asserted counterclaims against L-3 for, among other things, fraud, breach of fiduciary duty, breach of contract and failure to negotiate in good faith. In March 2003, L-3 amended its complaint and asserted claims against us for breach of contract, failure to negotiate in good faith, and tortious interference. In its amended complaint, L-3 requested both a declaratory judgment that it had fulfilled its obligations and an award of damages for an unspecified amount. These actions are pending in the District Court for the Southern District of New York.

During 2003 and 2004, we were informed that Science Applications International Corporation (“SAIC”) had made statements to prospective buyers of our gamma ray mobile detection system product (“GaRDS”) that GaRDS infringed upon unspecified SAIC patents. In April 2004, we received a letter from SAIC specifying a patent upon which SAIC claimed the GaRDS infringed. Contrary to SAIC’s claim, the patent cited by SAIC actually distinguished the technology used in GaRDS as a different, pre-existing technology. We therefore filed a lawsuit in the U.S. District Court, Central District of California for declaratory judgment. SAIC has since counter-claimed for patent infringement, citing the same patent, and unfair competition.

In March 2004, certain individuals named us and our subsidiary, Spacelabs Medical, as well as a hospital located in Bexar County, Texas, in a petition claiming that the individuals suffered injuries in March 2003 caused, in part, by a defective monitoring system manufactured by Spacelabs Medical. The petition was filed in the 285th Judicial District Court in Bexar County, Texas. The amount of the claim has not yet been specified.

In April 2004, certain individuals named our subsidiary, Spacelabs Medical, as well as several other defendants, in a petition that alleges, among other things, that a product possibly manufactured by Spacelabs Medical failed to properly monitor a hospital patient thereby contributing to the patient’s death in November 2001. The petition was filed in the 21st Judicial District Court, Parish of Tangipahoa, Louisiana. The amount of the claim has not yet been specified.

In August 2004, the former president of our subsidiary, Spacelabs Medical, submitted an arbitration claim alleging breach of a retention and severance agreement seeking approximately \$1.5 million and punitive damages. The claim is currently pending before the CPR Institute for Dispute Resolution in Chicago, Illinois.

We are also involved in various other claims and legal proceedings arising out of the conduct of our business. In our opinion after consultation with legal counsel, the ultimate disposition of such proceedings will not have a material adverse effect on our financial position, future results of operations, or cash flows.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT'S EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Stock Market and Other Information

Our Common Stock is traded on the NASDAQ National Market under the symbol "OSIS".

The following table sets forth the high and low sale prices of a share of our Common Stock as reported by the NASDAQ National Market on a quarterly basis for the fiscal years ended June 30, 2003 and June 30, 2004. The prices shown reflect inter-dealer prices, without retail markup, markdown or commission and may not necessarily represent actual transactions.

<u>2003:</u>	<u>High</u>	<u>Low</u>
Quarter ended September 30, 2002	\$20.75	\$12.57
Quarter ended December 31, 2002	\$18.65	\$15.25
Quarter ended March 31, 2003	\$19.76	\$14.32
Quarter ended June 30, 2003	\$16.99	\$13.72
<u>2004:</u>	<u>High</u>	<u>Low</u>
Quarter ended September 30, 2003	\$18.40	\$13.76
Quarter ended December 31, 2003	\$19.92	\$17.06
Quarter ended March 31, 2004	\$23.17	\$17.18
Quarter ended June 30, 2004	\$25.30	\$18.03

As of September 9, 2004 there were approximately 119 holders of record of our Common Stock. This number does not include beneficial owners holding shares through nominees or in "street" name.

Dividend Policy

We have not paid any cash dividends since the consummation of our initial public offering in 1997 and anticipate that we will retain any available funds for use in the operation of our business. We do not currently intend to pay any cash dividends in the foreseeable future. Our Board of Directors will determine the payment of future cash dividends, if any. Certain of our current bank credit facilities restrict the payment of cash dividends and future borrowing may contain similar restrictions.

Equity Compensation Plans

The following table provides information concerning our equity compensation plans as of June 30, 2004.

<u>Plan category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u>	<u>Weighted-average exercise price of outstanding options, warrants and rights</u>	<u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u>
	(a)	(b)	(c)
Equity compensation plans approved by security holders (1)	1,652,887	\$ 14.57	114,961
Equity participation plans not approved by security holders			
Total	1,652,887	\$ 14.57	114,961

(1) Includes shares of our Common Stock issuable upon exercise of options from our 1987 Incentive Stock Option Plan and the 1997 our Stock Option Plan.

Recent Sales of Unregistered Securities

In June 2004, we issued and sold an aggregate of 1,500,000 shares of our Common Stock in a private placement to institutional investors for an aggregate sales price of \$32.3 million. After agent's commissions, and expenses, net proceeds to us were \$31.0 million. As part of the transaction, we issued to the investors warrants to purchase 337,500 additional shares of our Common Stock at an exercise price of \$27.73 per share exercisable at any time in full or part no later than June 1, 2011. The fair value of the warrants was estimated at \$6,152,000 using the Black-Scholes option-pricing model with the following weighted-average assumptions: expected option life of seven years, dividend yield of 0%, volatility of 98% and a risk-free interest rate of 4.45%. The fair value of these warrants is included with the proceeds from the private placement under the common shares balance as of June 30, 2004. As part of the transaction, we agreed to file a registration statement on Form S-3 with the SEC.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth our selected consolidated financial data as of and for each of the five fiscal years ended June 30, 2004 and is derived from our Consolidated Financial Statements. The consolidated financial statements as of June 30, 2003 and June 30, 2004, and for each of the years in the three-year period ended June 30, 2004, and the report of independent registered public accounting firm thereon, are included elsewhere in this Annual Report on Form 10-K. The following data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K.

Year Ended June 30,

	2000	2001	2002	2003	2004 (1)
(In thousands, except share and per share data)					
Consolidated Statements of Operations Data:					
Revenues	\$ 110,938	\$ 111,099	\$ 124,230	\$ 182,644	\$ 247,069
Cost of goods sold	80,598	80,851	85,908	122,661	163,712
Gross profit	30,340	30,248	38,322	59,983	83,357
Operating expenses:					
Selling, general and administrative	19,828	21,572	21,647	29,160	54,161
Research and development	7,712	6,671	6,434	8,865	14,638
Goodwill amortization	529	488	402	—	—
Management retention bonus (2)	—	—	—	—	1,104
Restructuring costs (3)	1,898	—	—	—	1,061
Total operating expenses	29,967	28,731	28,483	38,025	70,964
Income from operations	373	1,517	9,839	21,958	12,393
Gain on sale of subsidiary (4)	—	2,967	—	—	—
Gain on sale of investment (5)	—	1,119	—	—	—
Gain on sale of marketable securities (6)	309	—	—	1,767	376
Write-off of deferred acquisition costs (7)	—	—	—	(608)	—
Writedown of equity investment (8)	—	—	—	(1,433)	(247)
Other income	126	—	—	—	—
Interest (expense) income, net	(721)	(995)	161	786	580
Income before income taxes and minority interest	87	4,608	10,000	22,470	13,102
Provision (benefit) for income taxes	(151)	1,250	3,000	6,521	3,316
Income before minority interest	238	3,358	7,000	15,949	9,786
Minority interest	389	146	(79)	(156)	170
Net income	\$ 627	\$ 3,504	\$ 6,921	\$ 15,793	\$ 9,956
Net income available to common shareholders	\$ 627	\$ 3,504	\$ 6,921	\$ 15,793	\$ 9,956
Basic earnings per Common Share	\$ 0.07	\$ 0.39	\$ 0.63	\$ 1.13	\$ 0.68
Diluted earnings per Common Share	\$ 0.07	\$ 0.38	\$ 0.60	\$ 1.09	\$ 0.65
Weighted average shares outstanding (diluted)	9,409,407	9,115,673	11,478,371	14,513,374	15,236,399
Consolidated Balance Sheet Data:					
Cash and cash equivalents (9)	\$ 10,892	\$ 4,467	\$ 67,604	\$ 94,246	\$ 39,879
Working capital (9)	45,899	46,314	115,631	141,916	143,398
Total assets (9)	103,023	92,396	175,358	229,538	331,801
Long term debt	7,698	7,003	4,463	1,838	32
Total debt	16,418	9,628	7,088	4,463	1,830
Total shareholders' equity (9)	\$ 64,207	\$ 62,481	\$ 135,734	\$ 180,399	\$ 227,482

- (1) Results of operations for the year ended June 30, 2004, and the financial position as of June 30, 2004 incorporate the effect of several acquisitions, including Spacelabs Medical. See Item 7. "Management's Discussions and Analysis of Financial Condition and Results of Operations."
- (2) Represents an expense resulting from retention obligations of key personnel of Spacelabs Medical. The expense had the effect of decreasing income from operations by \$1.1 million, net income by \$784,000, and net income available to common shareholders by \$784,000.
- (3) Represents a charge resulting from consolidating and restructuring certain subsidiaries. For the year ended June 30, 2000, the charge had the effect of decreasing by \$1.9 million each of income from operations, net income and income available to common shareholders. For the year ended June 30, 2004, the charge had the effect of decreasing income from operations by \$1.1 million, net income by \$753,000, and net income available to common shareholders by \$753,000.
- (4) Represents the gain on the sale of Silicon Microstructures, Inc.
- (5) Represents the gain on the sale of an equity investment.
- (6) Represents the gain on the sale of marketable securities classified as available-for-sale.
- (7) Represents professional fees and other transaction costs related to our agreement with L-3 Communications Corporation for the joint acquisition of certain detection and security businesses then owned by PerkinElmer, Inc. In November 2002, L-3 Communications Corporation terminated this transaction prior to consummation.
- (8) Represents the recognition of an other-than-temporary impairment of an equity investment.
- (9) The increase in fiscal year 2004 includes net proceeds of \$31.0 million received under a private placement. The increase in fiscal year 2003 includes net proceeds of \$20.5 million received under a private placement. The increase in fiscal year 2002 includes net proceeds of \$56.8 million received under private placements.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-looking Statements.

The following discussion should be read in conjunction with our consolidated financial statements and the notes thereto appearing elsewhere in this Annual Report on Form 10-K. Certain statements contained herein that are not related to historical results, including, without limitation, statements regarding our business strategy, objectives, and future financial position, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and involve risks and uncertainties. These forward-looking statements may be identified by the use of forward-looking terms such as "anticipate," "believe," "expect," "may," "should," or "will," or by discussions of strategy that involve risks and uncertainties. These forward-looking statements include assertions regarding anticipated future revenues, sales, operations, demand, competition, capital expenditures, credit arrangements, and other claims regarding matters that are not historical facts, involve predictions which are based upon a number of future conditions that ultimately may prove to be inaccurate.

Factors that may cause or contribute to such differences include those discussed in Risk Factors, Business, and Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as elsewhere in this Annual Report on Form 10-K. These factors, of course, do not include all factors that might affect our business and financial condition.

Although we believe that the assumptions upon which our forward-looking statements are based are reasonable, there can be no assurance that such assumptions will prove to be accurate and actual results could differ materially from those expressed in or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, changes in laws and regulations, accounting standards, taxation requirements and environmental laws in the United States and other countries; foreign currency fluctuations; market and general economic factors; competitive factors including other companies'

pricing and marketing efforts; fluctuations in the cost and availability of raw materials and components and the ability to maintain favorable supplier arrangements and relationships; risks of obsolescence due to shifts in market demand; risks in the marketplace associated with new product introductions; our ability to achieve sales and earnings forecasts which are based on assumptions about sales volume and other items; our ability to integrate acquisitions and joint ventures into our existing operations and the availability of new acquisition and joint venture opportunities; the success of divestitures and other business combinations; our ability to achieve cost savings objectives; the impact of unforeseen economic and political changes in markets where we compete; our ability to maintain profit margins; litigation outcomes; and such other risks and uncertainties as are described in this Annual Report on Form 10-K and other documents previously filed or hereafter filed by us from time to time with the Securities and Exchange Commission. All forward-looking statements contained in this Annual Report on Form 10-K are qualified in their entirety by this statement. We undertake no obligation other than as may be required under securities laws to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Overview

We are a vertically integrated, worldwide provider of security and inspection systems, medical monitoring and imaging systems, and optoelectronic devices and value-added subsystems.

Our company was incorporated in 1987. Initially, we manufactured optoelectronic devices and value-added subsystems for customers in several industries, including makers of security and inspection systems and medical monitoring and imaging systems. Through acquisitions we have entered the security and medical products markets because we believe that vertical integration make us more competitive in these areas.

We design, manufacture and market security and inspection systems worldwide to end users under trade names including “Rapiscan,” “Ancore,” “PNFA,” “Eagle,” “Metor,” and “Secure.” These products are used to inspect people, baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials.

In the medical field, we design, develop, manufacture, and market patient monitoring products, network connectivity solutions, ambulatory blood pressure monitors, and related services under trade names including “Spacelabs,” “Ultracare,” and “Ultraview.” We also design, develop, manufacture and market arterial hemoglobin saturation monitors and sensors, including hand-held and wireless monitoring tools under trade names including “Dolphin” and “NuCat,” and peripheral bone densitometers under trade names including “DTX-200” and “DTU-One,” which are used in the early stage detection or diagnosis of osteoporosis.

Our optoelectronic devices and value-added subsystems are used in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical diagnostics, fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. We design and manufacture optoelectronic devices and value-added subsystems for others through original equipment manufacturer arrangements, as well as for our security and medical equipment businesses.

In fiscal year 2004, revenues from the sale of security and inspection products amounted to \$117.8 million, or approximately 48% of our revenues, revenues from the sale of medical monitoring and imaging systems were \$ 60.7 million or 24% of our revenues, while revenues from the sale of optoelectronic devices and value-added subsystems amounted to \$68.6 million, or approximately 28% of our revenues.

We report segment information by geographic area. We are vertically integrated and our subsidiaries share common resources and facilities. Therefore, with the exception of external revenues, discrete financial information has not historically been available by product line at all operating locations. As a result of the changes in our structure and operations which have occurred, beginning in the first quarter of fiscal year 2005 we

will have discrete financial information available by product line for all operating locations and therefore will begin reporting our segment information by product line. Further information concerning reporting segments is available in Note 14 to our financial statements.

Our security and inspection systems business continues to grow. In fiscal year 2004, this growth occurred despite the completion during the first quarter of our contract to manufacture pre-scanners and related electronics for Invision Technologies, Inc.'s CTX products. The Invision Technologies, Inc. contract contributed approximately \$22 million to our sales in fiscal year 2003 (including approximately \$19.6 million to our security and inspection side of our business) compared to approximately \$300,000 in fiscal year 2004. We substantially offset this decrease in revenues with growth in both domestic and international sales of our conventional parcel security and our cargo inspection products.

As part of our security and inspection systems growth strategy, we continue to invest in acquisitions to broaden our technology and product portfolio. In January 2004, we completed the acquisition of Advanced Research & Applications Corp. ("ARACOR"), a privately held company based in Sunnyvale, California for approximately \$17.6 million (net of cash acquired). During seven years following the close, contingent consideration is payable to ARACOR's former shareholders based on ARACOR's net revenues, provided certain requirements are met. The contingent consideration is capped at \$30.0 million. ARACOR's "Eagle" product is a large, x-ray-based scanning system for inspecting containers at busy seaports. The Eagle was designed in partnership with U.S. Customs and U.S. Customs has issued a blanket purchase order for up to \$40 million over the next 5 years. Including options exercised by U.S. Customs as well as other orders, ARACOR has to date received orders totaling approximately \$14 million for the Eagle.

In December 2003, we acquired substantially all the assets of J&D Engineering (UK), Limited, a company registered in England and Wales for approximately \$820,000. This acquisition has provided us with the ability to design and manufacture metal frames for our x-ray machines and other products.

In June 2004, we increased our investment in CXR Limited, a U.K. based research and development venture that develops real time tomography systems, to approximately \$3.2 million (including a \$1.1 million loan). As a result of our additional equity investment, we now own approximately 75% of CXR Limited.

As a result of these and other developments, we continue to believe that our security and inspection systems business offers a broad product line in the conventional and cargo security business, including x-ray, gamma-ray and neutron technologies and hybrid products built on these technologies and we continue to invest in our research and development for our security and inspection business.

In March 2004, we significantly enhanced our medical monitoring and imaging systems activities through the acquisition of Spacelabs Medical Inc. ("Spacelabs Medical"), a global manufacturer and distributor of patient monitoring and clinical information systems for use primarily in hospitals. Spacelabs Medical's principal products encompass patient monitoring systems, network and connectivity solutions, ambulatory blood pressure monitors and medical data services. We completed the acquisition of Spacelabs Medical from Instrumentarium Corporation for approximately \$47.9 million in cash (net of cash acquired), including acquisition costs. The final purchase price is subject to certain working capital adjustments. In June 2004, we notified Instrumentarium Corporation's parent, GE Medical Systems, of a working capital and retention bonus adjustments resulting in what we believe to be a downward adjustment of the purchase price in the amount of \$25.9 million. In September 2004, GE Medical Systems responded that it believes the amount of the downward adjustment to be approximately \$7.8 million. No amounts have been recorded in the financial statements in relation to the expected reduction in the purchase price. The amount of the final adjustment will be resolved by way of a process established in the purchase agreement. Therefore, the final purchase price and the purchase price allocation may differ significantly from the preliminary estimates of these amounts.

Our other medical monitoring and imaging products are experiencing sales growth, especially our pulse oximetry products which compete directly with the products of Nellcor. In fiscal year 2004, we granted Conmed Corporation exclusive marketing and distribution rights to certain Dolphin Medical products in the

United States and other territories for a period of five years. These products are receiving considerable interest as we have begun to introduce them in the United States and other countries worldwide where key Nellcor patents have recently expired. We also sold a 10% interest in our Dolphin Medical subsidiary to Conmed Corporation and granted an option to Conmed Corporation to purchase the remaining shares of Dolphin Medical. We received proceeds of \$2.0 million related to the sale of the 10% interest, the grant of the option, and the grant of marketing and distribution rights to Conmed Corporation.

Our optoelectronic devices and subsystems product sales have weakened in certain areas. The growth that did occur in this area of our business was due to strategic acquisitions. In August 2003, we purchased the military, laser-based training business of Schwartz Electro-Optics, Inc. for \$3.7 million. We believe the products lines we acquired from this company, now sold by our newly-formed OSI Defense Systems, L.L.C. ("OSI Defense Systems") subsidiary, complement the defense product lines of our existing RapiTec, Inc. ("RapiTec") subsidiary. Both OSI Defense Systems and RapiTec develop, manufacture, market, and sell tactical engagement simulation systems, man-worn laser detectors, small arms transmitters, controller guns and a variety of targeting systems for the defense industry.

In October 2003, we acquired the assets of a manufacturing services company specializing in surface mount technology lines and PC board assembly operations for approximately \$4.5 million. The business, now operating as OSI Electronics, Inc. ("OSI Electronics"), has begun to provide our optoelectronic devices and subsystems group with increased manufacturing capacity and technologies to support internal needs as well as to offer a broad manufacturing platform to our existing customers.

In November 2003, we acquired substantially all of the remaining assets from Schwartz Electro-Optics, Inc., for approximately \$1.6 million. The acquired assets consist of a business that designs, manufactures, markets and sells laser-based systems used in traffic and toll management, precision agricultural management, and precision mapping and surveying. This business now operates under the name OSI Laserscan and offers, among other products, a unique, patented laser range finder technology, which is gaining acceptance by traffic and toll management authorities, as well as precision agricultural management, mapping, and survey technologies.

Overall as a company, we continue to move towards the consolidation of our various businesses. We do so in order to generate manufacturing, sales force, and administrative related efficiencies and to increase productivity. We also continue to invest in critical areas such as sales, marketing, and research and development. Our gross margin is dependent on our product mix. With the inclusion of Spacelabs Medical revenues, our gross margin as a percentage of revenues has increased; however, our operating expenses as a percentage of revenues have also increased as Spacelabs Medical has higher operating expenses as a percentage of revenues. Our gross margin as a percentage of revenues is also offset by the inclusion of the results of OSI Electronics, a manufacturing service company which operates in an area where gross margins are traditionally low.

We engage in significant international operations. We currently manufacture our security and inspection products at our facilities in Hawthorne, Santa Clara, Sunnyvale, California, and internationally in Canada, Finland, Malaysia, Singapore and the United Kingdom. Our medical monitoring and imaging systems are currently manufactured at our facilities in Hawthorne, California, and Issaquah, Washington and internationally in India, Malaysia, and Singapore. Our optoelectronic devices and value-added subsystems are manufactured in Camarillo, Hawthorne, Newbury Park, and Upland, California, Ocean Springs, Mississippi, and internationally in Malaysia, Norway, and Singapore. As of June 30, 2004 we marketed our products worldwide through approximately 310 sales and marketing employees located in more than a dozen countries, in addition to a global network of independent sales representatives. Revenues from shipments made outside of the United States accounted for 52% of revenues in fiscal year 2002, 51% of revenues in fiscal year 2003, and 41% of revenues in fiscal year 2004. Information regarding our operating income or loss and identifiable assets attributable to each of our geographic areas is set forth in Note 14 in our Consolidated Financial Statements.

Related-Party Transactions

In 1994, we, together with an unrelated company, formed ECIL-Rapiscan Security Products Limited, a joint venture organized under the laws of India. We own a 36% interest in the joint venture, our chairman and chief executive officer owns a 10.5% interest, and the president of our security and inspection products group owns a 4.5% ownership interest. Our initial investment was \$108,000. For the year ended June 30, 2002, our equity earnings in the joint venture amounted to \$154,000, for the year ended June 30, 2003 they amounted to \$249,000, and for the year ended June 30, 2004 they amounted to \$317,000, and are included in selling, general, and administrative expenses. During the year ended June 30, 2001, we increased our initial investment by \$39,000. Our ownership interest remained at 36% as all the shareholders increased their respective investments proportionately. We, our chairman and chief executive officer, and the president of our security and inspection products group collectively control less than 50% of the board of directors voting power in the joint venture. As a result, we account for the investment under the equity method of accounting. The joint venture was formed for the purpose of the manufacture, assembly, service, and testing of x-ray security and other products. Some of our subsidiaries are suppliers to the joint venture partner, which in turn manufactures and sells the resulting products utilizing technology received from the subsidiary. The joint venture agreement provides for technology transfers between us and the joint venture, subject to certain restrictions. During the year ended June 30, 2002, we earned a technical fee from the joint venture in the amount of \$35,000. We did not earn any technical fee during the years ended June 30, 2003 and 2004, as the technical agreement has expired.

We contracted with entities owned by members of our board of directors to provide messenger service, auto rental and printing services. Included in cost of sales, selling, general and administrative expenses for the years ended June 30, 2002, 2003 and 2004 are approximately \$107,000, \$101,000 and \$70,000 for messenger service and auto rental; and \$100,000, \$104,000 and \$73,000 for printing services; and \$14,000, \$0, and \$0 for professional services, respectively. We contracted during fiscal year 2002 for professional services of \$14,000 from a firm that has a partner serving as a member of our Board of Directors. We have discontinued the contract for professional services from that firm.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States. Our preparation of these consolidated financial statements requires us to make judgments and estimates that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from such estimates under different assumptions or conditions. The following summarizes our critical accounting policies and significant estimates used in preparing our consolidated financial statements:

Revenue Recognition. We recognize revenue upon shipment of products when title and risk of loss passes, and when terms are fixed and collection is probable. In accordance with the terms of Staff Accounting Bulletin No. 104, "Revenue Recognition" and EITF 00-21 "Revenue Arrangements with Multiple Deliverables," where installation services, if provided, are essential to the functionality of the equipment, the portion of revenue for the sale attributable to installation is deferred and recognized when the installation services are provided. In an instance where terms of sale include subjective customer acceptance criteria, revenue is deferred until the acceptance criteria are met. Concurrent with the shipment of the product, we accrue estimated product return reserves and warranty expenses. Critical judgments made by management related to revenue recognition include the determination of whether or not customer acceptance criteria are perfunctory or inconsequential. The determination of whether or not the customer acceptance terms are perfunctory or inconsequential impacts the amount and timing of revenue recognized.

We undertake projects that include the development and construction of large complex cargo inspection systems requiring installation and customization at the customer's site. Sales under such long-term contracts are recorded under the percentage-of-completion method. Costs and estimated revenues are recorded as work is performed based on the percentage that incurred costs bear to estimated total costs utilizing the most recent estimates of costs. If the current contract estimate indicates a loss, provision is made for the total anticipated loss in the current period. Critical estimates made by management related to revenue recognition under the percentage-of-completion method include the estimation of costs at completion and the determination of the overall margin rate on the specific project.

Revenues from separate service maintenance contracts are recognized ratably over the term of the agreements. For other services, service revenues are recognized as the services are performed. Deferred revenue for services arises from advance payments received from customers for services not yet performed.

Accounts Receivable. We perform ongoing credit evaluations of our customers and adjust credit limits based upon each customer's payment history and current credit worthiness, as determined by credit information available at that time. We continuously monitor collections and payments from our customers and we maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Inventory. Inventory is stated at the lower of cost or market; cost is determined on the first-in, first-out method. We write down inventory for slow-moving and obsolete inventory based on assessments of future demands for the next 12 to 36 months, market conditions and customers who may be experiencing financial difficulties. If these factors are less favorable than those projected, additional inventory write-downs may be required.

Deferred Tax Asset Valuation Allowance. We record a valuation allowance to reduce our deferred tax assets when it is more likely than not, based upon currently available evidence and other factors, that we will not realize some portion or all of our deferred tax assets. We base our determination of the need for a valuation allowance on an on-going evaluation of past and current evidence including, among other things, historical earnings, estimates of future earnings, the backlog of customer orders and the expected timing of deferred tax asset reversals. We charge or credit adjustments to the valuation allowance to income tax expense in the period in which these determinations are made. If we determine that we would be able to realize our deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase net income in the period this determination was made. Likewise, if we determine that we would not be able to realize all or part of our net deferred tax assets in the future, we would reduce net income and would establish a valuation allowance for the deferred tax asset in the period this determination was made.

Goodwill. We account for goodwill and intangible assets in accordance SFAS No. 142 "Goodwill and Other Intangible Assets." We assess impairment on an annual basis or on an interim basis if events occur or circumstances change that reduce the fair value of a reporting unit below its carrying value. This assessment requires the determination of the fair value of each reporting unit as compared to its carrying value. We determine the fair value of our reporting units on the income approach which requires the use of estimates of future revenues, cash flows, and capital expenditures as well as market trends and growth. We believe these estimates and assumptions to be reasonable, although they are inherently unpredictable and uncertain and actual results may differ from these estimates.

Results of Operations

The following table sets forth certain income and expenditure items as a percentage of total revenues for the periods indicated.

	Year Ended June 30,		
	2002	2003	2004
Revenues	100.0%	100.0%	100.0%
Cost of goods sold	69.2	67.2	66.3
Gross profit	30.8	32.8	33.7
Operating Expenses:			
Selling, general and administrative	17.4	16.0	21.9
Research and development	5.2	4.8	5.9
Goodwill amortization	0.3	—	—
Restructuring costs	—	—	0.4
Management retention bonus	—	—	0.5
Total operating expenses	22.9	20.8	28.7
Income from operations	7.9	12.0	5.0
Gain on sale of marketable securities	—	1.0	0.2
Write-off of deferred acquisition costs	—	(0.3)	—
Writedown of equity investment	—	(0.8)	(0.1)
Interest income	0.1	0.4	0.2
Income before provision for income taxes and minority interest	8.0	12.3	5.3
Provision for income taxes	2.4	3.6	1.3
Net income before minority interest	5.6	8.7	4.0
Minority interest	—	(0.1)	—
Net income	5.6	8.6	4.0

Comparison of Fiscal Year Ended June 30, 2004 to Fiscal Year Ended June 30, 2003

Revenues. Revenues consist of sales of security and inspection products, medical monitoring and imaging systems, and optoelectronic devices and value-added subsystems. Revenues are recorded net of inter-company eliminations. Revenues for the fiscal year ended June 30, 2004, increased by \$64.4 million, or 35.3%, to \$247.1 million from \$182.6 million for the fiscal year ended June 30, 2003.

Revenues from the sale of security and inspection products decreased \$3.0 million, or 2.5%, to \$117.8 million from \$120.8 million for fiscal year 2003. The decrease in revenues from the sale of security and inspection products was due to the decrease in sales of x-ray kits to Invision Technologies, Inc. of \$19.6 million and was offset in part by increased sales of x-ray screening machines in the United States and the international market, increased sales of large cargo products in the international market, and inclusion of ARACOR's revenues of \$9.5 million. We acquired ARACOR in January 2004.

Revenues for the sale of medical monitoring and imaging systems increased by \$49.8 million, or 458%, to \$60.7 million from \$10.9 million for fiscal year 2003. The increase in revenues from the sale of medical monitoring and imaging systems resulted primarily from the inclusion of \$47.2 million in revenues of Spacelabs Medical, acquired in March 2004, with additional revenue growth in sales of pulse oximetry products.

Revenues for the sale of optoelectronic devices and value-added subsystems, increased by \$17.7 million, or 35%, to \$68.6 million from \$50.9 million for fiscal year 2003. The increase in revenues from the sale of optoelectronic devices and value-added subsystems resulted from the inclusion of revenues from OSI Electronics, OSI Defense Systems, and OSI Laserscan totaling \$24.0 million, offset in part by lower sales primarily from defense optoelectronics.

Gross Profit. Gross profit consists of revenues less cost of goods sold. Cost of sales consists of material, labor, and manufacturing overhead. Gross profit increased by \$23.4 million, or 39.0%, to \$83.4 million from \$60.0 million for fiscal year 2003. As a percentage of revenues, gross profit increased to 33.7% in fiscal year 2004 from 32.8% in fiscal year 2003. The increase in gross margin as a percentage of revenues was driven by change in product mix, primarily due to the inclusion of Spacelabs Medical revenues which has higher gross margin compared to our other businesses and was offset in part by inclusion of OSI Electronics revenues which has lower gross margin compared to our other businesses.

Selling, General and Administrative. Selling, general, and administrative expenses consist primarily of compensation paid to sales, marketing, and administrative personnel, professional service fees and marketing expenses. For the year ended June 30, 2004, such expenses increased by \$25.0 million or 85.7%, to \$54.2 million from \$29.2 million for fiscal year 2003. The increase in selling, general, and administrative expenses was due primarily to increased sales and marketing expenses for the sales of security and inspection products of \$2.6 million, legal cost related to our lawsuit with L-3 Communications Corporation (“L-3”) amounting to approximately \$1.2 million, and the inclusion of selling, general, and administrative expenses of recent acquisitions (primarily Spacelabs Medical), totalling approximately \$20.5 million.

Research and Development. Research and development expenses include research related to new product development and product enhancement expenditures. For the year ended June 30, 2004, such expenses increased by \$5.8 million, or 65.1%, to \$14.6 million from \$8.9 million in fiscal year 2003. As a percentage of revenues, research and development expenses increased to 5.9% in fiscal year 2004 from 4.8% in fiscal year 2003. The increase in expenses was due primarily to increased research and development spending for security and inspection products of \$1.5 million and the inclusion of research and development expenses OSI Laserscan and Spacelabs Medical totaling approximately \$4.0 million.

Management Retention Bonus. Pursuant to the terms of the purchase agreement with Instrumentarium Corporation for the acquisition of Spacelabs Medical, we assumed management retention bonus obligations for key personnel of Spacelabs Medical, which could amount to \$5.9 million. These retention bonuses vest over a two-year period which began October 2003. Included in other accrued expenses and current liabilities, we have accrued a total of \$3.1 million, of which \$2.0 million relates to the period prior to the acquisition of Spacelabs Medical. The remaining retention bonus of \$2.8 million will be charged to operating income over the remaining vesting period.

Restructuring Charges. In the fiscal year 2004, we consolidated manufacturing processes and facilities of certain optoelectronic devices and value-added subsystems and medical monitoring and imaging systems businesses. These consolidations resulted in a pre-tax charge of \$1.1 million, consisting primarily of write-off of equipment and leasehold improvements of \$993,000 that were retired during the year and charges related to the clean-up of a vacated facility of \$60,000. These charges were calculated in accordance with SFAS No. 144, “Impairment or Disposal of Long-Lived Assets” and SFAS No. 146, “Accounting for Exit or Disposal Activities”.

Income from Operations. Income from operations for fiscal year 2004 decreased by \$9.6 million, or 43.6%, to \$12.4 million from \$22.0 million for fiscal year 2003. Income from operations decreased primarily due to increased selling, general, and administrative expenses and increased research and development expenses and was offset in part by an increase in revenues and in gross margins.

Gain on Sale of Marketable Securities. Gain on sale of marketable securities for the years ended June 30, 2004 and 2003 consisted of a realized gain on the sale of marketable securities classified as available for sale.

Write down of equity investment. In July 2002, we purchased from Imagis Technologies, Inc. (“Imagis”), 1,166,667 shares of its common stock (approximately 6% of its then-outstanding stock), and 2-year warrants to

purchase 291,667 additional shares of Imagis common stock (approximately 1.5% of its then-outstanding stock) at a price of \$1.50 per share, and certain ancillary rights, for an aggregate purchase price of \$1.75 million. Imagis develops facial recognition software for security applications. We have designated the investment as available for sale. The investment, adjusted for changes in the market value of Imagis' equity securities, is included under other assets in the accompanying consolidated financial statements. Based on the continued trading of Imagis common stock below the original purchase price for a prolonged period of time, we recognized an other-than-temporary impairment of the carrying value of this investment. For fiscal years 2004 and 2003 we recognized pre-tax charges of \$247,000 and \$1.4 million, respectively in our income statement.

Interest Income. For fiscal year 2004, we earned interest income of \$863,000 compared to \$1.2 million for fiscal year 2003. The decrease in interest income for fiscal year 2004 was due to the decrease in interest earning deposits in the current year.

Interest Expense. For fiscal year 2004, our interest expense was \$283,000 compared to \$380,000 for fiscal year 2003. The decrease in expense stems primarily from a decrease in borrowings in the current year compared to the prior year.

Provision for Income Taxes. Provision for income taxes decreased to \$3.3 million for fiscal year 2004, compared to \$6.5 million for fiscal year 2003. As a percentage of income before provision for income taxes and minority interest, provision for income taxes was 25.3% for fiscal year 2004, compared to 29.1% for fiscal year 2003. The change in the effective income tax rate was due to a favorable determination of tax contingencies. Our tax rate is dependent upon the mix of income from U.S. and foreign operations.

Net Income. For the reasons outlined above, the net income for the year ended June 30, 2004 was \$10.0 million compared to \$15.8 million for the year ended June 30, 2003.

Comparison of Fiscal Year Ended June 30, 2003 to Fiscal Year Ended June 30, 2002

Revenues. Revenues consist of sales of security and inspection products, medical monitoring and imaging systems, and optoelectronic devices and value-added subsystems. Revenues are recorded net of inter-company eliminations. Revenues for the fiscal year ended June 30, 2003, increased by \$58.4 million, or 47.0%, to \$182.6 million from \$124.2 million for the fiscal year ended June 30, 2002.

Revenues from the sale of security and inspection products increased \$47.4 million, or 64.5%, to \$120.8 million from \$73.4 million for fiscal year 2002. The increase in revenues from the sale of security and inspection products was due to increased sales of x-ray screening machines in the United States and the international market, increased sales of large cargo products in the international market and inclusion of Ancore revenues of \$7.5 million. We acquired Ancore in November 2002.

Revenue for the sale of medical monitoring and imaging systems increased \$4.7 million, or 75.8%, to \$10.9 million from \$6.2 million for fiscal year 2002. The increase was primarily due to increased sales of pulse oximetry products.

Revenues for the sale of optoelectronic devices and value-added subsystems increased by \$6.3 million, or 14.1%, to \$50.9 million from \$44.6 million for fiscal year 2002. The increase in revenue from the sale of optoelectronic devices and value-added subsystems was primarily due to the weapons simulation market and inclusion of Centro Vision's revenues of \$3.5 million. We acquired Centro Vision in July 2002.

Gross Profit. Cost of goods sold consists of material, labor, and manufacturing overhead. Gross profit increased by \$21.7 million, or 56.5%, to \$60.0 million from \$38.3 million for fiscal year 2002. As a percentage of revenues, gross profit increased to 32.8% in fiscal year 2003 from 30.8% in fiscal year 2002. The increase in gross profit was due primarily to increased security and inspection products shipments, which have a higher gross margin.

Selling, General, and Administrative. Selling, general, and administrative expenses consist primarily of compensation paid to sales, marketing, and administrative personnel, professional service fees and marketing expenses. For the year ended June 30, 2003, such expenses increased by \$7.5 million. The increase in expenses was due primarily to increased sales and marketing expenses for the sales of security and inspection systems and medical monitoring and imaging systems, of approximately \$3.0 million, legal and professional fees of \$1.0 million, administrative expenses of \$1.5 million, foreign currency losses of \$0.5 million, and inclusion of selling, general, and administrative expenses of Ancore and Centro Vision of \$1.5 million. As a percentage of revenues, selling, general, and administrative expenses decreased to 16.0% in fiscal year 2003 from 17.4% in fiscal year 2002, as expenses were leveraged over a larger revenue base.

Research and Development. Research and development expenses include research related to new product development and product enhancement expenditures. For the year ended June 30, 2003, such expenses increased by \$2.4 million or 37.8%, to \$8.9 million from \$6.4 million in fiscal year 2002. The increase in expenses was due primarily to increased research and development spending for security and inspection products, inclusion of research and development expenses of Ancore and Centro Vision and was offset in part by costs of certain research and development personnel who worked directly on specific products and whose costs were charged to manufacturing overhead.

Goodwill Amortization. For the year ended June 30, 2003, there was no amortization of goodwill. On July 1, 2002, we adopted SFAS No. 142, Goodwill and Other Intangible Assets, which changes the method of accounting for goodwill to a test of impairment and requires, among other things, the discontinuance of goodwill amortization. The amortization of goodwill was \$402,000 for the year ended June 30, 2002.

Income from Operations. Income from operations for fiscal year 2003 increased by \$12.1 million, or 123.2%, to \$22.0 million from \$9.8 million for fiscal year 2002. Income from operations increased primarily due to an increase in revenue and in gross margin and was offset in part by increased selling, general, and administrative expenses and increased research and development expenses.

Gain on Sale of Marketable Securities. Gain on sale of marketable securities for the year ended June 30, 2003, consisted of a realized gain on the sale of marketable securities classified as available for sale.

Write-off of deferred acquisition costs. In fiscal year 2002, we entered into an agreement regarding a joint acquisition with L-3 of certain detection and security businesses then owned by PerkinElmer, Inc. ("PerkinElmer"). The transaction as contemplated would have resulted in our acquisition from L-3 of a certain portion of PerkinElmer's detection and security businesses. L-3 completed the purchase of the entirety of the businesses from PerkinElmer in June 2002. In November 2002, L-3 terminated the L-3/OSI transaction prior to consummation. Because of L-3's termination of the transaction, for the year ended June 30, 2003, we recorded a charge of \$608,000 during the second quarter of fiscal year 2003 consisting of the write-off of deferred transaction-related expenses, primarily professional fees.

Write down of equity investment. In July 2002, we purchased from Imagis 1,166,667 shares of its common stock (approximately 6% of its then-outstanding stock), and 2-year warrants to purchase 291,667 additional shares of Imagis common stock (approximately 1.5% of its then-outstanding stock) at a price of \$1.50 per share, and certain ancillary rights, for an aggregate purchase price of \$1.75 million. Imagis develops facial recognition software for security applications. We have designated the investment as available for sale. The investment, adjusted for changes in the market value of Imagis' equity securities, is included under other assets in the accompanying consolidated financial statements. For the year ended June 30, 2003, based on the continued trading of Imagis common stock below the original purchase price for a prolonged period of time, we recognized an other than temporary impairment of the carrying value of this investment as of June 30, 2003 and recognized a pre-tax charge of \$1.4 million in our income statement.

Interest (Expense) Income. For the year ended June 30, 2003, we had a net interest income of \$786,000 compared to net interest income of \$161,000 for fiscal year 2002. The increase in net interest income for the

fiscal year ended June 30, 2003 was due to decreased borrowing and interest income on the proceeds from private placements in November and December 2001, and October 2002. These proceeds are primarily invested in short-term instruments with an original maturity date of less than ninety days.

Provision for Income Taxes. Provision for income taxes increased to \$6.5 million for the fiscal year ended June 30, 2003, compared to \$3.0 million for fiscal year 2002. As a percentage of income before provision for income taxes and minority interest, provision for income taxes was 29.1% for fiscal year 2003, compared to 30.0% for fiscal year 2002. The change in the effective income tax rate was due to a reduction in our deferred tax asset valuation allowance, partially offset by changes in the mix of income from U.S. and foreign operations.

Net Income. For the reasons outlined above, the net income for the year ended June 30, 2003 was \$16.0 million compared to \$6.9 million for the year ended June 30, 2002.

Liquidity and Capital Resources

We have financed our operations primarily through cash provided by operations, through various term loans, discounting facilities, and credit lines extended to our different subsidiaries worldwide and from our private offerings. Cash and cash equivalents as of June 30, 2004 were \$39.9 million, a decrease of \$54.3 million from \$94.2 million as of June 30, 2003. As of June 30, 2004, our principal source of liquidity consisted of \$39.9 million in cash and several credit agreements described below.

Our operations used net cash of \$10.4 million during fiscal year 2004 compared to net cash provided by operations of \$21.6 million in fiscal year 2003. The amount of net cash used in operations reflects increases in accounts receivable, inventory, prepaid expenses, and a reduction in advances from customers and accrued warranties, offset in part by an increase in accounts payable and accrued payroll and related expenses. The increase in accounts receivable of \$16.6 million was due to higher revenues and the increase in inventory of \$15.1 million was due to product mix and anticipated higher revenues.

The net cash used in investing activities was \$75.6 million during fiscal year 2004, compared to net cash used in investing activities of \$14.9 million in fiscal year 2003. In fiscal year 2004, net cash used in investing activities reflects primarily cash used for the acquisitions of OSI Electronics, OSI Defense Systems, OSI Laserscan, J&D Engineering (UK) Limited, CXR Limited, ARACOR, and Spacelabs Medical totaling \$77.5 million, and the purchase of property and equipment of \$5.4 million. Cash used in investing activities also reflects proceeds from the sale of marketable securities of \$5.3 million and a receipt of \$2.0 million from Conmed Corporation under the terms of a stock purchase and sale agreement, in which Conmed Corporation purchased a 10% equity interest in our subsidiary, Dolphin Medical, and has an option to purchase all of the remaining assets and the business of Dolphin Medical. As part of these transactions, Conmed Corporation acquired rights to sell certain Dolphin Medical products in the United States and certain other territories.

Net cash provided by financing activities was \$30.5 million in fiscal year 2004, compared to \$19.0 million for fiscal year 2003. Net cash provided by financing activities resulted primarily from the net proceeds received from the private placements totaling \$31.0 million and exercise of stock options, offset in part by repayment on the term loan.

In June 2004, we issued and sold an aggregate of 1,500,000 shares of our Common Stock in a private placement to institutional investors for an aggregate sales price of \$32.3 million. After placement agent commission and expenses, net proceeds to us were \$31.0 million.

In March 1999, we announced a stock repurchase program of up to 2,000,000 shares of our Common Stock. No share repurchases occurred during fiscal years 2003 or 2004. Through June 30, 2004, we had repurchased 1,404,500 shares at an average price \$4.37 per share. In September 2004, we repurchased 107,500 shares of our Common Stock at an average purchase price of \$14.73 per share and we increased the number of shares available

for repurchase under the stock repurchase program by 1,000,000 shares. As a result, 1,488,000 shares are available for repurchase under the program. The stock repurchase program did not have a material effect on our liquidity and is not expected to have a material effect on liquidity in subsequent quarters.

In December 2003, we negotiated and restated our credit agreement with Bank of the West, which provides for a \$50.0 million line of credit that includes a revolving line, letter-of-credit, acceptance and foreign exchange facility. The agreement provides that the aggregate principal balance of all advances under the various facilities shall not exceed the total balance available under the line of credit. In addition, we have a \$3.3 million term loan facility. Borrowings under the line of credit bear interest at the bank's variable reference rate (4.22% at June 30, 2003 and 4.0% at June 30, 2004) at our option, at a fixed rate as quoted by the bank upon request for specific advances. Commitment fees are payable based on a rate of 0.125% of the unused borrowing facility.

The credit agreement expires in November 2005. Borrowings under the credit agreement are collateralized by substantially all of the assets of our U.S. subsidiaries. At June 30, 2004, there were no amounts outstanding under the line of credit. At June 30, 2004 approximately \$3.4 million was issued and outstanding under letters of credit and \$1.8 million was outstanding under the term loan (see Note 5). Covenants in connection with the credit agreement impose restrictions and requirements related to, among other things, maintenance of certain financial ratios. As of June 30, 2004, we were not in compliance with a covenant related to the increase in our tangible net worth as a percentage of net income for fiscal year 2004 and a covenant related to the value of intangible assets that could be acquired during fiscal year 2004. Bank of the West has waived these covenants.

Our wholly-owned subsidiary, Opto Sensors (Singapore) Pte. Ltd. ("Opto Singapore") has a revolving line of credit agreement with a Singapore bank that provides for an accounts receivable discounting facility of up to 2.6 million Singapore dollars (approximately U.S. \$1.4 million at June 30, 2004). Borrowings under the line of credit bear interest at the bank's prime rate (5.0% at June 30, 2003 and 5.5% at June 30, 2004) plus 1.0%. Borrowings under the line of credit are collateralized by certain assets of Opto Singapore and are guaranteed by certain of our officers. Borrowings secured by inter-company receivables are guaranteed by us. At June 30, 2004, there were no amounts outstanding under the revolving line of credit. This facility expires in April 2005 and we believe that it will be renewed on the same or similar terms.

Advanced Micro Electronics, AS ("AME") has a loan agreement with a Norwegian bank that provides for revolving line-of-credit borrowings up to 10.0 million Norwegian kroner (approximately U.S. \$1.3 million at June 30, 2004). Borrowings under the line of credit bear interest at a variable rate, which was 5.5% and 4.25% at June 30, 2003 and 2004, respectively. Interest is payable quarterly. Borrowings under the line of credit are collateralized by certain AME assets. At June 30, 2004, 4.3 million Norwegian kroner (approximately U.S. \$620,000) was outstanding under the line of credit. This facility expires in March 2005, and we believe that it will be renewed on the same or similar terms.

Our Rapiscan Security Products, Ltd, subsidiary ("Rapiscan UK") has a loan agreement with a United Kingdom bank that provides for an overdraft facility up to a maximum amount of 2.0 million pounds sterling (approximately U.S. \$3.6 million at June 30, 2004) outstanding at any one time, which amounts are secured by certain assets of Rapiscan U.K. At June 30, 2004 no amounts were outstanding under the overdraft facility. Outstanding borrowings bear interest at a base rate (3.75% at June 30, 2003 and 4.5% at June 30, 2004) plus 1.35% per annum. The agreement also provides for a 2.5 million pounds sterling (approximately U.S. \$4.5 million at June 30, 2004) facility for tender and performance bonds and a 2.0 million pounds sterling (approximately U.S. \$3.6 million at June 30, 2004) facility for the purchase of foreign exchange contracts. These facilities are secured by certain assets of Rapiscan U.K., and we have guaranteed Rapiscan U.K.'s obligation under these facilities up to \$1.8 million. As of June 30, 2004 approximately \$1.9 million was outstanding under the performance bond facility. These facilities expire in May 2005, and we believe that they will be renewed on the same or similar terms.

Our wholly-owned subsidiary Opto Sensors (Malaysia) Sdn. Bhd. ("Opto Malaysia") has a loan agreement with a Malaysian bank that provides for a revolving line of credit up to 3.0 million Malaysian ringgits

(approximately U.S.\$789,000 at June 30, 2004). Borrowings under the line of credit bear interest at the bank's base lending rate (6.0% and 6.0% at June 30, 2003 and 2004, respectively) plus 1.75%. Interest is payable monthly. At June 30, 2004, no amounts were outstanding under this line of credit. Borrowings under this agreement are secured by certain assets of the subsidiary and guaranteed by us. This facility expires in August 2005, and we believe that it will be renewed on the same or similar terms.

Opto Malaysia also has a loan agreement with a Malaysian bank that provides for 10.0 million Malaysian ringgits (approximately U.S. \$2.6 million at June 30, 2004) under a performance bond facility. As of June 30, 2004, \$1.1 million was outstanding under this facility. The agreement provides for overdraft borrowings up to 2.0 million Malaysian ringgits (approximately U.S. \$526,000 at June 30, 2004). Borrowings under the overdraft facility bear interest at the bank's base lending rate (6.0% at June 30, 2003 and 6.0% at June 30, 2004) plus 1.75%. At June 30, 2004 and 2003, no amounts were outstanding under the overdraft facility. Borrowings under this agreement are secured by certain assets of Opto Malaysia and are guaranteed by us. This facility expires in January 2005, and we believe that it will be renewed on the same or similar terms.

Metorex Security Products, Oy has a loan agreement with a Finnish bank that provides for 525,000 euros (approximately U.S. \$640,000 at June 30, 2004) under a tender and performance bond facility. As of June 30, 2004 U.S. \$571,000 was outstanding under this facility. The agreement also provides for a foreign currency overdraft facility up to 460,000 euros (approximately U.S. \$561,000 at June 30, 2004). At June 30, 2004, 84,000 euros (approximately U.S \$103,000) was outstanding under the facility. Borrowings under these facilities bear interest rate at the bank's prime lending rate (4.0% at June 30, 2003 and 2.5% at June 30, 2004) plus 1.0%. These facilities expire in February 2006.

We believe that cash from operations, existing cash and lines of credit will be sufficient to meet our cash requirements for the foreseeable future.

The following is a summary of our contractual commitments at June 30, 2004 (in thousands):

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 Year	1-3 years	4-5 years	After 5 Years
Long-Term Debt	\$ 1,830	\$ 1,798	\$ 32	\$ —	\$ —
Operating Leases	\$48,090	\$ 9,312	\$13,808	\$9,932	\$15,038
Management Retention Bonus	\$ 5,900	\$ 3,175	\$ 2,725	\$ —	\$ —
Total Contractual Cash Obligations	\$55,820	\$ 14,285	\$16,565	\$9,932	\$15,038

Other Commercial Commitments	Amount of Commitment Expiration Per Period				
	Total Amounts Committed	Less than 1 Year	1-3 years	4-5 years	Over 5 Years
Standby Letters of Credit	\$ 6,971	\$ 6,367	\$555	\$ 49	\$ —
Total Commercial Commitments	\$ 6,971	\$ 6,367	\$555	\$ 49	\$ —

New Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation Number 46, Consolidation of Variable Interest Entities ("FIN 46"), an interpretation of Accounting Research Bulletin No. 51. FIN 46 requires that variable interest entities be consolidated by a company if that company absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding a variable interest. In December 2003, the FASB issued FIN 46R, which made certain amendments to FIN 46. The provisions of FIN 46R are effective for the first interim or annual period ending after March 15, 2004 when certain conditions are met by a variable interest entity.

We have adopted FIN 46R and have consolidated in our financial statements our investment in CXR Limited, which was previously accounted for under the equity method. The results and operations of this venture are not material to our financial position or results of operations. Creditors and other investors in the venture do not have any recourse to us.

In November 2002, the EITF reached a consensus on Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities and how arrangement considerations should be measured and allocated to the separate units of accounting in the arrangement. The provisions of EITF Issue No. 00-21 apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of EITF Issue No. 00-21 did not have a material effect on our financial position or result of operations.

In March 2004, the EITF reached a consensus on Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("EITF 03-1"). EITF 03-1 provides guidance for determining when an investment is other-than-temporarily impaired to be applied in reporting periods beginning after June 15, 2004 and contains disclosure requirements effective in annual financial statements for fiscal years ending after December 15, 2003 for investments accounted for under SFAS Nos. 115 and 124. For all other investments within the scope of this Issue, the disclosures are effective for fiscal years ending after June 15, 2004. The adoption of EITF Issue No. 03-1 did not have a material effect on our financial position or result of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk

We are exposed to certain market risks, which are inherent in our financial instruments and arise from transactions entered into in the normal course of business. We may enter into derivative financial instrument transactions in order to manage or reduce market risk in connection with specific foreign-currency-denominated transactions. We do not enter into derivative financial instrument transactions for speculative purposes.

We are subject to interest rate risk on our short-term borrowings under our bank lines of credit. Borrowings under these lines of credit do not give rise to significant interest rate risk because these borrowings have short maturities and are borrowed at variable interest rates. Historically, we have not experienced material gains or losses due to interest rate changes.

Foreign Currency

We maintain the accounts of our operations in Canada, India, Malaysia, Norway, Singapore, and the United Kingdom in Canadian dollars, Indian rupees, Malaysian ringgits, Norwegian kroners, Singapore dollars, and U.K. pounds, respectively. We maintain the accounts of our operations in Austria, Finland, France, Germany, and Greece in euros. Foreign currency financial statements are translated into U.S. dollars at current rates, with the exception of revenues, costs and expenses, which are translated at average rates during the reporting period. Gains and losses resulting from foreign currency transactions are included in income, while those resulting from translation of financial statements are excluded from income and accumulated as a component of shareholder's equity. We included transaction losses of approximately \$475,000 in income for fiscal year 2003 and \$377,000 in fiscal year 2004. A hypothetical 10% change in the relevant currency rates at June 30, 2003, would not have a material impact on our financial position or results of operations.

Our use of derivatives consists primarily of foreign exchange contracts and interest rate swaps. We purchase forward contracts to hedge foreign exchange exposure related to commitments to acquire inventory for sale. We do not use the contracts for trading purposes. As of June 30, 2004, there were no foreign exchange contracts outstanding. As of June 30, 2003, we had one foreign exchange contract with a notional amount of \$1.2 million to hedge foreign exchange exposure on accounts receivable and accounts payable.

Importance of International Markets

International markets provide us with significant growth opportunities. However, the following events, among others, could adversely affect our financial results in subsequent periods: periodic economic downturns in different regions of the world, changes in trade policies or tariffs, and political instability. For the year ended June 30, 2004, overall foreign currency fluctuations relative to the U.S. dollar had an immaterial effect on our consolidated revenues and results of operations. As a result of monetary policy in Malaysia, including the pegging of the Malaysian ringgit to the U.S. dollar, we believe that our foreign currency exposure in Malaysia will not be significant in the foreseeable future. We continue to perform ongoing credit evaluations of our customers' financial condition and, if deemed necessary, we require advance payments for sales. We monitor economic and currency conditions around the world to evaluate whether there may be any significant effect on our international sales in the future. Due to our overseas investments and the necessity of dealing with local currencies in our foreign business transactions, we are at risk with respect to foreign currency fluctuations.

Inflation

We do not believe that inflation has had a material impact on our results of operations.

Interest Rate Risk

All highly liquid investments with maturity of three months or less are classified as cash equivalent and recorded in the balance sheet at fair value. Short-term investments are comprised of high quality marketable securities. We have not historically used derivatives to hedge our interest rate risk. However, during the fiscal year 2002 we entered into interest rate swaps to convert a portion of our variable-interest-rate debt to a fixed-rate liability. As of June 30, 2004, all interest rate swaps had expired. The fair value of the swaps was (\$90,000) as of June 30, 2003.

The carrying amount, principal maturity and estimated value of our investment portfolio and long-term debt exposure as of June 30, 2003 are as follows:

	Carrying Amount	Maturity			Fair Value
	2003	2004	2005	2006	
Investments					
Cash and cash equivalents	\$94,246				\$94,246
Average interest rate	1.8%				
Long-term debt					
Secured long term loan	\$ 4,463	2,625	1,838		\$ 4,463
Average interest rate	4.6%	4.6%	4.6%		

The carrying amount, principal maturity and estimated value of our investment portfolio and long-term debt exposure as of June 30, 2004 are as follows:

	Carrying Amount	Maturity			Fair Value
	2004	2005	2006	2007	
Investments					
Cash and cash equivalents	\$39,879				\$39,879
Average interest rate	1.8%				
Long-term debt					
Secured long term loan	\$ 1,830	\$1,798	\$ 32		\$ 1,830
Average interest rate	5.0%	5.0%	5.0%		

RISK FACTORS

Investing in our Common Stock involves a significant degree of risk. Investors should carefully consider the following risk factors and all the other information contained in this report or incorporated by reference. If any of the following risks actually occurs, our business, financial condition and results of operations could suffer, in which case the trading price of our Common Stock may decline.

Risks Related to Our Business

Fluctuations in our operating results may cause our stock price to decline.

Given the nature of the markets in which we participate, we cannot reliably predict future revenues and profitability. Changes in competitive, market and economic conditions may cause us to adjust our operations. A high proportion of our costs are fixed, due in part to our significant sales, research and development, and manufacturing costs. Thus, small declines in revenue could disproportionately affect our operating results. Factors that may affect our operating results and the market price of our Common Stock include:

- demand for and market acceptance of our products;
- competitive pressures resulting in lower selling prices;
- adverse changes in the level of economic activity in regions in which we do business;
- adverse changes in industries, such as semiconductors and electronics, on which we are particularly dependent;
- changes in the portions of our revenue represented by various products and customers;
- delays or problems in the introduction of new products;
- the announcement or introduction of new products, services or technological innovations by our competitors;
- variations in our product mix;
- the timing and amount of our expenditures in anticipation of future sales;
- increased costs of raw materials or supplies; and
- changes in the volume or timing of product orders.

We face aggressive competition in many areas of business. If we do not compete effectively, our business will be harmed.

We encounter aggressive competition from numerous competitors in many areas of our business. In the security and inspection and medical monitoring and imaging systems markets, competition is based primarily on such factors as product performance, functionality and quality, cost, prior customer relationships, technological capabilities of the product, price, certification by government authorities, local market presence, and breadth of sales and service organization. In the optoelectronic devices and value-added subsystems market competition is based primarily on factors such as expertise in the design and development of optoelectronic devices, product quality, timeliness of delivery, price, customer technical support, and on the ability to provide fully-integrated services from application development and design through volume subsystem production. We may not be able to compete effectively with all of our competitors. To remain competitive, we must develop new products and enhance our existing products in a timely manner. We anticipate that we may have to adjust prices of many of our products to stay competitive. In addition, new competitors may emerge, and entire product lines may be threatened by new technologies or market trends that reduce the value of these product lines.

The September 11, 2001 terrorist attacks and the creation of the U.S. Department of Homeland Security have increased financial expectations that may not materialize.

The September 11, 2001 terrorist attacks and the subsequent creation of the U.S. Department of Homeland Security have created increased interest in our security and detection products; however, we are not certain whether the level of demand will continue to be as high as anticipated. We do not know what solutions will continue to be adopted by the U.S. Department of Homeland Security as a result of the terrorism and whether our products will be a part of the solution. Additionally, should our products be considered as a part of the future security solution, it is unclear what the level may be and how quickly funding to purchase our products may be made available. These factors may adversely impact us and create unpredictability in revenues and operating results.

Our revenues are dependent on orders in the security and inspection products, which have lengthy and unpredictable sales cycles.

Sales of security and inspection products depend in significant part upon the decision of governmental agencies to upgrade or expand existing airports, border crossing inspection sites, seaport inspection sites, and other security installations. Accordingly, a portion of our sales of security inspection and detection products is often subject to delays associated with the lengthy approval processes that typically accompany such capital expenditures. During these approval periods, we expend significant financial and management resources in anticipation of future orders that may not occur. If we fail to receive an order after expending such resources, such failure could have a material adverse effect on our business, financial condition and results of operations.

If we do not introduce new products in a timely manner, our products could become obsolete and our operating results would suffer.

We sell many of our products in industries characterized by rapid technological changes, frequent new product and service introductions and evolving industry standards. Without the timely introduction of new products and enhancements, our products could become technologically obsolete over time, in which case our revenue and operating results would suffer. The success of our new product offerings will depend upon several factors, including our ability to:

accurately anticipate customer needs;

innovate and develop new technologies and applications;

successfully commercialize new technologies in a timely manner;

price our products competitively and manufacture and deliver our products in sufficient volumes and on time; and

differentiate our offerings from our competitors' offerings.

Some of our products are used by our customers to develop, test, and manufacture their products. We therefore must anticipate industry trends and develop products in advance of the commercialization of our customers' products. In developing any new product, we may be required to make a substantial investment before we can determine the commercial viability of the new product. If we fail to accurately foresee our customers' needs and future activities, we may invest heavily in research and development of products that do not lead to significant revenues.

Interruptions in our ability to purchase raw materials and components may adversely affect our profitability.

We purchase certain raw materials and subcomponents from third parties pursuant to purchase orders placed from time to time. Purchase order terms range from three months to one year at fixed costs, but we do not have guaranteed long-term supply arrangements with our suppliers. Any material interruption in our ability to purchase necessary raw materials or subcomponents could have a material adverse effect on our business, financial condition and results of operations.

We may not be able to successfully implement our acquisitions strategy, integrate acquired businesses into our existing business or make acquired businesses profitable.

One of our strategies is to supplement our internal growth by acquiring businesses and technologies that complement or augment our existing product lines. This growth has placed, and may continue to place, significant demands on our management, working capital, and financial resources. We may be unable to identify or complete promising acquisitions for many reasons, including:

- competition among buyers;
- the need for regulatory approvals, including antitrust approvals; and
- the high valuations of businesses.

Some of the businesses we may seek to acquire may be marginally profitable or unprofitable. For these acquired businesses to achieve acceptable levels of profitability, we must improve their management, operations, products and market penetration. We may not be successful in this regard and may encounter other difficulties in integrating acquired businesses into our existing operations.

To finance our acquisitions, we may have to raise additional funds, through either public or private financings. We may be unable to obtain such funds or may be able to do so only on unfavorable terms.

Our acquisition and alliance activities could disrupt our ongoing business.

We intend to continue to make investments in companies, products, and technologies, either through acquisitions or investments or alliances. For example, we completed the acquisition of Spacelabs Medical this past year, a global manufacturer and distributor of patient monitoring and clinical information systems for use primarily in hospitals. Acquisitions and alliance activities often involve risks, including: (i) difficulty in assimilating the acquired operations and employees; (ii) difficulty in managing product co-development activities with our alliance partners; (iii) retaining the key employees of the acquired operation; (iv) disruption of our ongoing business; (v) inability to successfully integrate the acquired technologies and operations into our businesses and maintain uniform standards, controls, policies, and procedures; and (vi) lacking the experience necessary to enter into new product or technology markets. In addition, from time to time, our competitors acquire or enter into exclusive arrangements with companies with whom we do business or may do business in the future. Reductions in the number of partners with whom we may do business in a particular context may reduce our ability to enter into critical alliances on attractive terms or at all, and the termination of an existing alliance by a business partner may disrupt our operations.

Economic, political, and other risks associated with international sales and operations could adversely affect our sales.

In fiscal year 2002 revenues from shipments made outside of the United States accounted for approximately 52% of our revenues, 51% in fiscal year 2003, and 41% in fiscal year 2004. Of the revenues generated during fiscal year 2004 from shipments made to customers outside of the United States, 17% represented sales from the U.S. to foreign customers, and the balance represented sales generated by our foreign subsidiaries. Since we sell our products worldwide, our businesses are subject to risks associated with doing business internationally. We anticipate that revenues from international operations will continue to represent a substantial portion of our total revenue. In addition, many of our manufacturing facilities, employees and suppliers are located outside the United States. Accordingly, our future results could be harmed by a variety of factors, including:

- changes in foreign currency exchange rates;
- changes in a country's or region's political or economic conditions, particularly in developing or emerging markets;
- longer payment cycles of foreign customers and difficulty of collecting receivables in foreign jurisdictions;
- trade protection measures and import or export licensing requirements;

differing tax laws and changes in those laws;
difficulty in staffing and managing widespread operations;
differing labor laws and changes in those laws;
differing protection of intellectual property and changes in that protection; and
differing regulatory requirements and changes in those requirements.

Our failure to protect our intellectual property could impair our competitive position.

While we own certain patents and trademarks, some aspects of our business cannot be protected by patents or trademarks. Accordingly, in these areas there are few legal barriers that prevent potential competitors from copying certain of our products, processes, and technologies or from otherwise entering into operations in direct competition with us.

Our products may infringe on the intellectual property rights of others, and resulting claims against us could be costly and prevent us from making or selling certain products.

Third parties may seek to claim that our products and operations infringe their patent or other intellectual property rights. We may incur significant expense in any legal proceedings to protect our proprietary rights or to defend infringement claims by third parties. In addition, claims of third parties against us could result in awards of substantial damages or court orders that could effectively prevent us from making, using or selling our products in the U.S. or abroad.

A claim for damages could materially and adversely affect our financial condition and results of operations.

Our business exposes us to potential product liability risks, particularly with respect to our security and inspection products. There are many factors beyond our control that could lead to liability claims, including the failure of the products in which our subsystems are installed, the reliability of the customers' operators of the inspection equipment, and the maintenance of the inspection units by the customers. There can be no assurance that the amount of product liability insurance that we carry will be sufficient to protect us from product liability claims. A product liability claim in excess of the amount of insurance we carry could have a material adverse effect on our business, financial condition, and results of operations.

Our ongoing success is dependent upon the continued availability of certain key employees.

We are dependent in our operations on the continued availability of the services of our employees, many of whom are individually key to our current and future success, and the availability of new employees to implement our growth plans. In particular, we are dependent upon the services of Deepak Chopra, our Chairman of the Board of Directors, President and Chief Executive Officer. We have entered into a 5-year employment agreement with Mr. Chopra, which expires April 1, 2007 and we maintain a \$13.0 million policy of key man life insurance on the life of Mr. Chopra. The market for skilled employees is highly competitive, especially for employees in technical fields. While our compensation programs are intended to attract and retain the employees required for it to be successful, there can be no assurance that we will be able to retain the services of all of our key employees or a sufficient number to execute on our plans, nor can there be any assurances that we will be able to continue to attract new employees as required.

Our failure to comply with environmental regulations may create significant environmental liabilities and force us to modify our manufacturing processes.

We are subject to various federal, state and local environmental laws, ordinances and regulations relating to the use, storage, handling and disposal of certain hazardous substances and wastes used or generated in the manufacturing and assembly of our products. Under such laws, we may become liable for the costs of removal or remediation of certain hazardous substances or wastes that have been or are being disposed of offsite as wastes or that have been or are being released on or in our facilities. Such laws may impose liability without regard to

whether we knew of, or caused, the release of such hazardous substances or wastes. Any failure by us to comply with present or future regulations could subject us to the imposition of substantial fines, suspension of production, alteration of manufacturing processes, or cessation of operations, any of which could have a material adverse effect on our business, financial condition, and results of operations.

Changes in governmental regulations may reduce demand for our products or increase our expenses.

We compete in markets in which we or our customers must comply with federal, state, local, and foreign regulations, such as environmental, health, safety, and food and drug regulations. We develop, configure, and market our products to meet customer needs created by these regulations. Any significant change in these regulations could reduce demand for our products.

Risks Related To Our Capital Structure and Common Stock

Our Articles of Incorporation and other agreements contain provisions that could discourage a takeover.

Our Articles of Incorporation authorize our Board of Directors to issue up to 10,000,000 shares of Preferred Stock in one or more series, to fix the rights, preferences, privileges and restrictions granted to or imposed upon any wholly unissued shares of preferred stock, to fix the number of shares constituting any such series, and to fix the designation of any such series, without further vote or action by shareholders. The terms of any series of preferred stock, which may include priority claims to assets and dividends and special voting rights, could adversely affect the rights of the holders of our Common Stock and thereby reduce the value of our Common Stock. We have no present plans to issue shares of Preferred Stock. The issuance of Preferred Stock, coupled with the concentration of ownership in the directors and executive officers, could discourage certain types of transactions involving an actual or potential change in control of our company, including transactions in which the holders of Common Stock might otherwise receive a premium for their shares over then current prices, otherwise dilute the rights of holders of Common Stock, and may limit the ability of such shareholders to cause or approve transactions which they may deem to be in their best interests, all of which could have a material adverse effect on the market price of our Common Stock. We have in place a stockholder rights plan, adopted in 2000, under which our stockholders are entitled to purchase shares of preferred stock under certain circumstances. These circumstances include the purchase of 20% or more of the outstanding shares of Common Stock by a person or group, or the announcement of a tender or exchange offer to acquire 20% or more of the outstanding Common Stock. The stockholder rights plan may have the effect of impeding or preventing certain types of transactions involving a change in control of our company that could be beneficial to the stockholders.

Our Articles of Incorporation limit the liability of its directors, which may limit the remedies we or our shareholders have available.

Our Articles of Incorporation provide that, pursuant to the California Corporations Code, the liability of our directors for monetary damages shall be eliminated to the fullest extent permissible under California law. This is intended to eliminate the personal liability of a director for monetary damages in an action brought by us, or in our right, for breach of a director's duties to us or our shareholders and may limit the remedies available to us or our shareholders. This provision does not eliminate the directors' fiduciary duty and does not apply to liabilities for: (i) acts or omissions that involve intentional misconduct or a knowing and culpable violation of law; (ii) acts or omissions that a director believes to be contrary to the best interests of our company or our shareholders or that involve the absence of good faith on the part of the director; (iii) any transaction from which a director derived an improper personal benefit; (iv) acts or omissions that show a reckless disregard for the director's duty to the our company or our shareholders in circumstances in which the director was aware, or should have been aware, in the ordinary course of performing a director's duties, of a risk of serious injury to our company or our shareholders; (v) acts or omissions that constitute an unexcused pattern of inattention that amounts to an abdication of the director's duty to our company or our shareholders; (vi) certain transactions or the approval of transactions in which a director has a material financial interest; and (vii) expressly imposed by statute for approval of certain improper distributions to shareholders or certain loans or guarantees.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our Financial Statements are submitted as a separate section of this Annual Report on Form 10-K beginning on page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES**Evaluation of Disclosure Controls and Procedures**

As of June 30, 2004, the end of the period covered by this report, our Chief Executive Officer and our Chief Financial Officer reviewed and evaluated the effectiveness of the our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e) and 15d-15(e)), which are designed to ensure that material information we must disclose in our report filed or submitted under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized, and reported on a timely basis, and have concluded, based on that evaluation, that as of such date, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is accumulated and communicated to our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the fourth fiscal quarter of the fiscal year covered by this Annual Report on Form 10-K that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2004 Annual Meeting of Stockholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about September 27, 2004.

ITEM 11. EXECUTIVE COMPENSATION

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2004 Annual Meeting of Stockholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about September 27, 2004.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2004 Annual Meeting of Stockholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about September 27, 2004.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2004 Annual Meeting of Stockholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about September 27, 2004.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information called for by this item is hereby incorporated by reference from our definitive Proxy Statement relating to the 2004 Annual Meeting of Stockholders, which Proxy Statement will be filed with the Securities and Exchange Commission on or about September 27, 2004.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) List of documents filed as part of Report

(1) FINANCIAL STATEMENTS INCLUDED IN ITEM 8:

Report of Independent Registered Public Accounting Firm	F-1
Consolidated Balance Sheets at June 30, 2003 and 2004	F-2
Consolidated Statements of Operations for the years ended June 30, 2002, 2003 and 2004	F-3
Consolidated Statements of Shareholders' Equity for the years ended June 30, 2002, 2003 and 2004	F-4
Consolidated Statements of Cash Flows for the years ended June 30, 2002, 2003 and 2004	F-5
Notes to Consolidated Financial Statements	F-10

(2) FINANCIAL STATEMENT SCHEDULES INCLUDED IN ITEM 8:

Schedule II—Valuation and Qualifying Accounts

No other financial statement schedules are presented as the required information is either not applicable or included in the Consolidated Financial Statements or notes thereto.

(3) EXHIBITS

The exhibits listed on the accompanying Exhibit Index are filed as part of this Annual Report.

(b) Reports on Form 8-K

Report on Form 8-K filed on May 3, 2004, regarding the issuance by us of a news release on April 29, 2004 on the subject of third quarter consolidated earnings.

Report on Form 8-K/A filed on June 1, 2004 (amending a Report on Form 8-K filed on March 26, 2004) in order to include the financial statements of the Spacelabs Medical business we acquired on March 19, 2004 (required to be disclosed by Item 7(a) of Form 8-K) and the pro forma financial information of the Spacelabs Medical business (required to be disclosed by Item 7(b) of Form 8-K), as such delayed disclosure was permitted pursuant to Item 7(a)(4) and Item 7(b)(2) of Form 8-K.

Report on Form 8-K filed on June 2, 2004, announcing a private placement of 1,500,000 shares of OSI Systems, Inc. Common Stock.

Report on Form 8-K filed on September 9, 2004, announcing the repurchase by us of 107,500 shares of our Common Stock and announcing that our Board of Directors has authorized the repurchase of up to an additional 1,000,000 shares of our Common Stock under an existing stock repurchase plan.

INDEX TO EXHIBITS

<u>No.</u>	<u>Exhibit Description</u>
3.1	Articles of Incorporation of the Company (1)
3.2	Amended and Restated Bylaws of the Company (1)
4.1	Specimen Common Stock Certificate (2)
10.1	1987 Incentive Stock Option Plan, as amended, and form of Stock Option Agreement (1)
10.2	1997 Stock Option Plan and forms of Stock Option Agreements (3)
10.3	Incentive Compensation Agreement dated December 18, 1996 between the Company and Andreas F. Kotowski (1)
10.4	Form of Indemnity Agreement for directors and executive officers of the Company (2)
10.5	Agreement of Purchase and Sale and Joint Escrow Instructions dated as of June 23, 1998 by and between KB Chadron Building, LLC and UDT Sensors, Inc. (4)
10.6	Agreement of Purchase and Sale and Joint Escrow Instructions dated as of June 23, 1998 by and between Chadron II, LLC and UDT Sensors, Inc. (4)
10.7	Employment Agreement dated September 1, 2000 between the Company and Ajay Mehra (5)
10.8	Employment Agreement dated April 1, 2002 between the Company and Deepak Chopra (6)
10.9	Employment Agreement dated June 1, 2003 between the Company and Victor S. Sze (7)
10.10	Employment Agreement dated June 1, 2003 between the Company and Anuj Wadhawan (7)
10.11	Amended and Restated Credit Agreement dated as of December 1, 2003, by and between Bank of the West and OSI Systems, Inc. (8)
10.12	Merger Agreement and Plan of Organization dated as of December 18, 2003 by and among Advanced Research & Applications Corp., Robert A. Armistead, OSI Subsidiary, Inc., and OSI Systems, Inc. (9)
10.13	First Amendment and Waiver to Amended and Restated Credit Agreement dated as of April 1, 2004, by and between Bank of the West and OSI Systems, Inc. (10)
10.14	Purchase Agreement dated as of January 2, 2004 between Instrumentarium Corporation and OSI Systems, Inc. (11)
10.15	Letter Agreement dated as of March 19, 2004 between Instrumentarium Corporation and OSI Systems, Inc. amending and supplementing the Purchase Agreement dated as of January 2, 2004. (11)
10.16	Securities Purchase Agreement dated as of June 1, 2004, among OSI Systems, Inc. and various purchasers (12)
10.17*	Lease dated June 24, 2002 between S/I Sammamish I, LLC and Spacelabs Medical, Inc.
10.18*	Lease dated June 24, 2002 between S/I Sammamish I, LLC and Spacelabs Medical, Inc.
21.1*	Subsidiaries of the Company
23.1*	Consent of Independent Registered Public Accounting Firm
31.1*	Certification Pursuant to Section 302
31.2*	Certification Pursuant to Section 302

<u>No.</u>	<u>Exhibit Description</u>
32.1*	Certification Pursuant to Section 906
32.2*	Certification Pursuant to Section 906

* Filed herewith

- (1) Previously filed with the Company's Registration Statement filed June 13, 1997.
- (2) Previously filed with the Company's Amendment No. 2 to the Registration Statement filed August 15, 1997.
- (3) Previously filed with the Company's Amendment No. 1 to the Registration Statement filed August 1, 1997.
- (4) Previously filed with the Company's Annual Report on Form 10-K, as amended on Form 10-K/A, for the fiscal year ended June 30, 1998.
- (5) Previously filed with the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2000.
- (6) Previously filed with the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2002.
- (7) Previously filed with the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2003.
- (8) Previously filed with the Company's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2003.
- (9) Previously filed with the Company's Current Report on Form 8-K filed January 1, 2004.
- (10) Previously filed with the Company's Quarterly Report on Form 10Q for the quarterly period ended March 31, 2004.
- (11) Previously filed with the Company Current Report on Form 8-K filed March 26, 2004.
- (12) Previously filed with the Company Current Report on Form 8-K filed June 2, 2004.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of OSI Systems, Inc.:

We have audited the accompanying consolidated balance sheets of OSI Systems, Inc. and subsidiaries (the "Company") as of June 30, 2004 and 2003 and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended June 30, 2004. Our audits also included the financial statement schedule listed in the index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of June 30, 2004 and 2003 and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2004 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As described in Note 1 to the financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," effective July 1, 2002.

/s/ DELOITTE & TOUCHE LLP
Los Angeles, California
September 13, 2004

OSI SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2003 AND 2004
(Dollars in Thousands, Except Share Amounts)

	2003	2004
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 94,246	\$ 39,879
Marketable securities, available-for-sale	3,973	
Accounts receivable—net of allowance for doubtful accounts of \$1,098 and \$774 at June 30, 2003 and 2004, respectively	36,901	85,774
Other receivables	2,549	7,480
Inventory	42,415	97,174
Prepaid expenses	1,264	3,580
Prepaid income tax	191	391
Deferred income taxes	5,473	6,611
Total current assets	187,012	240,889
PROPERTY AND EQUIPMENT—Net	14,115	18,775
GOODWILL	11,436	23,925
INTANGIBLE ASSETS—Net	14,055	44,914
INVESTMENTS	1,697	1,475
OTHER ASSETS	665	1,035
DEFERRED INCOME TAXES	558	788
TOTAL	\$ 229,538	\$ 331,801
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Bank lines of credit		\$ 723
Current portion of long-term debt	\$ 2,625	1,798
Accounts payable	14,524	33,171
Accrued payroll and related expenses	5,122	13,006
Income taxes payable	3,192	3,075
Advances from customers	6,648	14,331
Accrued warranties	2,782	9,190
Provision for losses on long-term contract	4,644	858
Other accrued expenses and current liabilities	5,559	21,339
Total current liabilities	45,096	97,491
LONG-TERM DEBT	1,838	32
ACCRUED PENSION	1,340	1,529
DEFERRED INCOME TAXES	630	5,198
MINORITY INTEREST	235	69
Total liabilities	49,139	104,319
COMMITMENTS AND CONTINGENCIES (Note 7)		
SHAREHOLDERS' EQUITY:		
Preferred stock, no par value—authorized, 10,000,000 shares; no shares issued or outstanding at June 30, 2003 and 2004		
Common stock, no par value—authorized, 40,000,000 shares; issued and outstanding, 14,519,903 and 16,213,428 shares at June 30, 2003 and 2004, respectively	135,884	170,129
Retained earnings	45,005	54,961
Accumulated other comprehensive (loss) income	(490)	2,392
Total shareholders' equity	180,399	227,482
TOTAL	\$ 229,538	\$ 331,801

See accompanying notes to consolidated financial statements.

OSI SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED JUNE 30, 2002, 2003 AND 2004
(Dollars in Thousands, Except Per Share Amounts)

	2002	2003	2004
REVENUES	\$ 124,230	\$ 182,644	\$ 247,069
COST OF GOODS SOLD	85,908	122,661	163,712
GROSS PROFIT	38,322	59,983	83,357
OPERATING EXPENSES:			
Selling, general and administrative expenses	21,647	29,160	54,161
Research and development	6,434	8,865	14,638
Goodwill amortization	402		
Management retention bonus			1,104
Restructuring charges			1,061
Total operating expenses	28,483	38,025	70,964
INCOME FROM OPERATIONS	9,839	21,958	12,393
GAIN ON SALE OF MARKETABLE SECURITIES		1,767	376
WRITE OFF OF DEFERRED ACQUISITION COSTS		(608)	
WRITE OFF OF EQUITY INVESTMENTS		(1,433)	(247)
INTEREST INCOME	814	1,166	863
INTEREST EXPENSE	(653)	(380)	(283)
INCOME BEFORE PROVISION FOR INCOME TAXES AND MINORITY INTEREST	10,000	22,470	13,102
PROVISION FOR INCOME TAXES	3,000	6,521	3,316
MINORITY INTEREST IN NET (INCOME) LOSS OF SUBSIDIARY	(79)	(156)	170
NET INCOME	\$ 6,921	\$ 15,793	\$ 9,956
EARNINGS PER COMMON SHARE—Basic	\$ 0.63	\$ 1.13	\$ 0.68
EARNINGS PER COMMON SHARE—Diluted	\$ 0.60	\$ 1.09	\$ 0.65

See accompanying notes to consolidated financial statements.

OSI SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
YEARS ENDED JUNE 30, 2002, 2003 AND 2004 (Dollars in Thousands, Except Share Amounts)

	Preferred		Common		Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Comprehensive Income	Total
	Number of Shares	Amount	Number of Shares	Amount				
BALANCE, JULY 1, 2001			8,462,968	\$ 43,567	\$ 22,291	\$ (3,377)		\$ 62,481
Exercise of stock options			554,514	5,493				5,493
Stock option compensation				47				47
Tax benefit of stock options exercised				2,160				2,160
Shares purchased under the employee stock purchase program			22,468	71				71
Issuance of common stock and warrants under private placement			3,766,946	56,803				56,803
Comprehensive income (loss):								
Net income					6,921		\$ 6,921	6,921
Other comprehensive loss—translation adjustment						2,235	2,235	2,235
Unrealized gain on available for sale securities—net of tax						(194)	(194)	(194)
Change in fair value of derivative instruments—net of tax						(14)	(14)	(14)
Minimum pension liability adjustment—net of tax						(269)	(269)	(269)
Comprehensive income							\$ 8,679	
BALANCE, JUNE 30, 2002			12,806,896	108,141	29,212	(1,619)		135,734
Exercise of stock options			101,769	858				858
Stock option compensation				56				56
Tax benefit of stock options exercised				357				357
Shares purchased under employee stock purchase program			13,348	195				195
Issuance of common stock and warrants under private placement			1,250,000	20,528				20,528
Issuance of common stock as purchase consideration			347,890	5,749				5,749
Comprehensive income (loss):								
Net income					15,793		\$ 15,793	15,793
Other comprehensive income—translation adjustment						1,995	1,995	1,995
Unrealized loss on available for sale securities—net of tax						(468)	(468)	(468)
Change in fair value of derivative instruments—net of tax						50	50	50
Minimum pension liability adjustment—net of tax						(448)	(448)	(448)
Comprehensive income							\$ 16,922	
BALANCE, JUNE 30, 2003			14,519,903	135,884	45,005	(490)		180,399
Exercise of stock options			177,244	1,233				1,233
Tax benefit of stock options exercised				907				907
Shares purchased under employee stock purchase program			16,281	217				217
Issuance of common stock and warrants under private placement			1,500,000	30,975				30,975
Adjustment for minority interest				913				913
Comprehensive income (loss):								
Net income					9,956		\$ 9,956	9,956
Other comprehensive income—translation adjustment						2,418	2,418	2,418
Unrealized loss on available for sale securities—net of tax						564	564	564
Change in fair value of derivative instruments—net of tax						64	64	64
Minimum pension liability adjustment—net of tax						(164)	(164)	(164)
Comprehensive income							\$ 12,838	
BALANCE, JUNE 30, 2004		\$	16,213,428	\$ 170,129	\$ 54,961	\$ 2,392		\$ 227,482

See accompanying notes to consolidated financial statements.

OSI SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2002, 2003 AND 2004 (Dollars in Thousands)

	2002	2003	2004
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 6,921	\$ 15,793	\$ 9,956
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Provision for losses on accounts receivable	747	(13)	287
Depreciation and amortization	3,930	4,289	5,708
Write-off of deferred acquisition costs		608	
Write-off of equity investment		1,433	247
Gain on sale of marketable securities		(1,767)	(376)
Minority interest in net income (loss) of subsidiary	79	156	(170)
Equity earnings of unconsolidated affiliates	(154)	(76)	102
Tax effect of stock option benefit	2,160	357	907
Stock option compensation	47	56	
Deferred income taxes	(2,693)	607	(1,450)
Restructuring charges			1,061
Loss on sale of property and equipment	78	52	40
Changes in operating assets and liabilities—net of business acquisitions			
Accounts receivable	(9,942)	3,521	(16,623)
Other receivables	(1,305)	606	(4,551)
Inventory	(5,060)	(4,320)	(15,112)
Prepaid expenses	28	(136)	(1,035)
Accounts payable	2,335	(206)	11,111
Accrued payroll and related expenses	1,035	636	2,430
Income taxes payable	1,524	171	(206)
Advances from customers	3,523	1,482	(1,874)
Accrued warranties	440	516	(1,339)
Other accrued expenses and current liabilities	2,396	(2,209)	472
Net cash provided by (used in) operating activities	6,089	21,556	(10,415)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds on the sale of investments and marketable securities		18,271	5,256
Purchases of investments and marketable securities		(22,990)	
Proceeds from sale of property and equipment	99	53	8
Additions to property and equipment	(2,101)	(3,569)	(5,404)
Cash paid for business acquisition—net of cash acquired		(5,373)	(77,511)
Cash received on note receivable	450	800	
Cash proceeds from sale of minority interest and distribution rights for Dolphin Medical			2,000
Intangible and other assets	(816)	(2,081)	27
Net cash used in investing activities	(2,368)	(14,889)	(75,624)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net (repayment of) proceeds from bank lines of credit	(100)		715
Payments on long-term debt	(2,580)	(2,627)	(2,633)
Proceeds from exercise of stock options and employee stock purchase plan	5,564	1,053	1,450
Proceeds from private placement	56,803	20,528	30,975
Net cash provided by financing activities	59,687	18,954	30,507
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(271)	1,021	1,165
NET INCREASE (DECREASE) IN CASH EQUIVALENTS	63,137	26,642	(54,367)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	4,467	67,604	94,246
CASH AND CASH EQUIVALENTS, END OF YEAR	\$ 67,604	\$ 94,246	\$ 39,879
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION—Cash paid (received) during the year for:			
Interest	\$ (200)	\$ (813)	\$ (587)
Income taxes	\$ 2,017	\$ 6,731	\$ 3,775

OSI SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004
(Dollars in Thousands)

Acquisition of Centro Vision, Inc.

In July 2002, the Company acquired substantially all the assets and business of Centro Vision, Inc., (“Centro Vision”), formerly Thermo Centro Vision, Inc., for \$1,450. The assets acquired and liabilities assumed were as follows:

Fair value of assets acquired	\$1,461
Goodwill	399
Liabilities assumed	(410)
	<hr/>
Cash paid	\$1,450
	<hr/>

Acquisition of Ancore Corporation

In November 2002, the Company acquired all the outstanding capital stock of Ancore Corporation (“Ancore”) for an initial purchase payment of \$2,120, including legal and professional fees of \$120, the issuance of 347,890 shares of OSI Common Stock valued at \$5,749, and subsequent contingent payments of \$2,574. The assets acquired and liabilities assumed were as follows:

Fair value of assets (net of cash) acquired	\$ 3,150
Core technology	6,800
Developed technology	5,700
Goodwill	4,129
Liabilities assumed	(2,812)
Provision for losses on long-term contract	(6,524)
	<hr/>
Shares Issued and Cash paid	\$10,443
	<hr/>

Intangible assets acquired have the following useful lives: Developed Technology—20 years; Core Technology—30 years.

Acquisition of OSI Defense Systems, LLC

In August 2003, the Company acquired certain assets representing the military laser-based training business of Schwartz Electro-Optics. The acquisition was made through a newly formed, wholly-owned subsidiary, OSI Defense Systems, LLC (“OSI Defense”). Of the purchase price of \$3,661 including acquisition costs, the Company had paid a deposit of \$250 in fiscal 2003. The following table shows the purchase price allocation:

Fair value of assets (net of cash) acquired	\$ 102
Goodwill	3,157
Customer relationships	445
Liabilities assumed	(43)
	<hr/>
Cash paid	\$3,661
	<hr/>

OSI SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004
(Dollars in Thousands)

Acquisition of OSI Electronics, Inc.

In October 2003, the Company acquired the assets of a manufacturing services company specializing in surface mount technology lines and PC board assembly operations for approximately \$4,473 including acquisition costs. The acquisition was made through a wholly-owned subsidiary, OSI Electronics, Inc. (“OSI Electronics”). The following table shows the allocation of purchase price:

Fair value of assets (net of cash) acquired	\$ 5,483
Customer relationships	40
Liabilities assumed	(1,050)
	<hr/>
Cash paid	\$ 4,473
	<hr/>

Acquisition of OSI Laserscan

In November 2003, the Company acquired substantially all of the assets of Schwartz Electro-Optics in a bankruptcy court supervised auction. The Company paid approximately \$1,600, including acquisition costs. The business operates under the name OSI Laserscan. The following table shows the allocation of the purchase price:

Fair value of assets (net of cash) acquired	\$ 676
Goodwill	411
Developed technology	300
Customer relationships	250
Liabilities assumed	(37)
	<hr/>
Cash paid	\$1,600
	<hr/>

Acquisition of J&D Engineering (UK) through Rapiscan Security Products Limited

In December 2003, the Company acquired substantially all of the assets of J&D Engineering (UK) Limited (“J&D Engineering”), a company registered in England and Wales. The Company paid approximately 460,000 pounds sterling (or approximately \$820) including acquisition costs.

The acquisition was made through a wholly owned subsidiary, Rapiscan Security Products Ltd. (“Rapiscan UK”) The following table shows the allocation of the purchase price:

Fair value of assets (net of cash) acquired	\$435
Goodwill	385
	<hr/>
Cash paid	\$820
	<hr/>

Acquisition of the remainder of RapiTec, Inc.

In January 2004, minority shareholders of RapiTec, Inc. (“RapiTec”) subsidiary accepted an offer by the Company to purchase all shares of RapiTec common stock held by them. As a result of the transaction, the Company now wholly owns RapiTec. Consideration paid for the share purchase transaction consisted of an initial cash payment of approximately \$820, of which \$536 was allocated to goodwill. Subsequent to the year ended June 30, 2004, a second cash payment of approximately \$150 is due to the former minority shareholders of RapiTec, due to RapiTec meeting certain performance requirements. This amount will be recorded as goodwill.

OSI SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004
(Dollars in Thousands)

Acquisition of Advanced Research & Applications Corp.

In January 2004, the Company completed the acquisition of Advanced Research & Applications Corp. (“ARACOR”), a privately held company located in Sunnyvale, California. Consideration for the acquisition consisted of an initial cash payment of approximately \$17,602 (net of cash acquired), including acquisition costs. Furthermore, during the seven years following the close, contingent consideration is payable based on ARACOR’s net revenues, provided certain requirements are met. The contingent consideration is capped at \$30,000. The following table shows the allocation of the purchase price:

Fair value of assets (net of cash) acquired	\$ 2,509
Goodwill	8,302
Developed technology	14,300
Customer relationships	700
Liabilities assumed	(2,176)
Deferred taxes	(6,033)
	<hr/>
Cash paid	<u>\$17,602</u>

Intangible assets acquired have the following useful lives: Developed Technology—20 years; Customer Relationships—5 years.

Acquisition of Spacelabs Medical, Inc.

In March 2004, the Company completed the acquisition of Spacelabs Medical, Inc. (“Spacelabs Medical”), based in Issaquah, Washington, from Instrumentarium Corporation for approximately \$47,929 in cash (net of cash acquired), including acquisition costs. Spacelabs is a manufacturer and distributor of patient monitoring systems for critical care and anesthesia, wired and wireless networks, clinical information connectivity solutions, ambulatory blood pressure monitors, and medical data services. The final purchase price is subject to certain working capital adjustments. In June 2004, the Company notified Instrumentarium Corporation’s parent, GE Medical Systems, of a working capital and retention bonus adjustment resulting in what we believe to be a downward adjustment of the purchase price in the amount of \$25,900. In September 2004, GE Medical Systems responded that it believes the amount of the downward adjustment to be \$7,800. No amounts have been recorded in the financial statements in relation to the expected reduction in the purchase price. The amount of the final adjustment will be resolved by way of a process established in the purchase agreement. Therefore, the final purchase price and the purchase price allocation may differ significantly from the preliminary estimates of these amounts. The following table shows the preliminary allocation of the purchase price:

Current Assets (net of cash)	\$ 65,474
Fixed Assets	2,023
Developed Technology	5,771
Tradenames	6,041
Customer Relationships/Backlog	3,344
Other Long-term Assets	1,610
	<hr/>
Total Assets	84,263
Current Liabilities	(36,334)
	<hr/>
Total consideration paid in cash	<u>\$ 47,929</u>

OSI SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004
(Dollars in Thousands)

Intangible assets acquired have the following useful lives: Developed Technology—10 years; Customer Relationships/Backlog—10 years. Acquired intangible assets include amounts assigned to tradenames that are not subject to amortization.

Acquisition of CXR Limited

In August 2002, the Company purchased a minority interest in CXR Limited (“CXR”), a United Kingdom based research and development company that develops products able to generate x-ray images of fast moving objects. In June 2004, the Company subscribed to \$810 of additional shares issued by CXR. The Company further purchased shares held by third parties for a total of \$550, of which \$75 was allocated to goodwill and \$475 was allocated to amortizable intangible assets. With these additional investments, the Company increased its equity investment in CXR to approximately 75%.

See accompanying notes to consolidated financial statements.

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General—OSI Systems, Inc. and its subsidiaries is a vertically integrated, worldwide provider of security and inspection systems, medical monitoring and imaging systems, and optoelectronic devices and value-added subsystems.

The Company designs, manufactures and markets security and inspection systems worldwide to end users under trade names including “Rapiscan,” “Ancore,” “PFNA,” “Eagle,” “Metor,” and “Secure.” These products are used to inspect people, baggage, cargo, vehicles and other objects for weapons, explosives, drugs and other contraband. These systems are also used for the safe, accurate and efficient verification of cargo manifests for the purpose of assessing duties and monitoring the export and import of controlled materials.

In the medical field, the Company designs, develops, manufactures, and markets patient monitoring and imaging systems, network connectivity solutions, ambulatory blood pressure monitors, and related services under trade names including “Spacelabs,” “Ultracare,” and “Ultraview.” The Company also designs, develops, manufactures and markets arterial hemoglobin saturation monitors and sensors, including hand-held and wireless monitoring tools under trade names including “Dolphin” and “NuCat,” and peripheral bone densitometers under trade names including “DTX-200” and “DTU-One,” which are used in the early stage detection or diagnosis of osteoporosis.

The Company’s optoelectronic devices and value-added subsystems are used in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical diagnostics, fiber optics, telecommunications, gaming, office automation, computer peripherals and industrial automation. The Company designs and manufactures optoelectronic devices and value-added subsystems for others through original equipment manufacturer arrangements, as well as for its security and medical equipment businesses.

Consolidation—The consolidated financial statements include the accounts of OSI Systems, Inc. and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Cash Equivalents—The Company considers all highly liquid investments purchased with maturity of three months or less as of the acquisition date, to be cash equivalents.

Marketable Securities—Marketable securities consist of equity securities categorized as available-for-sale and carried at fair value. Unrealized holding gains and losses on marketable securities are included in accumulated other comprehensive loss until realized. Fair value of marketable securities is determined by the quoted market prices of each marketable security. For purposes of determining gross realized gains and losses, the cost of the securities sold is based upon specific identification. The following is a summary of marketable securities available-for-sale as of June 30, 2003 (in thousands):

	2003
Cost	\$4,740
Unrealized loss	(767)
	\$3,973

There were no marketable securities available for sale as of June 30, 2004. There were no realized gains or losses from sales of available-for-sale securities for the year ended June 30, 2002. Net realized gains on sales of available-for-sale securities amounted to \$1,767,000 and \$ 376,000 for the years ended June 30, 2003 and June 30, 2004 respectively.

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

Concentrations of Credit Risk—The Company’s financial instruments that are exposed to concentrations of credit risk consist primarily of its cash, cash equivalents, available-for-sale investments and accounts receivable. The Company restricts investments in cash equivalents to financial institutions with high credit standing. At June 30, 2003 and 2004, approximately 89% and 86% of the Company’s cash equivalents were held at two and three financial institutions, respectively. Credit risk on accounts receivable is minimized as a result of the large and diverse nature of the Company’s worldwide customer base. No one customer accounted for more than 10% of accounts receivable as of June 30, 2004. One customer accounted for approximately 10% of the Company’s accounts receivable balance as of June 30, 2003. The Company performs ongoing credit evaluations of its customers’ financial condition and maintains allowances for potential credit losses.

Accounts Receivable—Accounts receivable consisted of the following at June 30 (in thousands):

	<u>2003</u>	<u>2004</u>
Trade receivables—net	\$36,855	\$81,601
Receivables related to long term contracts—unbilled costs and accrued profit on progress completed	46	4,173
Total	<u>\$36,901</u>	<u>\$85,774</u>

The unbilled costs and accrued profit at June 30, 2004 are expected to be entirely billed and collected during fiscal 2005.

Inventory— Inventory is stated at the lower of cost or market; cost is determined on the first-in, first-out method. The Company writes down inventory for slow-moving and obsolete inventory based on assessments of future demands for the next 12 to 36 months, market conditions and customers who may be experiencing financial difficulties. If these factors are less favorable than those projected, additional inventory write-downs may be required.

Inventory consisted of the following at June 30 (in thousands):

	<u>2003</u>	<u>2004</u>
Raw materials	\$19,327	\$41,064
Work-in-process	13,097	25,283
Finished goods	9,991	30,827
Total	<u>\$42,415</u>	<u>\$97,174</u>

Property and Equipment—Property and equipment are stated at cost. Depreciation and amortization are computed using the straight-line and accelerated methods over the estimated useful lives of the assets. Amortization of leasehold improvements is calculated on the straight-line basis over the shorter of the useful life of the asset or the lease term.

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

Property and equipment consisted of the following at June 30 (in thousands):

	Estimated Useful Lives	2003	2004
Land		\$ 1,263	\$ 1,263
Buildings	20 years	2,948	2,948
Equipment	5-8 years	16,124	17,786
Leasehold improvements	3-8 years	5,458	6,830
Tooling	3 years	2,364	2,661
Furniture and fixtures	8 years	1,580	2,325
Computer	4 years	6,602	11,351
Vehicles	3 years	278	277
Total		36,617	45,441
Less accumulated depreciation and amortization		(22,502)	(26,666)
Property and equipment—net		\$ 14,115	\$ 18,775

Impairment of Long-Lived Assets—The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. If the sum of the expected future cash flows, undiscounted and without interest charges, is less than the carrying amount of the asset, the Company recognizes an impairment loss based on the estimated fair value of the asset.

Income Taxes—Deferred income taxes are provided for temporary differences between the financial statement and income tax basis of the Company's assets and liabilities, based on enacted tax rates. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred income tax assets will not be realized.

Fair Value of Financial Instruments—The Company's financial instruments consist primarily of cash, marketable securities, accounts receivable, accounts payable and debt instruments. The carrying values of financial instruments, other than debt instruments, are representative of their fair values due to their short-term maturities. The carrying values of the Company's long-term debt instruments are considered to approximate their fair values because the interest rates of these instruments are variable or comparable to current rates offered to the Company.

Derivative Instruments—Effective July 1, 2000, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. SFAS No. 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. Under SFAS No. 133, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. SFAS No. 133 requires that all derivatives be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction.

The Company's use of derivatives consists of the purchase of foreign exchange contracts, in order to attempt to reduce foreign exchange transaction gains and losses, along with an interest rate swap on a variable interest rate term loan. The Company purchases forward contracts to hedge foreign exchange exposure related to commitments to acquire inventory for sale and does not use the contracts for trading purposes. As of June 30, 2004 there were no foreign exchange contracts outstanding. As of June 30, 2003, the Company had a foreign

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exchange contract with a notional amount outstanding of 4,464,000 Malaysian ringgits (approximately \$1,161,000), which had no fair value. The foreign exchange contracts are effective foreign exchange hedges, and the changes in fair value are recorded as other comprehensive income.

In February 2001 and August 2001, the Company entered into interest rate swaps. The purpose for the swaps was to convert a portion of the variable interest debt into a fixed rate liability. As of June 30, 2004 all interest rate swaps had expired. As of June 30, 2003 interest rate swaps outstanding had a notional amount of \$4,196,000 and a fair value of (\$90,000). Any changes in the fair value of swaps are recorded in other comprehensive income—net of tax, due to swaps meeting the criteria of an effective cash flow hedge. All forward contracts, swaps and underlying transaction exposures are carried at fair value in other accrued expenses and liabilities in the accompanying consolidated balance sheets.

Revenue Recognition. The Company recognizes revenue upon shipment of products when title and risk of loss passes, and when terms are fixed and collection is probable. In accordance with the terms of Staff Accounting Bulletin No. 104 “Revenue Recognition” and Emerging Issues Task Force Issue No. 00-21, “Revenue Arrangements with Multiple Deliverables” where installation services, if provided, are essential to the functionality of the equipment, the portion of revenue for the sale attributable to installation is deferred and recognized when the installation services is provided. In an instance where terms of sale include subjective customer acceptance criteria, revenue is deferred until the acceptance criteria are met. Concurrent with the shipment of the product, the Company accrues estimated product return reserves and warranty expenses.

The Company undertakes projects that include the development and construction of large complex cargo inspection systems requiring installation and customization at the customer’s site. Sales under such long-term contracts are recorded under the percentage-of-completion method. Costs and estimated revenues are recorded as work is performed based on the percentage that incurred costs bear to estimated total costs utilizing the most recent estimates of costs. If the current contract estimate indicates a loss, provision is made for the total anticipated loss in the current period.

Revenues from separate service maintenance contracts are recognized ratably over the term of the agreements. For other services, service revenues are recognized as the services are performed. Deferred revenue for services arises from advance payments received from customers for services not yet performed.

Research and Development Costs. Research and development costs are charged to operations as incurred. Reimbursable costs for certain research and development activities are reflected as a reduction to research and development expense in the period the related costs are incurred.

Foreign Currency Translation—The accounts of the Company’s operations in Singapore, Malaysia, Norway, Finland, Germany, France, Austria, Greece, Canada, India and the United Kingdom are maintained in Singapore dollars, Malaysian ringgits, Norwegian kroners, euros, Canadian dollars, Indian rupees and U.K. pounds, respectively. Foreign currency financial statements are translated into U.S. dollars at current rates, with the exception of revenues, costs and expenses, which are translated at average rates during the reporting period. Gains and losses resulting from foreign currency transactions are included in income, while those resulting from translation of financial statements are excluded from income and accumulated as a component of accumulated other comprehensive loss. Transaction losses of approximately \$13,000, \$475,000 and \$377,000, were included in income for the years ended June 30, 2002, 2003 and 2004, respectively.

Earnings per Share—The Company has reflected the provisions of SFAS No. 128, “Earnings per Share,” in the accompanying consolidated financial statements for all periods presented. Earnings per common share are computed using the weighted-average number of shares outstanding during the period. Diluted earnings per

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common share are computed using the weighted-average number of shares outstanding during the period plus the dilutive effect of potential common stock. Potential common stock types are stock options, stock warrants and purchase rights.

As of June 30, 2002, 2003 and 2004, 891,000, 1,170,200 and 1,314,863, stock options, stock warrants and stock purchase rights, respectively, were not included in diluted earnings per common share calculation because to do so would have been antidilutive.

The following table reconciles the numerator and denominator used in calculating earnings per share and diluted earnings per common share for the years ended June 30:

	2002		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Earnings per common share			
Income available to common shareholders	\$ 6,921,000	10,938,921	\$ 0.63
Effect of dilutive securities			
(Treasury stock method)		539,450	
Total	\$ 6,921,000	11,478,371	\$ 0.60
	2003		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Earnings per common share			
Income available to common shareholders	\$ 15,793,000	14,013,584	\$ 1.13
Effect of dilutive securities			
(Treasury stock method)		499,790	
Total	\$ 15,793,000	14,513,374	\$ 1.09
	2004		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Earnings per common share			
Income available to common shareholders	\$ 9,956,000	14,733,700	\$ 0.68
Effect of dilutive securities			
(Treasury stock method)		502,699	
Total	\$ 9,956,000	15,236,399	\$ 0.65

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Goodwill—On July 1, 2002, the Company adopted SFAS No. 142, *Goodwill and Other Intangible Assets*, and discontinued the amortization of goodwill. SFAS No. 142 also established a new method of testing goodwill for impairment on an annual basis or on an interim basis if an event occurs or circumstances change that would reduce the fair value of a reporting unit below its carrying value. The Company performed its annual impairment test during the second quarter of fiscal 2003 and 2004 and concluded that there is no impairment of goodwill for the years ended June 30, 2003 and 2004. The changes in the carrying amount of goodwill for the year ended June 30, 2004, are as follows (in thousands):

	North America	Europe	Asia	Consolidated
Balance as of June 30, 2003	\$ 8,086	\$3,350	\$ —	\$ 11,436
Reduction related to net operating losses acquired on purchase of Ancore	(631)			(631)
Goodwill acquired during the period	12,406	460	—	12,866
Foreign currency translation adjustment	1	253	—	254
Balance as of June 30, 2004	\$19,862	\$4,063	\$ —	\$ 23,925

SFAS No. 142 requires that intangible assets that meet the criteria for recognition apart from goodwill be reclassified and that intangibles with indefinite lives cease to be amortized in favor of periodic impairment testing.

Intangible assets which have indefinite lives and are therefore not subject to amortization, consisted of the following (in thousands):

	June 30, 2003 Gross Carrying Value	June 30, 2004 Gross Carrying Value
Tradename	\$ —	\$ 6,041

Intangible assets subject to amortization consisted of the following (in thousands):

	June 30, 2003				June 30, 2004		
	Weighted Average Lives	Gross Carrying Value	Accumulated Amortization	Intangibles Net	Gross Carrying Value	Accumulated Amortization	Intangibles Net
Purchased Software	5 years	\$ 327	\$ 243	\$ 84	\$ 327	\$ 310	\$ 17
Software development costs	5 years	2,144	752	1,392	3,558	1,063	2,495
Patents	20 years	408	96	312	438	139	299
Core technology	30 years	6,800	132	6,668	6,800	359	6,441
Developed technology	18 years	5,850	251	5,599	26,221	1,116	25,105
Customer relationships/Backlog	5 years	—	—	—	4,779	263	4,516
		\$15,529	\$ 1,474	\$ 14,055	\$42,123	\$ 3,250	\$ 38,873

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Amortization expense for the years ended June 30, 2002, 2003 and 2004 was \$126,000, \$604,000 and \$1,739,000, respectively. At June 30, 2004, estimated future amortization expense is as follows (in thousands):

2005	\$ 2,919
2006	2,887
2007	2,872
2008	2,726
2009	2,394
2010 and thereafter	25,075
Total	\$38,873

Software development costs incurred in the research and development of software products are expensed as incurred until the technological feasibility of the product has been established. After technological feasibility is established, certain software development costs are capitalized. The Company amortizes these costs on a straight-line basis over a two- to five-year period, once it is put into use. During the years ended June 30, 2002, 2003 and 2004, the Company capitalized \$194,000, \$443,000 and \$90,000 respectively, of software development costs.

As required by SFAS No. 142, the results for the prior year have not been restated. A reconciliation of net income as if SFAS No. 142 had been adopted for the year ended June 30, 2002, along with reported results for the years ended June 30, 2003 and 2004 is as follows (in thousands except for per share amounts):

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Net income:			
As reported	\$ 6,921	\$ 15,793	\$ 9,956
Add back amortization of goodwill	323		
Adjusted net income	\$ 7,244	\$ 15,793	\$ 9,956
Basic earnings per share:			
As reported	\$ 0.63	\$ 1.13	\$ 0.68
Add back amortization of goodwill—net of tax	0.03		
Adjusted basic earnings per share	\$ 0.66	\$ 1.13	\$ 0.68
Diluted earnings per share:			
As reported	\$ 0.60	\$ 1.09	\$ 0.65
Add back amortization of goodwill—net of tax	0.03		
Adjusted diluted earnings per share	\$ 0.63	\$ 1.09	\$ 0.65

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Provision for Warranties—The Company offers its customers warranties on products sold to them. These warranties typically provide for repairs and maintenance of its products for a specified time period. Concurrent with the sale of products, a provision for estimated warranty expenses is recorded with a corresponding increase in cost of goods sold. This provision is adjusted periodically based on historical and anticipated experience. Actual expenses of repairs under warranty, including parts and labor are charged to this provision when incurred.

	Provision for Warranties (in thousands)
Balance on July 1, 2001	\$ 1,687
Additions	1,668
Reductions for warranty repair costs	(1,191)
<hr/>	
Balance on June 30, 2002	2,164
Additions	2,516
Reductions for warranty repair costs	(1,898)
<hr/>	
Balance on June 30, 2003	2,782
Additions	2,718
Increase as a result of acquisitions	7,719
Reductions for warranty repair costs	(4,029)
<hr/>	
Balance on June 30, 2004	\$ 9,190

New Accounting Pronouncements—In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation Number 46, Consolidation of Variable Interest Entities (“FIN 46”), an interpretation of Accounting Research Bulletin No. 51. FIN 46 requires that variable interest entities be consolidated by a company if that company absorbs a majority of the entity’s expected losses, receives a majority of its expected residual returns, or both, as a result of holding a variable interest. In December 2003, the FASB issued FIN 46R, which made certain amendments to FIN 46. The provisions of FIN 46R were effective for the first interim or annual period ending after March 15, 2004 when certain conditions are met by a variable interest entity. The Company adopted FIN 46R and consolidated its investment in CXR Limited (“CXR”), a U.K. based research and development venture that develops real time tomography systems, which was previously accounted for under the equity method. The results and operations of this venture are not material to the Company’s financial position or results of operations.

In November 2002, the EITF reached a consensus on Issue No. 00-21, “Revenue Arrangements with Multiple Deliverables.” EITF Issue No. 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities and how arrangement considerations should be measured and allocated to the separate units of accounting in the arrangement. The provisions of EITF Issue No. 00-21 apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of EITF Issue No. 00-21 did not have a material effect on the Company’s financial position or result of operations.

In March 2004, the EITF reached a consensus on Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” (“EITF 03-1”). EITF 03-1 provides guidance for determining when an investment is other-than-temporarily impaired to be applied in reporting periods beginning after June 15, 2004 and contains disclosure requirements effective in annual financial statements for fiscal years ending after December 15, 2003 for investments accounted for under SFAS Nos. 115 and 124. For all other investments within the scope of this Issue, the disclosures are effective for fiscal years ending after June 15, 2004. The adoption of EITF Issue No. 03-1 did not have a material effect on the Company’s financial position or result of operations.

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Stock Options—The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related interpretations to account for its fixed plan stock options. These interpretations include FASB Interpretation No. 44, “Accounting for Certain Transactions Involving Stock Compensation an interpretation of APB Opinion No. 25,” issued in March 2000. Under this method, compensation expense is generally recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. SFAS No. 123, “Accounting for Stock-Based Compensation,” established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic value-based method of accounting described above, and has adopted the disclosure requirements of SFAS No. 123.

The Company accounts for option grants to non-employees using the guidance of SFAS No. 123 and EITF No. 96-18, whereby the fair value of such options is determined using the Black-Scholes option pricing model at the earlier of the date at which the non-employee’s performance is complete or a performance commitment is reached.

The Company applies APB Opinion No. 25 in accounting for stock options and, accordingly, except for certain options issued to non-employees, as discussed above, no compensation cost using the intrinsic value method has been recognized for its stock option grants in the accompanying financial statements. If the fair value based method had been applied in measuring stock compensation expense under SFAS No. 123, the pro forma effect on net earnings and net earnings per share would have been as follows (in thousands except for per share amounts):

	Years Ended June 30,		
	2002	2003	2004
Net income—as reported	\$ 6,921	\$ 15,793	\$ 9,956
Add: Stock-based employee compensation expense included in reported net income—net of related tax effects	—	—	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards—net	1,652	2,540	4,936
Pro forma net income	\$ 5,269	\$ 13,253	\$ 5,020
Earnings per share:			
Basic—as reported	\$ 0.63	\$ 1.13	\$ 0.68
Basic—pro forma	\$ 0.48	\$ 0.95	\$ 0.34
Diluted—as reported	\$ 0.60	\$ 1.09	\$ 0.65
Diluted—pro forma	\$ 0.46	\$ 0.91	\$ 0.33

The per share weighted-average fair value of stock options granted during 2002, 2003 and 2004 were \$2,360,000, \$4,827,000 and \$6,608,000, respectively, on the date of grant. The fair value of option grants is determined using the Black-Scholes option pricing model with the following weighted average assumptions:

	Year Ended June 30,		
	2002	2003	2004
Expected dividend	0.0%	0.0%	0.0%
Risk free interest rate	4.2%	3.2%	3.3%
Expected volatility	92.0%	89.0%	98.0%
Expected life (in years)	5	5	5

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Use of Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications—Certain reclassifications have been made to prior year amounts to conform to the current year's presentation.

2. JOINT VENTURES AND EQUITY INVESTMENTS

In January 1994, the Company, together with an unrelated company, formed ECIL-Rapiscan Security Products Limited, a joint venture organized under the laws of India. The Company, the Company's chairman and chief executive officer, along with another director and officer of the Company have a 36%, 10.5% and 4.5% ownership interest, respectively, in the joint venture. The Company's initial investment was \$108,000. The Company and its directors and officers, collectively control less than 50% of the Board of Directors' voting power in the joint venture. As a result, the Company accounts for the investment under the equity method of accounting.

The joint venture was formed for the purpose of the manufacture, assembly, service and testing of x-ray security and other products. Some of the Company's subsidiaries are suppliers to the joint venture partner, which in turn manufactures and sells the resulting products to the joint venture utilizing technology received from the subsidiary. The joint venture agreement provides for technology transfer between the Company and the joint venture, subject to certain restrictions.

The Company did not earn a technical fee during the years ended June 30, 2003 or 2004, and during the year ended June 30, 2002, the Company earned a technical fee of \$35,000. At June 30, 2003, \$0 and at June 30, 2004 \$43,000, related to dividends declared was unpaid and thus was included in other receivables in the accompanying consolidated financial statements.

In August 2002, the Company invested \$775,000 to purchase a minority equity interest in CXR, a UK-based research and development company that develops real time tomography systems. The investment was accounted for under the equity method of accounting. The equity share in the losses of this investment was not material for the year ended June 30, 2003 and 2004. As a result of adopting FIN 46, the Company began consolidating this investment during fiscal year 2004. In June 2004, the Company subscribed to \$810,000 of additional shares issued by CXR. The Company further purchased shares held by third parties for a total of \$550,000 and increased its interest to 75%.

For the years ended June 30, 2002, 2003 and 2004, the Company's equity in the earnings (losses) of the above-mentioned joint ventures amounted to \$154,000, \$76,000 and (\$102,000) respectively, and is included in selling, general and administrative expenses.

In July 2002, the Company purchased from Imagis Technologies, Inc. ("Imagis") 1,166,667 shares of its common stock (approximately 6% of its then-outstanding stock), and 2-year warrants to purchase 291,667 additional shares of Imagis common stock (approximately 1.5% of its then-outstanding stock) at a price of \$1.50 per share, and certain ancillary rights, for an aggregate purchase price of \$1.75 million. Imagis develops facial recognition software for security applications. The investment is classified as available-for-sale and as a result of the long term nature of this investment, is included under other assets in the accompanying consolidated financial

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statements. For the years ended June 30, 2003 and 2004, based on the continued trading of Imagis common stock below the original purchase price for a prolonged period of time, an other than temporary impairment in the market value of this investment totaling \$1,433,000 and \$247,000, respectively (pre-tax) was recognized.

As a result of the acquisition of Spacelabs Medical, the Company acquired a 19.95% investment in a privately held company called Tempus Software. In June 2004, Quadramed Inc., a public company, traded over-the-counter, purchased Tempus Software from its shareholders for cash and unregistered shares. The Company received \$902,000 in cash plus unregistered shares in Quadramed Inc. In addition, \$115,000 in cash and additional unregistered shares in Quadramed Inc. were placed in escrow pending the resolution of final purchase adjustments.

As of June 30, 2004, the Company's investment in Quadramed Inc. unregistered shares is valued at \$322,000, which considers the restricted nature of the shares and the volatility of the stock price and is included under investments in the accompanying financial statements. In addition, the Company has not yet assigned a value to the cash and shares held in escrow as there are significant uncertainties as to the ultimate amount to which the Company will be entitled.

3. ACQUISITIONS AND DISPOSITIONS

During the year ended June 30, 1999, the Company invested \$1,002,000, including professional fees associated with the investment, in a company that was ultimately named OSI Medical, Inc. ("OSI Medical") for an initial equity share of 40.3%. The Company's initial investment, including goodwill of \$740,000, was accounted for under the equity method for the year ended June 30, 1999. In October 1999, the Company acquired an additional 15.3% equity interest in OSI Medical for \$1,225,000, including professional fees associated with the acquisition. The additional equity investment increased the Company's equity share in OSI Medical to 55.6%. The Company changed the method of accounting for OSI Medical from the equity to the purchase method of accounting in October 1999. During April 2000, the Company also received five-year warrants (subject to earlier termination upon the occurrence of certain events) to acquire up to 1,110,000 additional OSI Medical shares at a purchase price of \$1.35 per share. The warrants were first exercisable commencing on April 12, 2001.

In October 2000 and May 2001, the Company invested an additional \$182,000 and \$100,000, respectively, to increase the Company's equity percentage to 74.8%. The Company merged OSI Medical into a newly formed subsidiary, Dolphin Medical, Inc. ("Dolphin Medical") in March 2002. Dolphin Medical was formed in September 2001 when the medical device business of the Company's UDT Sensors, Inc. subsidiary was contributed to Dolphin Medical in exchange for stock in Dolphin Medical. In December 2003, the Company entered into a Stock Purchase and Option Agreement with Conmed Corporation, whereby Conmed Corporation purchased a 10% interest in Dolphin Medical and an option to purchase all of the remaining shares of Dolphin Medical. In addition, Conmed Corporation and Dolphin Medical entered into a distribution agreement, which provides Conmed Corporation with distribution rights for certain Dolphin Medical products within certain defined territories. The Company currently owns approximately 90% of Dolphin Medical. The Company received \$2.0 million in connection with the above-mentioned agreements of which \$800,000 is deferred over the five year term of the distribution agreement.

On March 31, 2001, the Company sold all the outstanding common stock of its subsidiary, Silicon Microstructures, Inc. ("SMI"), to Elmos Semiconductor AG, in Germany, for \$6,000,000 in cash. The intercompany loan that SMI held with the Company at the date of the sale was converted into a note for a total of \$2,179,000. At June 30, 2003, no amounts were outstanding under the note. As part of the sale agreement, the

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Company entered into a three-year commitment to supply certain products and manufacturing facilities to SMI. In July 2002, SMI served a notice to the Company terminating the commitment. There are no further obligations owed by either party.

In July 2002, the Company acquired substantially all the assets and business of Thermo Centro Vision, Inc., an opto-electronic subsystems designer and manufacturer based in Ventura County, California, for a purchase price of \$1,450,000. The acquisition was made through a newly formed, wholly owned subsidiary, Centro Vision. The acquisition has been accounted for using the purchase method of accounting. The excess of the purchase price over the fair value of the net assets acquired was allocated to goodwill. Although the agreement to purchase the assets and business of Thermo Centro Vision, Inc. included a provision for a contingent additional payment based on the financial performance of the business measured as of March 31, 2003, the minimum threshold for the contingent additional payment was not met. The Company is therefore under no further obligation to make additional purchase price payments in connection with this transaction.

In November 2002, the Company acquired all the outstanding capital stock of Ancore, a Santa Clara, California based privately held high-technology developer and provider of advanced inspection systems for aviation security, port and border inspection and counter-terrorism to enhance the Company's large cargo inspection system offerings. Consideration paid for the acquisition consisted of a combination of the Company's common stock and cash. At the close of the acquisition, the Company paid \$2,000,000 in cash, and issued 347,890 shares of its Common Stock valued at \$5,749,000. Expenses associated with the acquisition were approximately \$120,000, and have been included in the total purchase price. The acquisition agreement contains certain provisions for additional contingent purchase price payments. On December 9, 2002, the Company filed a registration statement on Form S-3 with the Securities and Exchange Commission to register the shares issued as part of the Ancore purchase consideration, as well as shares potentially issuable in satisfaction of contingent payments.

In January 2003, an additional contingent cash payment of \$2,000,000 was made to former Ancore stockholders based on Ancore meeting certain performance criteria. The additional contingent consideration of \$2,000,000 has been included in the allocated purchase price. In May 2003, an additional contingent cash payment of approximately \$574,000 was made to former Ancore stockholders, based on Ancore meeting certain performance criteria. The additional \$574,000 has been included in the allocated purchase price. In addition, during the five years subsequent to the acquisition, upon each commercial sale of a Pulsed Fast Neutron Analysis ("PFNA") inspection system, the Company will pay former Ancore stockholders an earn-out of 6% of the price of the PFNA system, up to \$750,000 per system, in either cash or stock, at the Company's election. The PFNA earn-out payments are capped at an aggregate of \$34,000,000. Initial PFNA systems are currently undergoing installation, and there is no assurance that PFNA systems will be successfully commercialized.

In August 2003, the Company acquired certain assets representing the military laser-based training business of Schwartz Electro-Optics, Inc. for \$3.7 million. The acquisition was made through a newly formed, wholly-owned subsidiary, OSI Defense. The acquired business now develops and manufactures tactical engagement simulation systems, man-worn laser detectors, small arms transmitters, controller guns and a variety of targeting systems for the defense industry.

In October 2003, the Company acquired the assets of a manufacturing services company specializing in surface mount technology lines and PC board assembly operations for approximately \$4,473,000 including acquisition costs (net of cash acquired). The acquisition was made through a wholly-owned subsidiary, OSI Electronics.

In November 2003, the Company acquired substantially all of the assets of Schwartz Electro-Optics, Inc. in a bankruptcy court supervised auction. The Company paid approximately \$1,600,000, including acquisition

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costs. The acquired assets comprise a business for the design, manufacturing and sale of laser-based systems used in traffic and toll management, precision agricultural management, and precision mapping and surveying. The business, located in Orlando, Florida now operates under the name OSI Laserscan. The acquisition was made through a wholly-owned subsidiary, OSI Defense.

In December 2003, the Company acquired substantially all of the assets of J&D Engineering, a company registered in England and Wales. The Company paid approximately 367,000 pounds sterling (or approximately \$649,000) including acquisition costs. A further 93,000 pounds sterling (or approximately \$171,000) was paid during the quarter ended March 31, 2004. The acquired assets comprise a business for the design, sale and manufacturing of, among other products, metal frames for x-ray scanners. The acquisition was made through the Company's wholly owned subsidiary, Rapiscan Security Products Limited ("Rapiscan U.K.").

In December 2003, we entered into a Stock Purchase and Option Agreement with Conmed Corporation, whereby Conmed Corporation purchased a 10% interest in, Dolphin Medical and an option to purchase all of the remaining assets and the business of Dolphin Medical. In addition, Conmed Corporation and Dolphin Medical entered into a distribution agreement, which provides Conmed Corporation with distribution rights for certain Dolphin Medical products within certain defined territories.

In January 2004, minority shareholders of the Company's RapiTec subsidiary accepted an offer by the Company to purchase all shares of RapiTec common stock held by them. As a result of the transaction, the Company now wholly owns RapiTec. Consideration paid for the share purchase transaction consisted of an initial cash payment of approximately \$820,000, of which \$536,000 was allocated to goodwill. Subsequent to the year ended June 30, 2004, a second cash payment of approximately \$150,000 is due to the former shareholders of RapiTec, due to RapiTec meeting certain performance requirements. This amount will be recorded as goodwill.

In January 2004, the Company completed the acquisition of ARACOR, a privately held company located in Sunnyvale, California. Consideration for the acquisition consisted of an initial cash payment of approximately \$17,602,000 (net of cash acquired), including acquisition costs. Furthermore, during the seven years following the close, contingent consideration is payable based on ARACOR's net revenues, provided certain requirements are met. The contingent consideration is capped at \$30,000,000. The acquisition of ARACOR broadens the Company's security product portfolio through ARACOR's mobile x-ray inspection system—the Eagle—which is designed for container scanning at busy seaports. The results of operations of ARACOR have been included in the Company's consolidated statement of operations from the acquisition date, January 7, 2004.

In March 2004, the Company completed the acquisition of Spacelabs Medical from Instrumentarium Corporation for approximately \$47,929,000 in cash (net of cash acquired), including acquisition costs. Spacelabs Medical is a leading global manufacturer and distributor of patient monitoring systems for critical care and anesthesia, wired and wireless networks, clinical information connectivity solutions, ambulatory blood pressure monitors, and medical data services. The final purchase price is subject to certain working capital adjustments. In June 2004, the Company notified Instrumentarium Corporation's parent, GE Medical Systems, of a working capital and retention bonus adjustment resulting in what the Company believes to be a downward adjustment of the purchase price in the amount of \$25,900,000. In September 2004, GE Medical Systems responded that it believes the amount of the downward adjustment to be \$7,800,000. No amounts have been recorded in the financial statements in relation to the expected reduction in the purchase price. The amount of the final adjustment will be resolved by way of a process established in the purchase agreement. Therefore, the final purchase price and purchase price allocation may differ significantly from the preliminary estimates of these amounts. The results of operations of Spacelabs Medical have been included in the Company's consolidated statement of operations from the acquisition date, March 19, 2004.

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Pursuant to the terms of the purchase agreement, the Company assumed management retention bonus agreement for key personnel of Spacelabs Medical, which could amount to \$5,900,000. These retention bonuses vest over a two year period beginning October 2003. Included in other accrued expenses and current liabilities, the Company has accrued a total of \$3,100,000 of which \$2,000,000 relates to the period prior to the acquisition of Spacelabs Medical.

Supplemental pro-forma disclosures of the results of operations for the years ended June 30, 2003 and 2004 as though the business combinations had been completed as of July 1, 2002 are as follows (in thousands except per share amounts):

	Unaudited	
	2003	2004
Revenue	\$ 376,347	\$359,311
Net income (loss) before taxes	\$ 275	\$ (12,840)
Net income (loss)	\$ 271	\$ (7,892)
Diluted earnings (loss) per Share (1)	\$ 0.02	\$ (0.52)

(1) Earnings per share is calculated based on 14,642,386 and 15,236,399 diluted ordinary shares for the years ended June 30, 2003 and 2004, respectively.

In fiscal 2002, the Company entered into an agreement regarding a joint acquisition with L-3 Communications Corporation (“L-3”) of certain detection and security businesses then owned by PerkinElmer, Inc. (“PerkinElmer”). The transaction as contemplated would have resulted in the acquisition from L-3 of a certain portion of PerkinElmer’s detection and security businesses. L-3 completed the purchase of the entirety of the businesses from PerkinElmer in June 2002. In November 2002, L-3 terminated the L-3/OSI transaction prior to consummation. Due to L-3’s termination of the transaction, an expense of \$608,000 was recorded for the year ended June 30, 2003, consisting of previously deferred transaction-related expenses.

4. LINE-OF-CREDIT BORROWINGS

The Company maintains a credit agreement with a U.S. bank, which provides for a \$50,000,000, line of credit that includes a revolving line, letter-of-credit, acceptance and foreign exchange facility. The agreement provides that the aggregate principal balance of all advances under the various facilities shall not exceed the total balance available under the line of credit. In addition, the Company has a \$3,300,000 term loan facility. Borrowings under the line of credit bear interest at the bank’s variable reference rate (4.22% at June 30, 2003 and 4.0% at June 30, 2004) plus a margin, or at the Company’s option, at a fixed rate as quoted by the bank upon request for specific advances. Commitment fees are payable based on a rate of 0.125% of the unused borrowing facility.

The credit agreement expires in November 2005. Borrowings under the credit agreement are collateralized by substantially all of the assets of the Company’s U.S. subsidiaries. At June 30, 2004, there were no amounts outstanding under the line of credit. At June 30, 2004 approximately \$3,400,000 was issued and outstanding under letters of credit and \$1,798,000 was outstanding under the term loan (see Note 5). Covenants in connection with the agreement impose restrictions and requirements related to, among other things, maintenance of certain financial ratios. Included in these restrictions is a requirement that the aggregate amount of revolving loans outstanding during any one-year period be \$0 for at least 30 consecutive days. As of June 30, 2004, the Company was not in compliance with covenants related to the increase in its tangible net worth as a percentage of net income for fiscal year 2004 and a covenant related to the value of intangible assets that could be acquired during fiscal year 2004. The lender has waived the non-complying covenants.

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Opto Sensors (Singapore) Pte. Ltd. (“Opto Singapore”) has a revolving line of credit agreement with a Singapore bank that provides for an accounts receivable discounting facility of up to 2,600,000 Singapore dollars (approximately U.S. \$1,400,000 at June 30, 2004). Borrowings under the line of credit bear interest at the bank’s prime rate (5.0% at June 30, 2003 and 5.5% at June 30, 2004) plus 1.0%. Borrowings under the line of credit are collateralized by certain assets of Opto Singapore and are guaranteed by certain officers of the Company. Borrowings secured by intercompany receivables are guaranteed by the Company. At June 30, 2004, there were no amounts outstanding under the revolving line of credit. The above facility expires in April 2005.

Advanced Micro Electronics, AS (“AME”) has a loan agreement with a Norwegian bank that provides for revolving line-of-credit borrowings up to 10,000,000 Norwegian kroner (approximately U.S. \$1,300,000 at June 30, 2004). Borrowings under the line of credit bear interest at a variable rate, which was 5.5% and 4.25% at June 30, 2003 and 2004, respectively. Interest is payable quarterly. Borrowings under the line of credit are collateralized by certain AME assets. At June 30, 2004, 4,300,000 Norwegian kroner (approximately U.S. \$620,000) was outstanding under the line of credit. The above facility expires in March 2005, and the Company believes that it will be renewed on the same or similar terms.

Rapiscan U.K. has a loan agreement with a U.K. bank that provides for an overdraft facility up to a maximum amount of 2,000,000 pounds sterling (approximately U.S. \$3,600,000 at June 30, 2004) outstanding at any one time, which amounts are secured by certain assets of Rapiscan U.K. At June 30, 2004 no amounts were outstanding under the overdraft facility. Outstanding borrowings bear interest at a base rate (3.75% and 4.5% at June 30, 2003 and 2004, respectively) plus 1.35% per annum. The agreement also provides for a 2,500,000 pounds sterling (approximately U.S. \$4,500,000 at June 30, 2004) facility for tender and performance bonds and a 2,000,000 pounds sterling (approximately U.S. \$3.6 million at June 30, 2004) facility for the purchase of foreign exchange contracts. These facilities are secured by certain assets of Rapiscan U.K., and the Company has guaranteed Rapiscan U.K.’s obligations under these facilities up to \$1,800,000. As of June 30, 2004 approximately \$1,900,000 was outstanding under the performance bond facility. The above facilities expire in May 2005, and the Company believes that they will be renewed on the same or similar terms.

Opto Sensors (Malaysia) Sdn. Bhd. (“Opto Malaysia”) has a loan agreement with a Malaysian bank that provides for a revolving line of credit up to 3,000,000 Malaysian ringgits (approximately U.S. \$789,000 at June 30, 2004). Borrowings under the line of credit bear interest at the bank’s base lending rate (6.0% and 6.0% at June 30, 2003 and 2004, respectively) plus 1.75%. Interest is payable monthly. At June 30, 2004, no amounts were outstanding under this line of credit. Borrowings under this agreement are secured by certain assets of the subsidiary and guaranteed by the Company. The above facility expires in August 2005, and the Company believes that it will be renewed on the same or similar terms.

Opto Malaysia has a loan agreement with a Malaysian bank that provides for 10,000,000 Malaysian ringgits (approximately U.S. \$2,600,000 at June 30, 2004) under a performance bond facility. As of June 30, 2004, \$1,100,000 was outstanding under this facility. The agreement also provides for overdraft borrowings up to 2,000,000 Malaysian ringgits (approximately U.S. \$526,000 at June 30, 2004). Borrowings under the overdraft facility bear interest at the bank’s base lending rate (6.0% and 6.0% at June 30, 2003 and, respectively) plus 1.75%. At June 30, 2004 and 2003, no amounts were outstanding under the overdraft facility. Borrowings under this agreement are secured by certain assets of the subsidiary and are guaranteed by the Company. The above facility expires in January 2005, and the Company believes that it will be renewed on the same or similar terms.

Metorex Security Products, Oy, has a loan agreement with a Finnish bank that provides for 525,000 euros (approximately U.S. \$640,000 at June 30, 2004) under a tender and performance bond facility. As of June 30, 2004 U.S. \$571,000 was outstanding under this facility. The agreement also provides for a foreign currency

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overdraft facility up to 460,000 euros (approximately U.S. \$561,000 at June 30, 2004). At June 30, 2004, 84,000 euros (approximately U.S. \$103,000) was outstanding under the facility at June 30, 2004. Borrowings under these facilities bear interest rate at the bank's prime lending rate (4.0% and 2.5% at June 30, 2003 and 2004 respectively) plus 1.0%. The above facilities expire in February 2006.

5. LONG-TERM DEBT

Long-term debt consisted of the following at June 30 (in thousands):

	<u>2003</u>	<u>2004</u>
Four-year term loan payable in monthly installments of \$114,583 until paid in full on February 1, 2005. Interest is due monthly at a rate of 5.26%	\$2,292	\$ 940
Four-year term loan payable in monthly installments of \$104,167 until paid in full on February 1, 2005. Interest is due monthly at a rate of 4.7%	2,132	858
Other	39	32
	<u>4,463</u>	<u>1,830</u>
Less current portion of long-term debt	<u>2,625</u>	<u>1,798</u>
Long-term portion of debt	<u>\$1,838</u>	<u>\$ 32</u>

Fiscal year principal payments of long-term debt as of June 30, 2004 are as follows (in thousands):

2005	\$1,798
2006	32
Total	<u>\$1,830</u>

6. INCOME TAXES

For financial reporting purposes, income before provision for income taxes and minority interest includes the following components (in thousands):

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Pre-tax income:			
United States	\$ 1,236	\$11,836	\$ 2,212
Foreign	8,764	10,634	10,890
Total pre-tax income	<u>\$10,000</u>	<u>\$22,470</u>	<u>\$13,102</u>

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The Company's provision for income taxes is composed of the following (in thousands):

	2002	2003	2004
Current:			
Federal	\$ 859	\$2,969	\$ 756
State	183	398	122
Foreign	2,491	3,391	2,691
	<u>3,533</u>	<u>6,758</u>	<u>3,569</u>
Tax effect of stock option benefits	2,160	357	907
Deferred	<u>(2,693)</u>	<u>(594)</u>	<u>(1,160)</u>
Total provision for income taxes	<u>\$ 3,000</u>	<u>\$6,521</u>	<u>\$ 3,316</u>

The Company does not provide for U.S. income taxes on the undistributed earnings of the foreign subsidiaries, as it is the Company's intention to utilize those earnings in the foreign operations for an indefinite period of time. At June 30, 2004, undistributed earnings of the foreign subsidiaries amounted to approximately \$34,062,000. It is not practical to determine the amount of income or withholding tax that would be payable upon the remittance of these earnings.

Deferred income tax assets (liabilities) at June 30 consisted of the following (in thousands):

	2003	2004
Deferred income tax assets:		
State income tax credit carryforwards	\$ 2,109	\$ 1,300
Federal income tax credit carryforwards	201	203
Net operating loss carryforwards	3,044	5,412
Revitalization zone deductions	125	999
Allowance for doubtful accounts	367	423
Inventory reserve	516	1,059
Provision for losses on long-term contracts	2,036	376
Accrued liabilities	1,003	3,485
Other assets	3,666	3,432
	<u>13,067</u>	<u>16,689</u>
Total deferred income tax assets	13,067	16,689
Valuation allowance	(1,434)	(1,434)
	<u>11,633</u>	<u>15,255</u>
Net deferred income tax assets	<u>11,633</u>	<u>15,255</u>
Deferred income tax liabilities:		
Depreciation	(181)	(1,214)
State income taxes	(971)	(628)
Amortization of intangible assets	(4,861)	(11,090)
Other liabilities	(219)	(122)
	<u>(6,232)</u>	<u>(13,054)</u>
Total deferred income tax liabilities	(6,232)	(13,054)
Net deferred income taxes	<u>\$ 5,401</u>	<u>\$ 2,201</u>

As of June 30, 2004, the Company has federal net operating loss carry forwards of approximately \$13,501,000 and state net operating loss carry forwards of approximately \$6,496,000. The Company's federal net operating losses will begin to expire in the tax year ending June 30, 2013 and the Company's state net operating losses will begin to expire in the tax year ending June 30, 2015.

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The Company also has federal credit carry forwards of approximately \$203,000 and state credit carry forwards, including revitalization zone deductions, of \$2,299,000. The Company's federal credit carry forwards will begin to expire in the tax year ending June 30, 2005 and its state credit carry forwards will begin to expire in the tax year ending June 30, 2007.

The Company has established a valuation allowance in accordance with the provisions of SFAS No. 109. The valuation allowance primarily relates to the net operating loss of a subsidiary, subject to Separate Return Limitation Year rules. The Company continually reviews the adequacy of valuation allowances and releases the allowances when it is determined that is more likely than not that the benefits will be realized. During fiscal year 2004, the valuation allowance did not change.

The consolidated effective income tax rate differs from the federal statutory income tax rate due primarily to the following:

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Provision for income taxes at federal statutory rate	35.0%	35.0%	35.0%
State income tax credits—net of federal benefit	(0.4)	2.9	0.6
Research and development tax credits	(2.0)	(1.3)	
Foreign income subject to tax at other than federal statutory rate	(5.6)	(4.6)	(7.7)
Nondeductible expenses	1.1	0.4	0.9
Other		4.0	
Change in valuation allowance	1.9	(7.3)	
Favorable determination of income tax contingencies			(3.5)
	<u> </u>	<u> </u>	<u> </u>
Effective income tax rate	30.0%	29.1%	25.3%

7. COMMITMENTS AND CONTINGENCIES

The Company leases some of its production and office facilities and certain equipment under various operating leases. Most of these leases provide for increases in rents based on the Consumer Price Index and include renewal options ranging from six months to ten years. Future minimum lease payments under such leases as of June 30, 2004 are as follows (in thousands):

2005	\$ 9,312
2006	7,483
2007	6,325
2008	5,132
2009	4,800
2010 and thereafter	15,038
	<u> </u>
Total	\$48,090

Total rent expense included in the accompanying consolidated financial statements was \$1,323,000, \$1,980,000 and \$4,507,000 for the years ended June 30, 2002, 2003 and 2004, respectively.

In March 2000, certain individuals filed a class action suit in Los Angeles Superior Court naming Rapiscan Security Products (U.S.A.), Inc. ("Rapiscan") subsidiary and others as defendants. The named plaintiffs are the

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wives of men incarcerated in California prisons. The plaintiffs allege that while attempting to visit their husbands in prison, as a condition to such visits, prison personnel have subjected them, and other members of the putative class, to scans by Rapiscan's Secure 1000 product, as well as strip searches, and body cavity searches, all of which plaintiffs allege to have been illegal searches and have caused them emotional injuries. The other defendants in the action include the State of California, the California Department of Corrections, its Director and other Department of Corrections personnel. The complaint asserts, among other things, that these types of searches are illegal and intrusive and have caused emotional injury to the plaintiffs. In addition to alleging that Rapiscan is responsible for illegal searches conducted by prison personnel, the complaint alleges that Rapiscan was negligent, that the Secure 1000 product is defective in design and manufacture, that Rapiscan failed to properly train the prison personnel in using the Secure 1000 product, that Rapiscan failed to warn subjects that they might be subjected to illegal searches using the Secure 1000 product, and that the scans are more intrusive than manual searches. Plaintiffs seek general, special and punitive damages in unspecified amounts and declaratory relief against illegal searches. The Company believes that these claims against Rapiscan have no merit and the Company intends to vigorously defend this suit.

In November 2002, L-3 brought suit against the Company for a declaratory judgment that L-3 had not breached its obligations to the Company concerning the acquisition of PerkinElmer, Inc's Security Detection Systems Business. In February 2003, the Company answered and asserted counterclaims against L-3 for, among other things, fraud, breach of fiduciary duty, breach of contract and failure to negotiate in good faith. In March 2003, L-3 amended its complaint and asserted claims against the Company for breach of contract, failure to negotiate in good faith, and tortious interference. In its amended complaint, L-3 requested both a declaratory judgment that it had fulfilled its obligations and an award of damages for an unspecified amount.

During 2003 and 2004, the Company was informed that Science Applications International Corporation ("SAIC") had made statements to prospective buyers of Rapiscan's gamma ray mobile detection system product ("GaRDS") that GaRDS infringed upon unspecified SAIC patents. In April 2004, the Company received a letter from SAIC specifying a patent upon which SAIC claimed the GaRDS infringed. Contrary to SAIC's claim, the patent cited by SAIC actually distinguished the technology used in GaRDS as a different, pre-existing technology. The Company therefore filed a lawsuit for declaratory judgment. SAIC has since counter-claimed for patent infringement, citing the same patent, and unfair competition.

In March 2004, certain individuals named the Company and its subsidiary, Spacelabs Medical, as well as a hospital located in Bexar County, Texas, in a petition claiming that the individuals suffered injuries in March 2003 caused, in part, by a defective monitoring system manufactured by Spacelabs Medical. The amount of the claim has not yet been specified.

In April 2004, certain individuals named Spacelabs Medical, as well as several other defendants, in a petition that alleges, among other things, that a product possibly manufactured by Spacelabs Medical failed to properly monitor a hospital patient thereby contributing to the patient's death in November 2001. The amount of the claim has not yet been specified.

In August 2004, the former president of Spacelabs Medical submitted an arbitration claim alleging breach of a retention and severance agreement seeking approximately \$1.5 million and punitive damages.

The Company is also involved in various other claims and legal proceedings arising out of the conduct of its business. In the Company's opinion after consultation with legal counsel, the ultimate disposition of such proceedings will not have a material adverse effect on the Company's financial position, future results of operations, or cash flows.

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8. STOCK OPTIONS

The 1997 plan was established in May 1997 and authorizes the grant of up to 850,000 shares of the Company's Common Stock in the form of incentive and nonqualified options. The authorized shares under the 1997 plan were increased to 2,350,000 in June 2003. Employees, officers and directors are eligible under this plan, which is administered by the board of directors, who determine the terms and conditions of each grant, with the advice of and input from the Compensation Committee. The exercise price of nonqualified options may not be less than 85% of the fair market value of the Company's Common Stock at the date of grant. The exercise price of incentive stock options may not be less than the fair market value of the Company's Common Stock at the date of grant. The exercise price of incentive stock options granted to individuals that own greater than 10% of the Company's voting stock may not be less than 110% of the fair market value of the Company's Common Stock at the date of grant.

Exercise periods for incentive and nonqualified options granted under this plan may not exceed five years from the grant date.

The following summarizes stock option activity for the years ended June 30:

	Number of Options	Option Price	
		Weighted Average	Total
Outstanding, July 1, 2001	1,251,956	8.12	10,170,000
Granted	477,225	14.47	6,906,000
Exercised	(554,514)	9.91	(5,493,000)
Canceled	(28,055)	11.62	(326,000)
Outstanding, June 30, 2002	1,146,612	9.82	\$ 11,257,000
Granted	421,748	16.15	6,812,000
Exercised	(101,769)	8.43	(858,000)
Canceled	(87,050)	7.64	(665,000)
Outstanding, June 30, 2003	1,379,541	11.99	\$ 16,546,000
Granted	455,765	19.31	8,801,000
Exercised	(176,494)	6.99	(1,233,000)
Canceled	(5,925)	6.74	(40,000)
Outstanding, June 30, 2004	1,652,887	14.57	\$ 24,074,000

The following summarizes pricing and term information for options outstanding as of June 30, 2004:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding at June 30, 2004	Weighted- Average Remaining Contractual Life (Years)	Weighted- Average Exercise Price	Exercisable at June 30, 2004	Weighted- Average Exercise Price	
\$3.13	108,475	1.80	\$3.13	108,475	\$3.13	
3.44 to 5.00	165,099	2.02	3.91	110,526	3.75	
6.56 to 7.00	26,250	0.09	7.00	26,250	7.00	
7.70 to 9.48	168,737	0.97	8.31	152,862	8.34	
14.76 to 20.25	1,184,326	3.68	18.16	255,361	17.94	
\$3.13 to \$20.25	1,625,887	3.06	\$14.57	653,474	\$10.39	

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As of June 30, 2003, options exercisable were 484,250 at a weighted-average exercise price of \$8.54. As of June 30, 2002, options exercisable were 276,750 at a weighted-average exercise price of \$7.33.

9. EMPLOYEE STOCK PURCHASE PROGRAM

In August 1998, the board of directors adopted the Company's Employee Stock Purchase Plan (the "1998 Plan"). The 1998 Plan, which was approved by the Company's shareholders in November 1998, provides persons who have been regular employees of the Company or its U.S. subsidiaries for at least six months and who meet certain other criteria, the opportunity to purchase through regular payroll deductions up to an aggregate of 200,000 shares of Common Stock. The 1998 Plan is administered by the board of directors or a committee of the board. The 1998 Plan qualifies as an "employee stock purchase plan" as defined in Section 423 of the Internal Revenue Code.

To participate in the 1998 Plan, eligible employees submit a form to the Company's payroll office authorizing payroll deductions in an amount between 1% and 10% of the employee's regular annual pay. At the end of each offering period, initially set at six months duration, the aggregate amount deducted from each participating employee's paycheck is applied to the purchase of a whole number of shares of Common Stock, with any sums remaining being returned to the employee. No interest accrues on payroll deductions. The purchase price of the Common Stock is 85% of the lesser of the fair market value of the Common Stock (as determined by the board of directors) on the first day or the last day of the offering period. If the aggregate number of shares of Common Stock that all participants elect to purchase during any offering period is greater than the number of shares remaining available for issuance under the 1998 Plan, the remaining shares will be allocated pro rata among participants. Notwithstanding any of the foregoing, no employee may purchase Common Stock under the 1998 Plan if (i) after any such purchase, the employee would own 5% or more of the total combined voting power or value of all classes of the Company's stock on a consolidated basis, or (ii) the rights to purchase Common Stock under the 1998 Plan and all other qualified employee stock purchase plans of the Company or any of its subsidiaries granted to that employee would exceed \$25,000 per calendar year.

A participant may elect to withdraw from the 1998 Plan at any time up to the last day of an offering period by filing a form to such effect. Upon withdrawal, the amount contributed to the employee will be refunded in cash, without interest. Any person withdrawing may not participate again in the 1998 Plan until the end of one complete offering period. Termination of a participant's employment for any reason shall be treated as a withdrawal.

The 1998 Plan purchased 22,648 shares of Common Stock, for a total of \$71,000 during the year ended June 30, 2002, 13,348 shares of Common Stock for a total of \$195,000 during the year ended June 30, 2003 and 16,281 shares of Common Stock for a total of \$217,000 during the year ended June 30, 2004. The Company's liability to the 1998 Plan was \$114,000 and \$175,000 at June 30, 2003 and 2004, respectively.

10. SHAREHOLDERS' EQUITY

In March 1999, the board of directors instituted a treasury stock program under which the Company was authorized to purchase up to a total of 2,000,000 shares. The Company purchased 405,500 shares at a cost of \$1,820,000 during fiscal 2000 and an additional 914,000 shares for \$3,886,000 during fiscal 2001. In September 2004, the Company repurchased 107,500 shares of its Common Stock at an average purchase price of \$14.73 per share and it increased the number of shares available for repurchase under the stock program by 1,000,000 shares. As a result, 1,488,000 shares are available for repurchase under the program. The stock repurchase program did not have a material effect on the Company's liquidity and is not expected to have a material effect

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on liquidity in subsequent quarters. The Company retires the treasury shares as they are repurchased, and they are disclosed as a deduction from common shares in the accompanying consolidated financial statements.

In November 2001, the Company issued and sold an aggregate of 1,696,946 shares of its Common Stock in a private placement to institutional investors for an aggregate sales price of \$19,900,000. After placement agents' commission and expenses, net proceeds to the Company were \$18,500,000. Roth Capital Partners and William Blair & Company acted as placement agents. In connection with the transactions, Roth Capital Partners received warrants to purchase 84,847 shares of the Company at \$15.00 per share, exercisable at any time in full or part after May 13, 2002 and no later than May 13, 2005. The fair value of the warrants was estimated at \$806,000 using the Black-Scholes option pricing model with the following weighted-average assumptions: expected option life of three and one-half years, dividend yield of 0%, volatility of 92% and a risk-free interest rate of 4.06%. The fair value of these warrants is included with the proceeds from the private placement under the common shares balance as of June 30, 2003 and 2004. The Company filed a registration statement on Form S-3 with the SEC on November 19, 2001 for the purpose of registering these securities.

In December 2001, the Company issued and sold an aggregate of 2,070,000 shares of its Common Stock in a private placement to institutional investors for an aggregate sales price of \$40,400,000. After placement agent commission and expenses, net proceeds to the Company were \$38,300,000. Roth Capital Partners acted as placement agent in the transaction. As part of the transaction, the Company issued to the investors warrants to purchase 517,500 additional shares of the Company at an exercise price of \$23.47 per share exercisable at any time in full or part no later than December 10, 2008. In connection with the transaction, Roth Capital Partners received warrants to purchase 103,500 shares of the Company at an exercise price of \$23.47 per share exercisable at any time in full or part no later than December 10, 2008. The fair value of the warrants was estimated at \$10,229,000 using the Black-Scholes option-pricing model with the following weighted-average assumptions: expected option life of seven years, dividend yield of 0%, volatility of 92% and a risk-free interest rate of 5.42%. The fair value of these warrants is included with the proceeds from the private placement under the common shares balance as of June 30, 2003 and 2004. The Company filed a registration statement on Form S-3 with the SEC on December 14, 2001 for the purpose of registering these securities.

In October 2002, the Company issued and sold an aggregate of 1,250,000 shares of Common Stock in a private placement to institutional investors for an aggregate sales price of \$21.6 million. After agent's commissions, and expenses, net proceeds to the Company were \$20.5 million. As part of the transaction, the Company issued to the investors warrants to purchase 281,250 additional shares of the Company's Common Stock at an exercise price of \$21.22 per share exercisable at any time in full or part no later than October 21, 2009. The fair value of the warrants was estimated at \$3,365,000 using the Black-Scholes option-pricing model with the following weighted-average assumptions: expected option life of seven years, dividend yield of 0%, volatility of 89% and a risk-free interest rate of 3.18%. The fair value of these warrants is included with the proceeds from the private placement under the common shares balance as of June 30, 2003 and 2004. The Company filed a registration statement on Form S-3 with the SEC on November 14, 2002 for the purpose of registering these securities.

In June 2004, the Company issued and sold an aggregate of 1,500,000 shares of Common Stock in a private placement to institutional investors for an aggregate sales price of \$32.3 million. After agent's commissions, and expenses, net proceeds to the Company were \$31.0 million. As part of the transaction, the Company issued to the investors warrants to purchase 337,500 additional shares of the Company's Common Stock at an exercise price of \$27.73 per share exercisable at any time in full or part no later than June 1, 2011. The fair value of the warrants was estimated at \$6,152,000 using the Black-Scholes option-pricing model with the following weighted-average assumptions: expected option life of seven years, dividend yield of 0%, volatility of 98% and a

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

risk-free interest rate of 4.45%. The fair value of these warrants is included with the proceeds from the private placement under the common shares balance as of June 30, 2004. As part of the transaction, the Company agreed to file a registration statement on Form S-3 with the SEC.

11. RELATED-PARTY TRANSACTIONS

The Company contracts with entities owned by directors of the Company to provide messenger service and auto rental and printing services. Included in cost of sales, selling, general and administrative expenses for the years ended June 30, 2002, 2003 and 2004 are approximately \$107,000, \$101,000 and \$70,000 for messenger service and auto rental; \$100,000, \$104,000 and \$73,000 for printing services; and \$14,000, \$0 and \$0 for professional services, respectively.

12. EMPLOYEE BENEFIT PLANS

The Company has a qualified employee retirement savings plan. The plan provides for a contribution by the Company, which is determined annually by the board of directors. In addition, the plan permits voluntary salary reduction contributions by employee. The Company contributed \$93,000, \$123,000 and \$239,000 to the plan for the years ended June 30, 2002, 2003, and 2004, respectively.

During 2000, AME established a defined contribution plan. The plan provides for contributions by AME at a fixed percentage of employee salaries. Contributions made during the years ended June 30, 2002, 2003 and 2004 by AME were approximately \$107,000, \$164,000 and \$149,000, respectively.

During 1993, Rapiscan U.K. transferred its existing employees from their former owner's plan to a new plan, the Rapiscan U.K. Defined Benefit Plan, which covers certain Rapiscan U.K. employees. The benefits under this plan are based on years of service and the employees' highest 12 months' compensation during the last five years of employment.

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

Rapiscan U.K.'s funding policy is to make the minimum annual contributions required by applicable regulations based on an independent actuarial valuation sufficient to provide for benefits accruing after that date. The following provides a reconciliation of the changes in the plan's benefit obligation and fair value of assets over two years, and a statement of the funded status as of June 30, 2003 and 2004, respectively (in thousands):

	2003	2004	
Change in Benefit Obligation			
Benefit obligation at beginning of year	\$ 3,228	\$ 3,181	
Translation adjustment	321	287	
Service costs	58	60	
Interest costs	176	165	
Plan participants' contributions	15	14	
Augmentations	100		
Actuarial loss (gain)	242	(77)	
Actuarial loss from settlement	176	206	
Benefits paid	(1,135)	(390)	
Benefit obligation at end of year	3,181	3,446	
Change in Plan Assets			
Fair value of plan assets at beginning of year	2,693	1,647	
Translation adjustment	268	149	
Actual return on plan assets	(489)	157	
Company contributions	295	217	
Plan participants' contributions	15	14	
Benefits paid	(1,135)	(390)	
Fair value of plan assets at end of year	1,647	1,794	
Funded status	(1,534)	(1,652)	
Unrecognized net actuarial loss	1,296	1,477	
Net amount recognized	\$ (238)	\$ (175)	
Amount recognized in balance sheets consist of:			
Accumulated other comprehensive income	1,102	1,354	
Accrued pension liability	(1,340)	(1,529)	
Net amount recognized	\$ (238)	\$ (175)	
	2002	2003	2004
Net Periodic Benefit Costs			
Service costs	\$ 58	\$ 56	\$ 60
Interest costs	193	169	165
Expected return on plan assets	(175)	(151)	(85)
Amortization of prior service costs		95	
Settlement cost		169	206
Recognized actuarial loss	35	37	139
Net periodic benefit cost	\$ 111	\$ 375	\$ 485

The accumulated benefit obligation for the Rapiscan U.K. Defined Benefit Plan was \$2,987,000 as of June 30, 2003 and \$ 3,323,000 as of June 30, 2004.

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

Plan assumptions

	2003	2004
Weighted average assumptions at year-end:		
Discount rate	5.3%	5.8%
Expected return on plan assets	5.7%	6.2%
Rate of compensation increase	4.0%	4.5%

The long term return on assets has been derived from the weighted average of assumed returns on each of the major asset categories. The weighted average is based on the actual proportion of each major asset class held, rather than a benchmark portfolio of assets. The expected returns for each major asset class have been derived from a combination of both historical market returns and current market data as well as the views of a range of investment managers.

Rate of compensation increase was estimated at 4.0% as of June 30, 2003. As of June 30, 2004 the directors of the pension plan have increased the assumed rate of compensation increase to 4.5% to reflect an increase in the long term inflation rate in the United Kingdom ("U.K.").

Plan assets and Investment Policy

	Fiscal year ended June 30, 2003		Fiscal year ended June 30, 2004	
	Proportion of fair value	Expected rate of return	Proportion of fair value	Expected rate of return
Equity securities	41.7%	7.0%	48.2%	7.0%
Debt securities	52.8%	4.7%	51.4%	5.5%
Real estate	—	—	—	—
Other	5.5%	5.0%	0.4%	5.0%
Combined	100.0%	5.7%	100.0%	6.2%

The pension plan assets are invested in a range of pooled investment funds that provide access to a diverse range of asset classes. The investment objective is to maximize the investment return over the long term without exposing the fund to an unnecessary level of risk. Within this objective it is recognized that benefits will be secured by the purchase of annuities at the time of employee retirement. The plan invests in pooled insurance funds, as the size of the pension plan precludes direct investment.

The Trustees benchmark is to hold assets broadly in the proportion 50% equity securities and 50% debt securities. This proportion is allowed to fluctuate with market movements and is not formally rebalanced. The equity holding is maintained in a balanced fund, with the decision on whether to hold UK equities or non-UK equities being under the control of the investment manager. Typically this proportion is close to 65% UK and 35% non-UK equities. The debt securities are predominantly from the UK, with 70% held in UK government bonds (gilts) and the balance held in corporate bonds.

Day to day equities selection decisions are delegated to the investment manager, although these are monitored against performance and risk targets. Due to the nature of the pooled funds, there are no significant holdings in any single company (greater than 5% of the total assets). The investment strategy is reviewed on a regular basis, based on the results of the liability studies.

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

Projected Benefit Payments

The following table reflects estimated benefits payments, based upon the same assumptions used to measure the benefit obligation and net pension cost, as of June 30, 2004 (in thousands):

Fiscal period	Pension Benefits
July 1, 2004 to June 30, 2005	\$ 682
July 1, 2005 to June 30, 2006	92
July 1, 2006 to June 30, 2007	—
July 1, 2007 to June 30, 2008	206
July 1, 2008 to June 30, 2009	—
July 1, 2009 to June 30, 2014	1,061

Company contribution

Currently the agreed Company contribution rate is 17.9% of pensionable salaries, plus \$6,700 per month, with death in service insurance premiums being paid in addition. If the Company contributions continue at the current rate, the estimated total Company contributions for the fiscal year 2005 will be \$217,200.

13. UNAUDITED QUARTERLY RESULTS

The following table's present unaudited quarterly financial information for the four quarters ended June 30, 2003 and 2004 (in thousands):

	Quarter Ended			
	September 30, 2002	December 31, 2002	March 31, 2003	June 30, 2003
	(Unaudited)			
Revenues	\$ 37,101	\$ 43,673	\$ 50,946	\$ 50,924
Costs of goods sold	24,121	29,186	34,852	34,502
Gross profit	12,980	14,487	16,094	16,422
Operating expenses:				
Selling, general and administrative expenses	6,819	6,771	7,474	8,096
Research and development	1,546	2,215	2,702	2,403
Total operating expenses	8,365	8,986	10,176	10,499
Income from operations	4,615	5,501	5,918	5,923
Write-off of deferred acquisition costs		(608)		
Write down of equity investment			(1,026)	(407)
Gain on sale of investment				1,767
Interest income—net	174	207	203	202
Income before provision for income taxes and minority interest	4,789	5,100	5,095	7,485
Provision for income taxes	1,583	1,302	1,447	2,189
Minority interest in net income of subsidiary	(5)	(38)	(41)	(71)
Net income	\$ 3,201	\$ 3,760	\$ 3,607	\$ 5,225
Basic earnings per common share	\$ 0.25	\$ 0.26	\$ 0.25	\$ 0.36
Diluted earnings per common share	\$ 0.24	\$ 0.25	\$ 0.24	\$ 0.35

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

	Quarter Ended			
	September 30, 2003	December 31, 2003	March 31, 2004*	June 30, 2004*
	(Unaudited)			
Revenues	\$ 38,645	\$ 51,095	\$ 61,531	\$ 95,798
Costs of goods sold	26,079	36,498	41,957	59,178
Gross profit	12,566	14,597	19,574	36,620
Operating expenses:				
Selling, general and administrative expenses	7,521	8,189	12,419	26,107
Research and development	2,037	2,373	3,543	6,685
Restructuring charges	1,061			
Management retention bonus				1,029
Total operating expenses	10,619	10,562	15,962	33,821
Income from operations	1,947	4,035	3,612	2,799
Write down of equity investment	(247)			
Gain on sale of investment			376	
Interest income (expense)—net	223	221	144	(9)
Income before provision for income taxes and minority interest	1,923	4,256	4,132	2,790
Provision for income taxes	583	1,221	739	774
Minority interest in net (income) loss of subsidiary	(57)	9	48	170
Net income	\$ 1,283	\$ 3,044	\$ 3,441	\$ 2,186
Basic earnings per common share	\$ 0.09	\$ 0.21	\$ 0.24	\$ 0.14
Diluted earnings per common share	\$ 0.09	\$ 0.20	\$ 0.23	\$ 0.14

* Results of operations for the three month periods ended March 31, 2004 and June 30, 2004 include the effect of the acquisition of Spacelabs Medical (see note 3)

14. SEGMENT INFORMATION

The Company has adopted SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. The Company has reflected the provisions of SFAS No. 131 in the accompanying consolidated financial statements for all periods presented. Segment information is provided by geographic area. As discussed in Note 1, the Company is vertically integrated and is sharing common resources and facilities. Therefore, with the exception of external revenues, discrete financial information is not available by product segment at all operating locations.

The Company believes that it operates in three product segments, a) security and inspection systems, b) medical monitoring and imaging systems, and c) optoelectronic devices and value-added subsystems. For the years ended June 30, 2002, 2003, and 2004, revenues from the sale of security and inspection systems were \$73.4 million, \$120.8 million, and \$117.8 million, respectively. For the years ended June 30, 2002, 2003, and 2004, revenues from the sale of medical monitoring and imaging systems were \$6.2 million, \$10.9 million, and \$60.7 million (including the effect in 2004 of the acquisition of Spacelabs Medical), respectively. For the years ended June 30, 2002, 2003, and 2004, external revenues from the sale of optoelectronic devices and value-added subsystems were \$44.6 million, \$50.9 million, and \$68.6 million, respectively.

OSI SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
YEARS ENDED JUNE 30, 2002, 2003 AND 2004

The Company's operating locations include the North America (United States and Canada), Europe (United Kingdom, Finland, Norway, Germany, France, Greece and Austria) and Asia (Singapore, India and Malaysia). The Company's operations and identifiable assets by geographical area are as follows for the years ended June 30 (in thousands):

	2002				
	North America	Europe	Asia	Eliminations	Consolidated
Revenues:					
Product revenues	\$ 81,076	\$28,843	\$ 9,176	\$ —	\$ 119,095
Service revenues	1,484	3,505	146	—	5,135
Transfer between geographical areas	8,160	5,264	34,443	(47,867)	
Net revenues	\$ 90,720	\$37,612	\$43,765	\$ (47,867)	\$ 124,230
(Loss) income from operations	\$ 1,544	\$ 2,681	\$ 6,412	\$ (798)	\$ 9,839
Capital expenditure	\$ 1,028	\$ 568	\$ 505	\$ —	\$ 2,101
Depreciation	\$ 2,084	\$ 867	\$ 450	\$ —	\$ 3,401
	2003				
	North America	Europe	Asia	Eliminations	Consolidated
Revenues:					
Product revenues	\$ 120,663	\$37,710	\$16,630	\$ —	\$ 175,003
Service revenues	1,915	5,529	197	—	7,641
Transfer between geographical areas	14,286	7,425	39,859	(61,570)	
Net revenues	\$ 136,864	\$50,664	\$56,686	\$ (61,570)	\$ 182,644
Income from operations	\$ 10,487	\$ 3,582	\$ 7,391	\$ 498	\$ 21,958
Identifiable assets	\$ 379,626	\$33,355	\$42,232	\$ (225,675)	\$ 229,538
Capital expenditure	\$ 2,118	\$ 723	\$ 728	\$ —	\$ 3,569
Depreciation	\$ 2,173	\$ 851	\$ 661	\$ —	\$ 3,685
	2004				
	North America	Europe	Asia	Eliminations	Consolidated
Revenues:					
Product revenues	\$ 169,346	\$42,600	\$15,762	\$ —	\$ 227,708
Service revenues	12,220	6,481	660	—	19,361
Transfer between geographic areas	10,097	7,933	41,380	(59,410)	—
Net revenues	\$ 191,663	\$57,014	\$57,802	\$ (59,410)	\$ 247,069
Income from operations	\$ 2,436	\$ 1,391	\$ 9,383	\$ (817)	\$ 12,393
Identifiable assets	\$ 612,632	\$51,630	\$49,114	\$ (381,575)	\$ 331,801
Capital expenditure	\$ 4,250	\$ 784	\$ 370	\$ —	\$ 5,404
Depreciation	\$ 2,558	\$ 786	\$ 626	\$ —	\$ 3,970

As a result of the changes in the Company's structure and operations which have occurred, beginning in the first quarter of fiscal year 2005, the Company will have discrete financial information available by product line for all operating locations and therefore will begin reporting segment information by product line.

* * * * *

SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS
(in thousands)

Description	Balance at Beginning of period	Additions		Deductions- Write-offs	Balance at end of period
		Charged to costs and expenses	(1) Charged in other accounts		
Balance for doubtful accounts:					
Year ended June 30, 2002	\$ 903	\$ 747		\$ 165	\$ 1,485
Year ended June 30, 2003	\$ 1,485	\$ (13)		\$ 374	\$ 1,098
Year ended June 30, 2004	\$ 1,098	\$ 287		\$ 611	\$ 774
Balance for warranty reserve:					
Year ended June 30, 2002	\$ 1,687	\$ 1,668		\$ 1,191	\$ 2,164
Year ended June 30, 2003	\$ 2,164	\$ 2,516		\$ 1,898	\$ 2,782
Year ended June 30, 2004	\$ 2,782	\$ 2,718	\$ 7,719	\$ 4,029	\$ 9,190

(1) Included in the additions to the warranty reserve for the year ended June 30, 2004 is \$7,719 of additional warranty reserves relating to the acquisitions completed during fiscal year 2004.

THIS LEASE ("Lease") dated as of the 24th day of June 2002, is made by and between S/I SAMMAMISH I, LLC, A WASHINGTON LIMITED LIABILITY COMPANY ("Landlord"), and SPACELABS MEDICAL, INC., A DELAWARE CORPORATION ("Tenant").

ARTICLE I: DEFINITIONS

1.01 Defined Terms. The following terms shall have the meanings specified in this Section, unless otherwise specifically provided. Other terms may be defined in other parts of the Lease.

- (a) Landlord: S/I SAMMAMISH I, LLC
- (b) Landlord's Address: c/o Schnitzer Northwest
225 – 108th Avenue NE, Suite 400
Bellevue, Washington 98004
Telephone: (425) 452-3700
Facsimile: (425) 454-1505
- With a Copy to: Jameson Babbitt Stites & Lombard, P.L.L.C.
999 Third Avenue, Suite 1900
Seattle, Washington 98104
Attn: Jennifer Cobb
Telephone: (206) 292-1994
Facsimile: (206) 292-1995
- (c) Tenant: SPACELABS MEDICAL, INC., a
Delaware corporation
- (d) Tenant's Address: Prior to Lease Commencement:
15220 N.E. 40th Street
Redmond, Washington 98052
Attn: Karyn Beckley
Telephone (425) 882-3753
Facsimile (425) 702-2310
- After Lease Commencement:
At the Premises:
22011 S.E. 51st St.
Issaquah, Washington 98027

-
- with a copy to: Spacelabs Medical, Inc.
22011 S.E. 51st St.
Issaquah, WA 98027
Attn: General Counsel
- (e) Tenant's Use: Corporate offices, warehouse/distribution and related assembly activities for medical electronics development and ancillary uses consistent with a Class A business park, including, without limitation, an internal food service for Tenant's employees and guests.
- (f) Project: SAMMAMISH PARK PLACE, including all buildings and Common Areas (as hereinafter defined) thereon and related thereto.
- (g) Property: The real property described in Exhibit "A" and depicted on the Project Site Plan attached as Exhibit "B."
- (h) Building: That certain 2-story office building designated as Building A on the Project Site Plan attached hereto as Exhibit B with a rentable area of approximately 95,600.
- (i) Premises: Approximately 95,600 rentable square feet consisting of the entire rentable area of the Building, as shown on the Tenant Improvement Turn-Key Floor Plan(s) attached as Exhibit "C-1".
- (j) Term: Commencing upon the Commencement Date (as defined in Section 4.01) and expiring on the Expiration Date determined pursuant to Section 4.01 (approximately ten (10) years) (subject to extension, if applicable, pursuant to Section 4.03 below).
- (k) Scheduled Commencement Date: February 15, 2003. The actual Commencement Date is subject to determination pursuant to Subsection 4.01 below.

(l) Base Rent:

<u>Ten (10) Year Rent Schedule</u>	<u>Mo. Rate Per RSF</u>	<u>Annual Rate Per RSF</u>	<u>Monthly Total</u>
Months 1-12	\$0.0000	\$ 0.00	\$ 0
Months 13-24	\$1.4125	\$ 16.95	\$ 135,035
Months 25-36	\$1.4542	\$ 17.45	\$ 139,018
Months 37-48	\$1.5000	\$ 18.00	\$ 143,400
Months 49-60	\$1.5500	\$ 18.60	\$ 148,180
Months 61-72	\$1.6017	\$ 19.22	\$ 153,119
Months 73-84	\$1.6550	\$ 19.86	\$ 158,218
Months 85-96	\$1.7100	\$ 20.52	\$ 163,476
Months 97-108	\$1.7667	\$ 21.20	\$ 168,893
Months 109-120	\$1.8250	\$ 21.90	\$ 174,470

- (m) Prepaid Rent: \$135,035.00 applicable to Month 13
- (n) Security Deposit: \$174,470.00; subject to the terms of Section 5.04.
- (o) Tenant's Share of Building: 100%
- (p) Tenant's Share of Project: 47.50%
- (q) Surface Parking Spaces: 287 uncovered surface parking spaces adjacent to the Building shall be provided for the use of Tenant, its employees and visitors, subject to a decrease resulting from Tenant requested site improvements/equipment.
- (r) Broker(s): Pacific Real Estate Partners, representing Landlord Broderick Group, Inc., representing Tenant
- (s) Guarantor: Instrumentarium Corporation, a Finnish corporation

(t)	Exhibits:	Exhibit A:	Legal Description of Property
		Exhibit B:	Project Site Plan
		Exhibit C-1:	Tenant Improvement Turn-Key Floor Plans
		Exhibit C-2:	Outline Specifications for Turn-Key Tenant Improvements
		Exhibit D:	Work Schedule
		Exhibit E:	Lease Confirmation
		Exhibit F:	Estoppel Certificate
		Exhibit G:	Rules and Regulations
		Exhibit H:	Memorandum of Lease
		Exhibit I:	Letter of Credit Form
		Exhibit J:	Form of Guaranty

2.01 Premises.

(a) Landlord hereby leases to Tenant, and Tenant hereby leases from Landlord, subject to the provisions of this Lease, certain premises ("Premises") to be located within that certain building ("Building") described in Subsection 1.01(h) above and situated on the real property ("Property") legally described in Exhibit A attached hereto and by this reference incorporated herein, which Property is a portion of the "Project" identified in Section 1.01(f). The location of the Property, the Building and the Premises are more particularly shown on the Project Site Plan and the Tenant Improvement Turn-Key Floor Plan(s) attached hereto as Exhibit B and Exhibit C-1, respectively.

(b) The term "Rentable Area of the Premises," "rentable square feet" "actual square footage" and words of similar import (whether or not spelled with initial capitals) as used in this Lease will be determined using the "Standard Method of Measuring Floor Area in Office Buildings" (approved June 7, 1996) by BOMA International for a single-tenant occupied building with the exception that Rentable Area shall be calculated by the BOMA definition of gross measured area (as opposed to the BOMA definition of Gross Building Area) (the "BOMA Standard"). Landlord and Tenant agree that, for purposes of this Lease, the Rentable Area of the Premises as of the Commencement Date of the Lease will be that set forth in Subsection 1.01(i) above and that Landlord and Tenant have both confirmed such area. Tenant acknowledges that, except as otherwise expressly set forth in this Lease, neither Landlord nor any agent of Landlord has made any representation or warranty with respect to the Premises, the Building, the Common Areas or the Project or their suitability for the conduct of Tenant's business.

2.02 Exclusive Areas; Common Areas.

(a) Subject to the terms of Section 8.05 below and/or except as otherwise expressly allowed by this Lease, Landlord agrees that Tenant shall have the exclusive right to possess and use the Building and all areas within the Building, Landlord acknowledges that the Building is a single tenant building and all of the space within constitutes the Premises. For so long as Tenant leases the entire Building pursuant to this Lease, Tenant shall have the exclusive right to control access to and from the Building utilizing any and all security and or access control, protocols or mechanisms as Tenant shall deem necessary in Tenant's sole and absolute discretion.

(b) In addition to the facilities located within the Property, Tenant shall have the non-exclusive right to use in common with other tenants and/or occupants of the Project, the following areas appurtenant to the Building: parking areas and facilities, roadways, sidewalks, walkways, parkways, plazas, driveways and landscaped areas and similar areas and facilities situated within the exterior areas of the Project and not otherwise designated for the exclusive or restricted use by Landlord and/or individual tenants of other buildings located within the Project (the "Common Areas"). Tenant acknowledges that Landlord shall have no obligation to construct or complete any additional buildings within the Project or improvements to the Common Areas other than Landlord's obligation to complete the construction of the sitework and

Common Areas of the Property pursuant to Article III below. Tenant's right to utilize the Common Areas shall at all times be subject to Landlord's reserved rights therein as described in Section 18.05 hereof, the existing Rules and Regulations referred to in Section 18.15 hereof and all covenants, conditions and restrictions ("CC&Rs") now or hereafter affecting or encumbering the Project; provided that the same do not materially adversely affect the rights of Tenant under this Lease. To the extent of any inconsistency between the Rules and Regulations or CC&Rs enacted after the date of this Lease, the terms and conditions of this Lease shall control as between Landlord and Tenant.

ARTICLE III: IMPROVEMENTS

3.01 Construction of Building and Premises.

(a) Completion Schedule. Landlord hereby agrees to construct the tenant improvements to the Building and Premises in a commercially reasonable and diligent manner substantially in accordance with the Tenant Improvement Plans described hereinbelow. Attached hereto as Exhibit D is a schedule (the "Work Schedule") setting forth the estimated timetable for the planning, permitting, construction and completion of the Tenant Improvements to the Building and Premises. Notwithstanding the foregoing, Landlord and Tenant shall periodically update the Work Schedule to incorporate Tenant's intended FF&E activities into the Work Schedule so as to coordinate integration of the same into the schedule for completion of the Tenant Improvements by Landlord.

(b) Plans. A list of the Turn-Key Tenant Improvement Plans are attached hereto as Exhibit C-1 and Outline Specifications for Turn-Key Tenant Improvements are attached hereto as Exhibit C-2 (collectively "Preliminary Plans"). Landlord's architect, in cooperation with Tenant and Landlord, shall prepare final working drawings and specifications for the improvements to the office area of the Premises (the "Tenant Improvement Plans") which shall be subject to the approval of Landlord and Tenant in accordance with the Work Schedule and shall not materially deviate from the Preliminary Plans referenced in Exhibits C-1 and C-2, respectively, unless Tenant agrees to pay for the costs, including design, permitting, construction and sales tax associated with such deviations. Tenant shall also have the right to request changes in the Tenant Improvement Plans and any such change shall be documented by Landlord's architect and subject to approval by Landlord, which approval shall not be unreasonably withheld, conditioned or delayed. Notwithstanding the above, it shall not be unreasonable for Landlord to disapprove a proposed change to the Preliminary Plans and/or Tenant Improvement Plans that results in a cumulative increase or decrease of more than 5% in the respective ratio between finished office area and assembly/distribution area. Upon Landlord's receipt of Tenant's request for a change to the Preliminary Plans or Tenant Improvement Plans, Landlord shall, as soon as practicable, using diligence, but no later than five (5) business days after receipt of such request, notify Tenant in writing as to (a) the affect of such change on the cost of the Tenant Improvements, including without limitation construction costs, sales tax, design costs and permits and fees (either a cost increase or cost decrease, if any); and (b) whether or not the implementation of such change will affect the timing of the construction of the Tenant Improvements, including without limitation, if the same will constitute a Tenant Delay (as defined below). Tenant shall have three (3) business days after Tenant's receipt of such notice

and information from Landlord to elect to proceed with such change and to deposit with Landlord 100% of the sum of any increased cost resulting in connection with such change, thereby agreeing with any change in cost of the Tenant Improvements. Landlord and Tenant agree that, with respect to any Tenant-requested change to the Preliminary Plans and/or Tenant Improvement Plans, Tenant shall be solely responsible for all cost increases but Tenant shall also receive the benefit of any cost savings by way of the netting of such savings against cost increases resulting from other modifications requested by Tenant to the Preliminary Plans and/or Tenant Improvement Plans. If Tenant shall fail to respond during such 3-business day period (or to deposit the required cost increase amount), then Tenant shall be conclusively presumed to have elected to not institute the relevant change.

(c) Construction of Tenant Improvements. Landlord shall cause Pennon Construction or other contractor(s) chosen by Landlord and reasonably approved by Tenant (the "Contractor") to construct the tenant improvements to the Premises ("Tenant Improvements") pursuant to the Tenant Improvement Plans. The Landlord shall enter into a separate or supplemental guaranteed maximum price contract with Contractor for construction of the Tenant Improvements. Landlord shall supervise the completion of such work and shall use its good faith diligent efforts to secure substantial completion of the work in accordance with the Work Schedule. The cost of such work shall be paid as provided in Paragraph 3.01(d) below.

(d) Payment for Construction of Tenant Improvements

(1) Subject to Sections 3.01(d)(2) and (3) below and subject to Tenant's obligation to pay for Tenant-initiated changes pursuant to Subsection 3.01(b) above, Landlord shall pay for all costs in connection with construction of the Tenant Improvements including, without limitation, the following:

(aa) Payment of the cost of preparing the Tenant Improvement Plans;

(bb) The payment of plan check, permit and license fees relating to construction of the Tenant Improvements (but specifically excluding permits, fees and other costs relating to Tenant's furniture, fixtures and/or equipment).

(cc) Construction of the Tenant Improvements pursuant to the Tenant Improvement Plans on a "turn-key" basis.

(2) Tenant shall pay any additional costs resulting from deviations from the Preliminary Plans contained in Exhibits C-1 and C-2 requested by Tenant and revisions to the Tenant Improvement Plans requested by Tenant, all of which shall be paid by Tenant upon approval of such deviations, as more particularly set forth in Subsection 3.01(b) above.

(3) Tenant will, at its sole cost and expense, pay for any improvements to the Premises not expressly included in the Tenant Improvement Plans which are outside the scope of the Tenant Improvement Plans and which were expressly authorized or requested by Tenant, and shall arrange for the installation of all Tenant's furniture, fixtures, equipment and cabling associated with its business. Costs associated with Tenant's equipment, layout, design and construction coordination are also the sole responsibility of Tenant.

(e) Delay in Completion. If there shall be a delay in substantial completion of the Tenant Improvements or the issuance of a Certificate of Occupancy, or other approval to occupy the Building and Premises, as a result of:

(1) Tenant's failure to approve any item or perform any other obligation within five (5) business days after receipt of notice from Landlord;

(2) Changes in materials, finishes or installations other than those readily available, if requested by Tenant and the effect of which Landlord has notified Tenant as provided hereinabove and/or failure of Tenant to approve substitute materials, finishes or installations upon notice from Landlord that the same are unavailable within the timeframes required by the Work Schedule;

(3) Deviation from the Preliminary Plans or Tenant Improvement Plans, if requested by Tenant and the effect of which Landlord has notified Tenant as provided hereinabove;

(4) Tenant's material interference with Landlord's construction of the Tenant Improvements during Tenant's work within the Premises (whether such work is performed by Tenant or its contractor or by Landlord or its contractor on Tenant's behalf) after Landlord has notified Tenant in writing of the likelihood of a delay resulting from such interference and Tenant has failed to cease such interference; or

(5) Coordination or installation of cabling and/or furniture, fixtures or equipment by Tenant or Tenant's contractors;

(each of which shall be deemed a "Tenant Delay") then the Commencement Date of the Term of the Lease shall be accelerated by the number of days of such Tenant Delay.

(f) Landlord Delay. If there shall be a delay in Landlord's delivery of the Premises to Tenant in FF&E Ready Condition as required by Subsection 4.01 below by the Scheduled Delivery Date, then the Fixturing Period (as defined in Subsection 3.04 below) shall not commence until Landlord has so delivered the Premises to Tenant in FF&E Ready Condition and the Commencement Date shall likewise be extended as contemplated by Subsection 4.01.

3.02 Completion and Delivery. The terms "substantial completion," "Substantial Completion," "Substantially Complete," "Substantially complete" and words of similar import (whether or not spelled with initial capitals) as used in the Lease shall mean the date of substantial completion of the Tenant Improvements pursuant to the Tenant Improvement Plans such that Tenant may occupy the Premises for the conduct of its business (subject to the completion of any additional construction to be performed by Tenant). The Premises shall be deemed substantially complete notwithstanding the fact that minor details of construction, mechanical adjustments or decorations which do not unreasonably interfere with Tenant's use and enjoyment of the Premises (items normally referred to as "punch list" items) remain to be performed; provided, however, substantial completion shall not be achieved until and unless all

of the following have occurred: (i) all primary Building operating systems serving the Premises and the Common Areas, as described in the Tenant Improvement Plans (including without limitation the vertical telephone risers or conduits to accommodate cables) are operational; (ii) at least one (1) passenger elevator is servicing the Premises from the ground floor lobby of the Building; (iii) the restrooms are fully operational and are substantially complete with all finishes installed therein, except for minor punch list items; (iv) Tenant has reasonably unimpeded and safe access for itself, its employees and invitees to the Building, parking facility and the Premises; (v) one (1) freight elevator and at least one (1) passenger elevator in the Building are operational and accessible by Tenant and Tenant's furniture installers and movers; (vi) the ground floor lobby of the Building is substantially complete in accordance with the Tenant Improvement Plans, subject to normal and customary punch list items; (vii) the parking facility for the Building is substantially complete with safe and unimpeded vehicular access thereto reasonably available; and (viii) access between the parking facility and the Building is substantially complete with reasonable unimpeded and safe access from the parking facility to the Building. Notwithstanding the above, if and to the extent any of (i)-(viii) above involve systems requiring integral Tenant-provided components (such as data/voice cabling, cubical office partitions, data/phone room equipment, furniture, UPS, fume hoods, card access readers, manufacturing/assembly equipment, etc.), the failure of such systems to be fully operable shall not delay the date of substantial completion, but Landlord shall diligently complete the same upon Tenant's furnishing and/or installation of such Tenant-provided components. Certification by Landlord's architect as to the substantial completion of the Premises together with a certificate of occupancy or other comparable approval to occupy issued by the City of Issaquah with respect to the Premises (temporary or permanent) shall be conclusive and binding upon Landlord and Tenant. By taking occupancy of the Premises, Tenant shall be deemed to have accepted the Premises and the Building as substantially complete, except that Tenant shall, within twenty (20) days after entering into possession of the Premises, provide Landlord with a list of punch list items remaining to be completed. Landlord shall diligently complete such punch list items, as soon as reasonably possible (but in no event later than 30 days after Landlord's receipt of such punch list except to the extent material or labor availability makes such 30 day period commercially unreasonable for an applicable punch list item, in which event such item shall be completed diligently and in a commercially reasonable time frame). The Commencement Date shall not be delayed because of the existence of uncorrected punch list items. If and to the extent required and requested by Tenant with respect to any applicable and discovered defect or deficiency required to be repaired by Tenant pursuant to this Lease, Landlord hereby agrees to assign to Tenant the benefit of any applicable warranties with respect to the Premises or any portion of thereof for which Tenant shall have repair or maintenance responsibility under this Lease which warranties, Landlord covenants and agrees, shall include a twelve (12) month warranty with respect to new systems associated with the Tenant Improvements. At Landlord's election, Landlord may, by written notice to Tenant, pursue any warranty claim and pursue such repairs covered by warranty notwithstanding that Tenant may be responsible for the applicable repair pursuant to this Lease.

3.03 Delay in Construction, Substantial Completion and/or Delivery.

(a) Delay Penalties. Notwithstanding the above, in the event the Premises are not tendered to Tenant in Tenant FF&E Ready Condition (as defined in Section 4.01) by February 1, 2003 (which such date is referred to herein as the "Scheduled Delivery Date"), Landlord shall pay

Tenant (or, at Tenant's election Tenant shall receive as a credit against Base Rent payable under this Lease) an amount equal to \$2,500.00 per day for each of the initial fifteen (15) days of delay beyond the Scheduled Delivery Date, and \$5,000.00 per day for the next one hundred and twenty (120) days of delay (after the first 15 days of delay beyond the Scheduled Delivery Date), up to and including one hundred thirty-five (135) days of total delay beyond the Scheduled Delivery Date; provided, however, the Scheduled Delivery Date shall be extended by a day for each day of delay in completion of the Premises resulting from any "Tenant Delay" (as defined in Section 3.01(e) above, inclement weather (defined as weather which delays critical path activities of construction of the Tenant Improvements), earthquake, flood, fire or other casualty, strike, work stoppages, acts of war or terrorism, slow downs or other labor trouble caused by organized labor, governmental controls (other than failure to receive permits for the Tenant Improvements), or any similar causes, beyond Landlord's reasonable control (any of which delays are referred to herein as "delays beyond Landlord's reasonable control"). Except as expressly contemplated above in this Section 3.03, Landlord shall not be liable to Tenant or any other party, nor shall Tenant have any recourse against Landlord, for any direct or indirect damages as a result of Landlord's failure to deliver the Premises to Tenant within the time periods contemplated herein and/or in the Work Schedule.

(b) Termination Rights. In the event Landlord has not delivered the Premises to Tenant in FF&E Ready Condition on or before the date one hundred and thirty-five (135) days after the Scheduled Delivery Date (the "First Termination Milestone"), then either Landlord or Tenant may elect to terminate this Lease by written notice to the other within ten (10) days after said First Termination Milestone; provided, however, the First Termination Milestone shall be extended by a day for each day of delay in completion of the Premises to FF&E Ready Condition resulting from any "Tenant Delay" or other delays beyond Landlord's reasonable control (each as defined above). In addition, in the event Landlord has not delivered the Premises to Tenant in FF&E Ready Condition on or before the date one hundred and ninety-five (195) days after the Scheduled Delivery Date (the "Second Termination Milestone"), then either Landlord or Tenant may elect to terminate this Lease by written notice to the other within ten (10) days after said Second Termination Milestone; provided, however, the Second Termination Milestone shall be extended by a day for each day of delay in completion of the Premises to FF&E Ready Condition resulting from any "Tenant Delay" (as defined above).

3.04 Early Access. Landlord agrees to allow Tenant limited access to the Premises not less than fifteen (15) days prior to the Commencement Date for installation of Tenant's furniture, fixtures and equipment ("Fixturing Period"); provided, that such early entry by Tenant shall in no way materially interfere with or cause delays in Landlord's construction. Tenant shall be deemed to have waived and released Landlord, its agents, employees and contractors from and with respect to any personal injury or property damage resulting from, during or in connection with such early occupancy by Tenant. During the Fixturing Period, Landlord and Tenant agree to cause their respective contractors (and subcontractors) to reasonably cooperate with each other so as to minimize any potential Tenant Delay and or Landlord Delay resulting from Tenant's early access. Any such early access or occupancy by Tenant shall be subject to the terms and conditions of this Lease (including without limitation any required insurance coverage) except that Tenant shall not be required to pay Base Rent or Operating Expenses during or with respect to such early access or occupancy period.

ARTICLE IV: TERM

4.01 Term. The Term shall commence (“Commencement Date”) on the latest to occur of (a) the date of substantial completion of the Tenant Improvements, or (b) the date of receipt of a temporary certificate of occupancy or other approval by the City of Issaquah allowing occupancy of the Premises by Tenant, or (c) the date fifteen (15) days following Landlord’s delivery of the Premises to Tenant in FF&E Ready Condition. “FF&E Ready Condition” shall be defined as the Premises being improved to a level of completeness that allows Tenant to commence installation of data/voice cabling, cubical office partitions, and data/phone room equipment and shall specifically require that carpet be installed at floor areas to receive cubical office furniture, walls to be painted that are to receive fixed office furniture systems, and that overhead work be complete, except for final electrical/mechanical trim, acoustical tile, installation of Tenant’s manufacturing/assembly equipment and data/voice systems. Notwithstanding the foregoing, in the event the Commencement Date does not occur on the Scheduled Commencement Date, or any date thereafter, due to a Tenant Delay, then the Commencement Date shall be deemed to have occurred on the date on which the Commencement Date would have otherwise occurred but for the Tenant Delay. In the event Landlord is not able to deliver the Premises to Tenant in FF&E Ready Condition by the Scheduled Delivery Date or Landlord cannot substantially complete the Premises on or before the Scheduled Commencement Date, then Landlord shall notify Tenant in writing as soon as Landlord reasonably determines that it will not make such dates, which notice shall specify the new estimated Scheduled Delivery Date and/or the new Scheduled Commencement Date, as applicable. The Term shall expire upon the later to occur of (which later to occur date is referred to as the “Expiration Date”): (i) the date ten (10) years (120 months) after the Commencement Date, or (ii) the “Expiration Date” of Tenant’s lease of Building B of the Project, unless sooner terminated as hereinafter provided.

4.02 Notice of Commencement Date/Lease Confirmation. Landlord shall use good faith efforts to inform Tenant of the estimated date of substantial completion at least ten (10) days prior to such date. Upon ascertaining the date of substantial completion and the Commencement Date, Landlord shall deliver to Tenant a written confirmation in the form attached hereto as Exhibit E (“Lease Confirmation”) of said dates of substantial completion and the Commencement Date. The Lease Confirmation shall be binding upon Tenant unless Tenant objects to the same in writing delivered to Landlord within five (5) days of Tenant’s receipt of said Lease Confirmation.

4.03 Option to Extend. Landlord hereby grants Tenant the right to extend the term of the Lease for one (1) period of five (5) years (such extended period is hereinafter referred to as the “Extended Term”) on the same terms and conditions contained in the Lease, except that (i) Base Rent for the Extended Term shall be as set forth hereinbelow, and (ii) no additional options to extend shall apply following the expiration of the Extended Term. Written notice of Tenant’s exercise of its option to extend (“Option to Extend”) the Term of this Lease for the Extended Term must be given to Landlord no less than twelve (12) months prior to the Expiration Date. If Tenant is in default under this Lease and all applicable notice and cure periods have run, then Tenant shall have no right to extend the Term of this Lease; provided, however that the period of time within

which said option may be exercised shall not be extended or enlarged by reason of Tenant's inability to exercise said option because of such default. In the event Tenant validly exercises its Option to Extend the Term of this Lease as herein provided, Base Rent shall be adjusted as of the commencement date of the Extended Term as follows:

(a) Within thirty (30) days after exercise of its Option to Extend by Tenant, Landlord shall provide Tenant with Landlord's determination of the fair market Base Rent for the Extended Term, including periodic increases as dictated by the current market ("Landlord's Determination of Base Rent for Extended Term"). No later than the date thirty (30) days after Tenant's receipt of Landlord's Determination of Base Rent for Extended Term, Tenant shall provide notice to Landlord electing either: (i) to accept Landlord's Determination of Base Rent for Extended Term; or (ii) to withdraw Tenant's exercise of its Option to Extend, or (iii) to disapprove Landlord's Determination of Base Rent for Extended Term but to not withdraw its exercise of the Option to Extend. In the event Tenant fails to give Landlord notice of its election of (i), (ii), or (iii) in the preceding sentence, Tenant shall be deemed to have elected to disapprove Landlord's Determination of Base Rent and to have withdrawn its exercise of its Option to Extend and the Term shall expire at the end of the initial Term and Tenant shall have no further rights under this Subsection 4.03. In the event Tenant accepts Landlord's Determination of Base Rent for Extended Term, then the Landlord's Determination of Base Rent for Extended Term shall be the Base Rent for the Extended Term. In the event Tenant elects to withdraw its exercise of its Option to Extend for the applicable Extended Term by timely notice as required in (ii) above, then this Lease shall terminate at the expiration of the initial Term and neither party shall have any further rights or obligations pursuant to this Subsection 4.03. In the event Tenant gives notice that Tenant disapproves Landlord's Determination of Base Rent for Extended Term without withdrawing its exercise of its Option to Extend, as contemplated by (iii) above, then Landlord and Tenant shall be bound to extend the Term of the Lease for the Extended Term and the Base Rent for the Extended Term shall be determined as set forth below.

(b) Within thirty (30) days after the election of the alternative set forth in Subsection 4.03(a)(iii) above, each party, at its own cost and by giving notice to the other party, shall appoint a real estate appraiser with at least ten (10) years full-time commercial real estate appraisal experience in the area in which the Premises are located to appraise and set Base Rent for the Extended Term. If a party does not appoint an appraiser by the later to occur of (i) the expiration of such thirty (30) day period or, (ii) the date ten (10) days after the other party has given notice of the name of its appraiser, the single appraiser appointed shall be the sole appraiser and shall set Base Rent for the Extended Term. If each party shall have so appointed an appraiser, the two appraisers shall meet promptly and attempt to set the Base Rent for the Extended Term. If the two appraisers are unable to agree within thirty (30) days after the second appraiser has been appointed, they shall attempt to select a third appraiser meeting the qualifications herein stated within ten (10) days after the last day the two appraisers are given to set Base Rent. If the two appraisers are unable to agree on the third appraiser within such ten (10) day period, either of the parties to this Lease, by giving five (5) days notice to the other party, may apply to the then presiding judge of the Superior Court of King County for the selection of a third appraiser meeting the qualifications stated in this paragraph. Each of the parties shall bear one-half (1/2) of the cost of appointing the third appraiser and of paying the third appraiser's fee. The third appraiser, however selected, shall be a person who has not previously acted in any capacity for either party.

(c) Within thirty (30) days after the selection of the third appraiser, a majority of the appraisers shall set Base Rent for the Extended Term. If a majority of the appraisers are unable to set Base Rent within the stipulated period of time, the three appraisals shall be added together and their total divided by three (3). The resulting quotient shall be the Base Rent for the Premises during the Extended Term. If, however, the low appraisal and/or the high appraisal is/are more than ten percent (10%) lower and/or higher than the middle appraisal, the low appraisal and/or the high appraisal shall be disregarded. If only one (1) appraisal is disregarded, the remaining two (2) appraisals shall be added together and their total divided by two (2), and the resulting quotient shall be Base Rent for the Premises during the Extended Term.

(d) For purposes of the appraisal, the term “-fair market Base Rent-” shall mean the price that a ready and willing tenant would pay, as of the Extended Term commencement date, as a base rent to a ready and willing landlord of buildings of comparable size and quality (assuming improved as office space), if such premises were exposed for lease on the open market for a reasonable period of time; including any rent increases over the Extended Term to the extent normal under then current market conditions. In no event shall there be deducted from such fair market Base Rent, the value of any concessions, including without limitation tenant improvements, commissions, free rent and/or “downtime”. In no event shall the fair market Base Rent determined pursuant to this Section 4.03 be less than the Base Rent in effect during the last month of the initial Lease Term.

(e) In the event Tenant timely exercises its Option to Extend pursuant to this Subsection 4.03 (and Tenant does not withdraw its exercise pursuant to Subsection 4.03(a)(ii) above), then Landlord shall provide Tenant with an allowance for re-painting and re-carpeting of the Premises in an amount of \$6.40 per square foot of the Premises, to be used to reimburse Tenant for actual substantiated costs incurred by Tenant in re-painting and/or re-carpeting the Premises during the first twelve (12) months of the Extended Term.

4.04 Option to Terminate. Tenant shall have the one time only option to terminate this Lease (“Option to Terminate”) effective at the end of the sixtieth (60th) full calendar month (sometimes referred to as the “effective date of the Lease termination”) of the initial ten (10) year Lease Term. The Tenant’s Option to Terminate is subject to the following terms and provisions:

(a) Tenant shall provide written notice (the Tenant’s Notice”) of its election to exercise the Option to Terminate. The Tenant’s Notice shall be delivered to Landlord not later than the date eighteen (18) months prior to the last day of the sixtieth (60th) full calendar month of the initial ten (10) year Lease term.

(b) Tenant shall not be in default under the terms and provisions of this Lease when the Tenant gives Landlord the Tenant’s Notice or at the effective date of the Lease termination.

(c) On or before the date thirty (30) days prior to the effective date of the Lease termination, the Tenant shall pay to Landlord the cash sum of \$2,360,000.00 (the “Lease Termination Fee”).

(d) Tenant may only exercise its right to terminate this Lease pursuant to this Subsection 4.04 if Tenant also simultaneously terminates its Lease of Building B of the Project.

Failure of Tenant to timely meet the conditions set forth in Subsection 4.04(a)-(d) above shall, at Landlord's election, render Tenant's election to terminate hereunder null and void and the Lease shall continue to be in full force and effect for the entire Term.

ARTICLE V: RENT

5.01 Base Rent. The Base Rent ("Base Rent") shall be as set forth in Section 1.01(l). The Base Rent shall be paid in advance on the first day of each and every month during the Term to Landlord at the address set forth in Section 1.01(b) hereof or at such other place as Landlord may direct in writing, without any prior demand therefor and without any abatement, deduction or setoff whatsoever, except as expressly set forth herein. If the Term commences on any day other than the first day of a calendar month and/or ends on any day other than the last day of a calendar month, Base Rent for the fraction(s) of a month at the commencement and/or upon the expiration of the Term shall be prorated based upon the actual number of days in such fractional month(s). Simultaneously with execution of this Lease, Tenant shall deposit with Landlord the Prepaid Rent identified in Section 1.01(m), which sum shall be applied by Landlord as indicated in said Section 1.01(m).

5.02 Additional Rent. In addition to Base Rent, Tenant shall pay to Landlord all sums of money or other charges required to be paid by the Tenant under this Lease (other than Base Rent and the Prepaid Rent), including but not limited to Tenant's Share of Operating Expenses (as defined in Article VI hereof) (all such sums being herein deemed "Additional Rent"), and whether or not the same are designated "Additional Rent" the same shall be payable in lawful money of the United States of America without deduction, set-off or abatement whatsoever, except as expressly set forth herein. Any Additional Rent provided for in this Lease shall become due with the next monthly installment of Base Rent unless otherwise provided. The term "Rent", as used in this Lease, shall refer collectively to "Base Rent" and "Additional Rent."

5.03 Late Payment. If any payment of Rent is not received by Landlord within five (5) days after written notice from Landlord to Tenant that the same is past due (provided, however, Tenant shall only be entitled to one (1) such notices in any twelve (12) month period; thereafter, Tenant shall pay a late fee if Tenant fails to pay within five (5) days after the same is due), Tenant shall pay to Landlord a late payment charge equal to five percent (5%) of the amount of such delinquent payment of Rent in addition to the installment of Rent then owing. In addition, Tenant shall pay interest on such late payment and late charge from and after the expiration of thirty (30) days following the due date of the late payment at an interest rate equal to the lesser of (a) the prevailing prime (reference) rate as published by Bank of America (or any successor bank) at its Seattle main branch office, or any successor rate of interest, plus three (3) percentage points, or (b) the maximum rate permitted by applicable law (hereafter the "Default Rate"), until such amounts are paid. Landlord and Tenant recognize that the damages which Landlord will suffer as a result of Tenant's failure to timely pay Rent are difficult or impracticable to ascertain, and agree that said interest and late charge are a reasonable approximation of the damages which

Landlord will suffer in the event of Tenant's late payment. This provision shall not relieve Tenant from payment of Rent at the time and in the manner herein specified. Acceptance by Landlord of any such interest and late charge shall not constitute a waiver of Tenant's default with respect to said overdue amount, nor shall it prevent Landlord from exercising any other rights or remedies available to Landlord.

5.04 Security Deposit.. Tenant will simultaneously with execution of this Lease, deposit with Landlord the sum specified in Section 1.01(n) of this Lease. This sum shall belong to Landlord and shall constitute partial consideration for the execution of this Lease. Landlord shall pay Tenant the remaining balance thereof, without any liability for interest thereon, within thirty (30) days after the expiration or prior termination of the Lease Term, or any extension thereof, if and only if Tenant has fully performed all of its obligations under the terms of this Lease. Landlord shall be entitled to withdraw from the deposit the amount of any unpaid Base Rent, Additional Rent or other charges not paid to Landlord when due, and Tenant shall immediately re-deposit an amount equal to that so withdrawn within ten (10) days of demand.

ARTICLE VI: ADDITIONAL RENT AND CHARGES

6.01 Operating Expenses. In addition to Base Rent and other sums payable by Tenant under this Lease, Tenant shall pay to Landlord, as Additional Rent, Tenant's Share of the Operating Expenses (as such term is defined below).

(a) Estimated Expenses.

(i) Prior to the Commencement Date, and thereafter prior to the commencement of each calendar year occurring wholly or partially within the Term, Landlord shall estimate the annual Operating Expenses payable by Tenant pursuant to this provision, and Tenant shall pay to Landlord on the first day of each month in advance, one-twelfth (1/12th) of Tenant's Share of such estimated amount. In the event that during any calendar year of the Term, Landlord determines that the actual Operating Expenses for such year will exceed the estimated Operating Expenses, Landlord may revise such estimate by written notice to Tenant (but only once per year), and Tenant shall pay to Landlord, concurrently with the regular monthly rent payment next due following the receipt of the revised estimate, an amount equal to one monthly installment of such increase multiplied by the number of months expired during such calendar year to and including the month of such payment; provided, however, in the event any line item of Landlord's estimate for any calendar year increases by more than three percent (3%) over the prior calendar year, Landlord shall, at the time of the estimate revision, provide Tenant with reasonable substantiation of such increase. Subsequent installments shall be payable concurrently with the regular monthly Base Rent due for the balance of the calendar year and shall continue until the next calendar year's estimate is rendered. Notwithstanding the foregoing, at Tenant's request, Landlord agrees to meet with Tenant to discuss Landlord's budget and estimate of the next year's Operating Expenses.

(ii) Within ninety (90) days following the end of each calendar year falling wholly or partially during the Lease Term, Landlord shall provide Tenant with a written statement of the actual total Operating Expenses for such year and there shall be an adjustment

made to account for any difference between Tenant's Share of the actual and the estimated Operating Expenses for the previous year. If Tenant has overpaid the amount of Operating Expenses owing pursuant to this provision, Landlord shall credit such overpayment to Tenant's account. If Tenant has underpaid the amount of Operating Expenses owing pursuant to this provision, Tenant shall pay the total amount of such deficiency to Landlord as Additional Rent with the next payment of Base Rent due under this Lease following delivery of written notice of said deficiency from Landlord to Tenant.

(iii) Landlord shall keep its books of account and records concerning Operating Expenses in compliance with generally accepted accounting principles and retain the same for five (5) years after the calendar year for which they were prepared. Tenant shall have the right, at such time and place as Landlord may reasonably designate, not more than once in any twelve (12) month period, to inspect and audit Landlord's books and records related to the operation and maintenance of the Project, for the purpose of verifying Operating Expenses payable by Tenant. Tenant may employ an independent public accounting firm or other consulting company to conduct the audit. The costs of the audit shall be paid by Tenant unless the audit shows that Landlord's adjusted statement over-charged Tenant its share of Operating Expenses by more than three percent (3%), in which case Landlord shall pay all Tenant's costs of the audit; provided, however, in the event Landlord disputes the results of Tenant's audit, Landlord may, upon written notice to Tenant, submit the issue to binding arbitration pursuant to the rules of the American Arbitration Association, which arbitration shall take place in Seattle, Washington. Unless Tenant objects in writing regarding specific discrepancies in the Operating Expense calculations for any calendar year within twelve (12) months after receipt of Landlord's final calculations for such calendar year, Tenant shall be deemed to have approved the same and to have waived the right to object to such calculations. Notwithstanding anything in this Section 6.01 to the contrary, commencing with the second calendar year of the Lease Term, Tenant's Share of controllable Common Area costs (defined as the cost of landscaping, parking sweeping and snow removal, janitorial and other controllable expenses associated with the physical upkeep of the Common Areas) shall not increase by more than five percent (5%) per calendar year on a cumulative basis.

(b) Defined Terms.

(i) Operating Expenses Inclusions. For purposes of this Lease, "Operating Expenses" means, except as provided below, an amount equivalent to the total of all expenses and costs incurred in connection with the ownership, operation, management, maintenance, repair and replacement of the Property, the Building and the Common Areas, including, but in no way limited to, the following:

A. The costs of operating, maintaining, repairing and replacing the Property, the Building and the Common Areas, including but not limited to: gardening and landscaping; painting; lighting; sanitary control; personal property taxes; public liability insurance and property damage insurance; utilities for the Common Areas; licenses and fees for the Common Area facilities; sweeping; removal of snow and ice, trash, rubbish, garbage and other refuse; repairing, restriping and resurfacing of parking area; and maintenance of and property taxes on personal property, machinery and equipment used in Common Area maintenance.

B. The Building's pro rata share of the costs of operating, maintaining, repairing and replacing the Common Areas, and other reasonable Project costs that are equitably allocated among the benefited properties.

C. All Real Property Taxes (as defined below) assessed against the Property, including land, Building and improvements thereon or thereto.

D. All premiums for fire, extended coverage and other insurance the Landlord reasonably deems necessary and keeps in force on or with respect to the Property and the Building of which the Premises are a part and/or the Common Areas, as the case may be, and commercially reasonable deductibles payable in connection therewith.

E. The cost of operating, maintaining, repairing and replacing any electrical, mechanical, automatic fire sprinkler and other utilities systems serving the Property, the Building and/or the Premises.

F. The cost of maintenance, repair and replacement of the structural and non-structural portions of the roof, roof membrane, exterior walls, foundation, and other exterior portions of the Building.

G. Property management charges in an amount equal to 3% of Base Rent and Operating Expenses payable hereunder (provided that during any free rent period the 3% shall be based on the Base Rent and Operating Expenses next payable after the applicable free rent period), together with the reasonable allocation of costs incurred in the operation of a management office, including without limitation the equitably allocated cost of rent and utilities.

H. Costs of replacements and improvements which are necessary to adequately maintain or protect the Property, the Building and/or the Common Areas, as the case may be, and/or which are required by law or governmental regulation enacted after the Commencement Date of this Lease, which are of a capital nature (as determined by GAAP accounting) to the extent amortization over the useful life thereof is applicable to the periods during the Lease Term.

I. Any other costs levied, assessed or imposed by or at the direction of, or resulting from statutes or regulations or interpretations thereof promulgated by any federal or governmental authority in connection with the use or occupancy of the Building.

J. Assessments made on or with respect to the Property made pursuant to any CC&Rs, Public Utility District conditions, Local Improvement District conditions and/or owner's associations affecting the Property, or any portion thereof, to the extent not recovered pursuant to Section B above.

K. Compensation (including wages and employer paid benefits and taxes) of employees and contractors proportionately to the extent engaged in the operation and maintenance of the Project, Property and/or Building.

(ii) Operating Expense Exclusions. Notwithstanding the foregoing, Operating Expenses to be reimbursed by Tenant shall not include:

A. Expenses which are separately metered or calculated for the Premises or other leased area of the Project or the Building, as the case may be, which expenses shall be billed separately to Tenant or such other tenant(s), as applicable.

B. Costs incurred in connection with the initial construction or design of the Tenant Improvements or to correct defects in the original construction or design of the Building.

C. Depreciation or amortization of expenses, except as expressly permitted above.

D. Costs, fines, interest or penalties incurred due to violation by Landlord of any applicable law.

E. Expenses incurred by Landlord in respect of individual tenants and/or the improvement or renovation of tenants' leasehold improvements, including leasing commissions, attorneys' fees arising from lease disputes and other specific costs incurred for the account of, separately billed to and paid by specific tenants.

F. Repairs or replacements to the extent that the cost of the same is recoverable by the Landlord pursuant to original construction warranties.

G. Interest on debt or capital retirement of debt, and costs of capital improvements except as expressly provided above.

H. Legal fees and disbursements relating to legal matters other than such fees and costs directly relating to Operating Expense issues in connection with the Project, the Property, the Building, the Premises and/or the Common Areas.

I. Latent defects in the initial construction of the Building and Premises.

J. The failure of the Building, as initially constructed, to comply with laws, regulations and ordinances in effect as of the date of permit vesting.

K. Except to the extent included in the costs described in subsections (i)(G) and/or (i)(K) above, costs associated with the operation of the business of the ownership or entity which constitutes "Landlord", as distinguished from the costs of building operations, including, but not limited to, partnership accounting, consulting and legal matters not

specifically benefiting the Property or occupants thereof, costs of defending any lawsuits with any mortgagee (except as the actions of any tenant may be in issue), costs of selling, syndicating, financing, mortgaging or hypothecating any of Landlord's interest in the Building, costs of any disputes between Landlord and its employees (if any) not engaged in Building operations, disputes of Landlord with Building management, or outside fees paid in connection with disputes with other tenants;

L. Costs of alterations or improvements to the Premises or the premises of other tenants;

M. Expenses directly resulting from the negligence and/or willful misconduct of Landlord, its agents, servants or employees;

N. Costs for which Landlord is reimbursed by its insurance carrier or any tenant's insurance carrier (excluding deductibles);

O. Any bad debt loss, rent loss, or reserves for bad debts or rent loss;

P. Wages and salaries of management or supervising employees offsite above the level of asset manager; and the wages of any employee who does not devote substantially all of his or her time to the Building (such as senior asset manager) except to the extent equitably apportioned among all projects for which such employee performed services based upon the time such employee spent on each project relative to the total time devoted by such employee to all projects;

Q. Amounts paid as ground rental by Landlord;

R. Any recalculation of or additional Operating Expenses actually incurred more than three (3) years prior to the year in which Landlord proposes that such costs be included, except to the extent Landlord did not have notice and was unaware of such additional costs at the expiration of such three (3) year period;

S. Costs incurred by Landlord with respect to goods and services (including utilities sold and supplied to tenants and occupants of the Building) to the extent that Landlord is entitled to and actually receives reimbursement for such costs directly from such tenant(s);

T. Costs incurred by Landlord for alterations which are considered capital improvements under generally accepted accounting principles, consistently applied, except as set forth in subsection (i)H above;

U. Any costs paid to Landlord or to subsidiaries or affiliates of Landlord for services in the Building to the extent the same exceeds the costs of such services rendered by unaffiliated third parties on a competitive basis;

V. Rentals and other related expenses incurred in leasing air conditioning systems, elevators or other equipment ordinarily considered to be of a capital nature, except equipment not affixed to the Building which is used in providing janitorial or similar services and except for temporary rentals that are necessitated by an emergency;

W. Any costs to repair or restore any portion of the Project following a condemnation or a casualty (except to the extent of a commercially reasonable deductible amount);

X. Any costs incurred by Landlord to correct any violation of any laws, ordinances, rules, regulations, permits or licenses in effect as of the date of permit vesting for the Building;

Y. Costs incurred to remove, encapsulate or remediate asbestos or any Hazardous Materials (as defined in Section 10.02).

Z. Costs associated with the development, leasing, landscaping, taxes, maintenance or sale of or any other costs attributable to pad sites, development sites or any other non Building areas within the Project which are not common areas which benefit the Building.

It is understood that Operating Expenses shall be reduced by all cash discounts, trade discounts, or quantity discounts received by Landlord or Landlord's managing agent in the purchase of any goods, utilities, or services in connection with the operation of the Building. In the calculation of any expenses hereunder, it is understood that no expense shall be charged in duplicate. Landlord shall use commercially reasonable efforts to effect an equitable proration of bills for services rendered to the Building and to any other property owned by Landlord. Landlord agrees to keep books and records showing the Operating Expenses in accordance with a system of generally accepted accounting practices consistently maintained on a year-to-year basis.

Additional Rent payable by Tenant which would not otherwise be due until after the date of the expiration or earlier termination of the Lease shall, if the exact amount is uncertain at the time this Lease expires or terminates, be paid by Tenant to Landlord upon such expiration or termination in an amount to be determined by Landlord, with an adjustment to be made once the exact amount is known.

(iii) Tenant's Share. For purposes of this Lease, "Tenant's Share" means the percentage, as set forth in Section 1.01(o) or Section 1.01(p), as appropriate, and obtained by dividing the Rentable Area of the Premises by the aggregate Rentable Area of all premises available for lease, whether leased or not, in the Building or Project, as applicable, subject to adjustment in the event of changes in Rentable Area of the Project, the Building and/or the Premises. Notwithstanding the above, Landlord shall have the right, but not the obligation, to equitably adjust Tenant's Share of any specific Operating Expense so as to render such expense payable proportionately by those parties benefited by the same or otherwise in order to appropriately allocate such Operating Expense over the area covered by such Operating Expense.

(iv) Real Property Taxes. For purposes of this Lease, "Real Property Taxes" shall consist of all transit charges, housing fund assessments, real estate taxes and all other taxes relating to the Building, the Property, and the Common Areas located on the Property, all other taxes which may be levied in lieu of real estate taxes, all assessments, local improvement districts, assessment bonds, levies, fees and other governmental charges, including, but not limited to, charges for traffic facilities and improvements, water service studies, and improvements or amounts necessary to be expended because of governmental orders, whether general or special, ordinary or extraordinary, unforeseen as well as foreseen, of any kind and nature for public improvements, services, benefits, or any other purpose, which are assessed, levied, confirmed, imposed or become a lien upon the Building or any portion of the Property, or become payable during the Term (or which become payable after the expiration or earlier termination hereof and are attributable in whole or in part to any period during the Term hereof), together with all costs and expenses incurred by Landlord in successfully contesting, resisting or appealing any such taxes, rates, duties, levies or assessments. "Real Property Taxes" shall exclude any franchise, estate, inheritance or succession transfer tax of Landlord, or any federal or state income, profits or revenue tax or charge upon the net income of Landlord from all sources; provided, however, that if at any time during the Term there is levied or assessed against Landlord a federal, state or local tax or excise tax on rent, or any other tax however described on account of rent or gross receipts or any portion thereof, Tenant shall pay one hundred percent (100%) of the Tenant's Share of any said tax or excise applicable to Tenant's Rent as Additional Rent.

During any period in which Tenant leases 100% of the Rentable Area of the Property, if the ad valorem tax assessment of the Property and Building for any calendar year increases by more than five percent (5%) from the prior year's assessment, Tenant shall have the right, by written notice to Landlord, to cause Landlord to contest or protest, through appropriate legal proceedings, such increased assessment. The cost of any such challenge shall be borne by Tenant but, if Landlord is successful in obtaining a reduced assessment or tax refund, Tenant shall be entitled to recoup its reasonable out-of-pocket expenses from the refund before the refund is applied against Operating Expenses. Tenant may only require Landlord to contest the amount or validity of any real estate taxes by appropriate proceedings and only if the Property or any part thereof would not by reason of such postponement or deferment be in danger of being forfeited or lost. Landlord shall not be subjected to any liability for the payment of any costs or expenses in connection with any such proceedings or any increased assessment of the Project which results from such proceeding.

6.02 Tenant's Personal Property Taxes. Tenant shall pay or cause to be paid, prior to delinquency, any and all taxes and assessments levied upon any trade fixtures, inventories and other real or personal property placed or installed in and/or upon the Premises by Tenant. If any such taxes on Tenant's personal property or trade fixtures are levied against Landlord or Landlord's property or if the assessed value of the Building is increased by the inclusion therein of a value placed upon such real or personal property or trade fixtures of Tenant, and if Landlord pays the taxes based upon such increased assessment, Tenant shall, upon not less than 30-days prior demand, repay to Landlord the taxes so levied or the portion of such taxes resulting from such increase in the assessment.

ARTICLE VII: INSURANCE

7.01 Landlord's Insurance. During the Term, Landlord shall procure and maintain in full force and effect with respect to the Building a an "all-risk" policy or policies of property insurance (including, to the extent required, sprinkler leakage, vandalism and malicious mischief coverage, and any other endorsements required by the holder of any fee or leasehold mortgage and earthquake and flood insurance if Landlord so requires) in 100% replacement value of the Building and Premises (excluding foundations). Landlord shall have the right, at its option, to keep and maintain in full force and effect during the Term such other insurance in such amounts and on such terms as Landlord and/or any first mortgagees or the beneficiary of any first trust deed against the Building, or the portion of the Property and/or the Project in which the Building is located, may reasonably require from time to time in form, in amounts and for insurance risks against which a prudent Landlord of similarly situated first class office buildings in the Issaquah, Washington area would protect itself, including but not limited to rental abatement, rental interruption, general commercial liability and earthquake and flood insurance.

7.02 Liability Insurance. Tenant shall, at its own cost and expense, keep and maintain in full force during the Term and any other period of occupancy of the Premises by Tenant, a policy or policies of commercial liability insurance, written by a reputable insurance company authorized to do business in the State of Washington in form and content acceptable to Landlord insuring Landlord's and Tenant's activities with respect to the Premises, the Common Areas and the Building for loss, damage or liability for personal injury or death of any person or loss or damage to property occurring in, upon or about the Building in an amount of not less than Three Million Dollars (\$3,000,000) combined single limit (with a \$5,000,000 of umbrella coverage). The policy shall insure the hazards of the Premises and Tenant's operations therein, shall include independent contractor and contractual liability coverage (covering the indemnity contained in Section 7.08 hereof) and shall name both Landlord and Tenant as insureds as their interests appear and shall contain a provision that the insurance provided hereunder shall be primary and non-contributing with any other insurance available to the other party.

7.03 Tenant's Property and Other Insurance. Tenant shall, at its own cost and expense, keep and maintain in full force during the Term and any other period of occupancy of the Premises, a policy or policies of standard form property insurance insuring against the perils of fire, extended coverage, vandalism, malicious mischief, special extended coverage and sprinkler leakage. This insurance policy shall be upon all property owned by Tenant, for which Tenant is legally liable or that was installed at Tenant's expense, and which is located in the Premises, including without limitation, furniture, fittings, installations, fixtures (other than the improvements installed by Landlord), and any other personal property, in the amount of not less than one hundred percent (100%) of the full replacement costs thereof.

7.04 Form of Insurance/Certificates. All policies shall be written in a form satisfactory to Landlord and shall be taken out with insurance companies licensed in the state in which the Building is located and holding a General Policy Holder's Rating of "A" and a financial rating of "VII" or better, as set forth in the most current issues of Best's Insurance Guide. Tenant shall

furnish to Landlord, prior to Tenant's entry into the Premises and thereafter within ten (10) days prior to the expiration of each such policy, a copy of the certificate of insurance (or renewal thereof) issued by the insurance carrier of each policy of insurance carried by Tenant pursuant hereto. Said certificates shall expressly provide that such policies shall not be cancelable or subject to reduction of coverage below the minimum amounts required by this Lease or required by any lender having an interest in the Building or otherwise be subject to modification except after thirty (30) days prior written notice to the parties named as insured in this Section 7.04. Any policies to be maintained by Tenant hereunder shall name Landlord and, if requested, Landlord's mortgagee, as additional named insureds.

7.05 Failure to Maintain Insurance. If either party fails to maintain any insurance required in the Lease, the failing party shall be liable for any loss or cost resulting from said failure, and the non defaulting party shall have the right, by not less than five (5) days written notice to the other party and failure of the defaulting party to correct such failure within said five (5) days period, to obtain such insurance on the other party's behalf and at their sole expense. This Section 7.05 shall not be deemed to be a waiver of any of their rights and remedies under any other section of this Lease. If Landlord or Tenant obtains any insurance which is the responsibility of the other to obtain under this Article VII, the failing party shall deliver to the other a written statement setting forth the cost of any such insurance and showing in reasonable detail the manner in which it has been computed and the failing party shall promptly remit said amount to the party who has paid the applicable costs.

7.06 Waiver of Subrogation. Any all risk policy or policies of fire, extended coverage or similar casualty insurance which either party obtains in connection with the Property, the Building, the Premises or Tenant's personal property therein shall include a clause or endorsement denying the insurer any rights of subrogation against the other party to the extent rights have been waived by the insured prior to the occurrence of injury or loss. Landlord and Tenant waive any rights of recovery against the other for injury or loss due to hazards covered by insurance containing such a waiver of subrogation clause or endorsement to the extent of the injury or loss covered thereby.

7.07 Tenant's Properties and Fixtures. Tenant assumes the risk of damage to any furniture, equipment, machinery, goods, supplies or fixtures which are or remain the property of Tenant or as to which Tenant retains the right of removal from the Premises, except to the extent due to the negligent act or omission of Landlord and except as set forth herein. In no event shall Tenant carry on any activities which would invalidate any insurance coverage maintained by Landlord. Tenant shall promptly comply with all reasonable requirements of the insurance underwriters and/or any governmental authority having jurisdiction thereover, necessary for the maintenance of reasonable fire and extended insurance for the Building and/or the Project.

7.08 Indemnification.

(a) (i) Tenant, as a material part of the consideration to be rendered to Landlord, and subject to subsection (b) below, hereby indemnifies and agrees to defend and hold Landlord, its agents, employees, and lenders, harmless from and against (i) any and all liability, penalties, losses, damages, costs and expenses, demands, causes of action, claims, judgments and

appeals arising from any injury to any person or persons or any damage to any property as a result of Tenant's or Tenants' officers, employees, agents, assignees, subtenants, concessionaires, licensees, contractors or invitees' use, maintenance, occupation, operation or control of the Premises during the Term, or resulting from any breach or default in the performance of any obligation to be performed by Tenant hereunder or for which Tenant is responsible under the terms of the Lease or pursuant to any governmental or insurance requirement, or arising from any act, neglect, fault or omission of Tenant or any of Tenant's officers, employees, agents, servants, subtenants, concessionaires, licensees, contractors or invitees, and (ii) from and against all reasonable legal costs and charges, including reasonable attorneys' and other reasonable professional fees, incurred in and about any of such matters and the defense of any action arising out of the same or in discharging the Project, the Property and/or Premises or any part thereof from any and all liens, charges or judgments which may accrue or be placed thereon by reason of any act or omission of the Tenant, except and to the extent as may arise out of the negligence or willful misconduct of Landlord and/or its agents or employees.

(ii) Landlord, as a material part of the consideration to be rendered to Tenant, and subject to subsection (b) below, hereby indemnifies and agrees to defend and hold Tenant harmless from and against (i) any and all liability, penalties, losses, damages, costs and expenses, demands, causes of action, claims, judgments and appeals arising from any injury to any person or persons or any damage to any property as a result of Landlord's or Landlord's' officers, employees, agents, assignees, subtenants, concessionaires, licensees, contractors or invitees' use, maintenance, occupation, operation or control of the Building, Common Areas or Project during the Term, or resulting from any breach or default in the performance of any obligation to be performed by Landlord hereunder or for which Landlord is responsible under the terms of the Lease or pursuant to any governmental or insurance requirement, or arising from any act, neglect, fault or omission of Landlord or any of Landlord's officers, employees, agents, servants, subtenants, concessionaires, licensees, contractors or invitees, and (ii) from and against all reasonable legal costs and charges, including reasonable attorneys' and other reasonable professional fees, incurred in and about any of such matters and the defense of any action arising out of the same or in discharging Tenant and/or Premises or any part thereof from any and all liens, charges or judgments which may accrue or be placed thereon by reason of any act or omission of the Landlord, except and to the extent as may arise out of the negligence or willful misconduct of Tenant and/or its agents or employees.

(b) In the event of the concurrent negligence of Tenant, its sublessees, assignees, invitees, agents, employees, contractors, or licensees on the one hand and the negligence of Landlord, its agents, employees or contractors on the other hand, which concurrent negligence results in injury or damage to persons or property of any nature and howsoever caused, and relates to the construction, alteration, repair, addition to, subtraction from, improvement to or maintenance of the Common Areas or Premises such that RCW 4.24.115 is applicable, then (i) Tenant's obligation to indemnify Landlord as set forth in this Section 7.08 shall be limited to the extent of Tenant's negligence and that of Tenant's officers, sublessees, assignees, invitees, agents, employees, contractors or licensees, including Tenant's proportional share of costs, reasonable attorneys' fees and expenses incurred in connection with any claim, action or proceeding brought with respect to such injury or damage; and (ii) Landlord's obligation to indemnify Tenant as set forth in this Section 7.08 shall be limited to the extent of

Landlord's negligence and that of Landlord's officers, agents, employees, contractors or licensees, including Tenant's proportional share of costs, reasonable attorneys' fees and expenses incurred in connection with any claim, action or proceeding brought with respect to such injury or damage.

(c) LANDLORD AND TENANT HEREBY WAIVE AND AGREE THAT IT WILL NOT ASSERT ITS INDUSTRIAL INSURANCE IMMUNITY UNDER TITLE 51 RCW IF SUCH ASSERTION WOULD BE INCONSISTENT WITH THE RIGHT OF THE OTHER PARTY TO INDEMNIFICATION PURSUANT TO THIS ARTICLE 7. THE PARTIES AGREE THAT THIS PROVISION WAS MUTUALLY NEGOTIATED AND RELATES ONLY TO A WAIVER OF IMMUNITY WITH RESPECT TO THE OTHER PARTY AND NO THIRD PARTY, INCLUDING BUT NOT LIMITED TO, ANY INJURED EMPLOYEE OF EITHER PARTY, SHALL BE A THIRD PARTY BENEFICIARY OF THIS PROVISION.

(d) In no event shall Landlord, its agents, employees and/or contractors be liable for any personal injury or death or property damage caused by other lessees or persons in or about the Premises, the Property, the Project and/or the Building, as the case may be, or caused by public or quasi-public work, or for consequential damages arising out of any loss of the use of the Premises or any equipment or facilities therein by Tenant or any person claiming through or under Tenant, except to the extent any such injury or damage is due to the negligent act or omission of Landlord.

7.09 Damage to Tenant's Property. Notwithstanding the provisions of Section 7.08 to the contrary, except to the extent due to the negligent act or omission of Landlord or except as may be covered by any insurance maintained by or in favor of Landlord, Landlord, its agents, employees and contractors shall not be liable for (i) any damage to property entrusted to employees or security officers of the Project, (ii) loss or damage to any property by theft or otherwise, or (iii) any injury or damage to persons or property resulting from fire, explosion, falling substances or materials, steam, gas, electricity, water or rain which may leak from any part of the Building, the Common Areas, or the Property or from the pipes, appliances or plumbing work therein or from the roof, street, or subsurface or from any other place or resulting from dampness or any other cause. Neither Landlord nor its agents shall be liable for interference with light or other incorporeal hereditaments. Tenant shall give prompt notice to Landlord in case Tenant is or becomes aware of fire or accidents in the Building, the Building Common Areas or any other portion of the Project.

ARTICLE VIII: REPAIRS AND MAINTENANCE

8.01 Landlord Repairs and Maintenance. Subject to Landlord's right to reimbursement from Tenant pursuant to Section 6.01 hereof, to the extent applicable, Landlord shall at its expense maintain in good condition, repair and replace (as necessary) the structural portions of the Building including without limitation the foundation, roof and membrane and shall maintain in good condition the exterior of the Building, utilities to their point of connection to the Premises and the Common Areas of the Property, and any aspect of the Premises not expressly to be maintained by Tenant in Section 8.03 below, all in a manner consistent with other first class

office buildings in the area. Tenant shall give Landlord prompt notice of any repairs required of Landlord and Landlord shall not be liable to Tenant for any failure to make any repairs or perform any maintenance unless such failure shall persist for an unreasonable time after written notice of the need for such repair or maintenance is given to Landlord. Except as otherwise provided in this Article 8, there shall be no abatement of Rent and, except for the negligence or willful misconduct of Landlord or its employees, no liability of Landlord by reason of any injury to or interference with Tenant's business arising from the making of any repairs, alterations or improvement in or to any portion of the Premises or in or to fixtures, appurtenances and equipment therein; provided, that Landlord, its employees, agents and contractors use reasonable efforts not to unreasonably interfere with Tenant's business in exercise of Landlord's rights or obligations hereunder.

8.02 Utilities and Services. Subject to reimbursement pursuant to Section 6.01 above, Landlord shall furnish or cause to be furnished to the Premises lines for water, electricity, sewage, telephone and any other utilities necessary for the use and occupancy of the Premises (but not including natural gas and cable television). Tenant shall pay before delinquency, at its sole cost and expense, all charges for water, heat, electricity, power, telephone service, sewer service charges and other utilities or services charged or attributable to the Premises; provided, however, that if any such services or utilities shall be billed to Landlord and are not separately billed to the Premises, Tenant shall pay to Landlord as Additional Rent, an amount equal to that proportion of the total charges therefor which the Rentable Area of the Premises bears to the rentable area of leased area covered by such charges.

8.03 Tenant Repairs and Maintenance. Except as otherwise set forth in Sections 8.01 and 8.02 above, Tenant shall, at Tenant's sole cost and expense, keep, maintain and, to the extent reasonably required, replace the interior, nonstructural components of the Premises, including but not by way of limitation, all interior walls, doors, ceiling, fixtures, furnishings, drapes, specialty lamps, light bulbs, starters and ballasts, power generator, carpets and floor coverings within the Premises. In addition, Tenant, at Tenant's sole cost and expense, shall provide or obtain regular janitorial services, elevator and HVAC maintenance and any other services associated with the regularly scheduled maintenance of the Building systems (as specified by applicable maintenance schedules) and all security services. Landlord shall have the right to approve Tenant's contractors and vendors and to ensure that the same are properly licensed and bonded. Upon expiration or earlier termination of the Term, Tenant shall surrender the Premises to Landlord in the same condition as when leased, reasonable wear and tear and damage by fire or other casualty not required to be repaired by Tenant pursuant to this Lease excepted and except as permitted by Article IX below.

8.04 Non-liability of Landlord. Notwithstanding anything to the contrary contained in Sections 8.01 or 8.02 above or elsewhere in this Lease, Landlord shall not be in default hereunder or be liable for any damages directly or indirectly resulting from, nor shall the Rent herein reserved be abated or rebated by reason of (a) the interruption or curtailment of the use of the Premises as a result of the installation of any equipment in connection with the Building or Project; or (b) any failure to furnish or delay in furnishing any services required to be provided by Landlord, unless and to the extent such failure or delay is caused by accident or any condition created by Landlord's active negligence or by Landlord's failure to respond within a reasonable

period of time to any written request for service or repair for which Landlord is obligated under this Lease; or (c) the limitation, curtailment, rationing or restriction of the use of water or electricity, or any other form of energy or any other service or utility whatsoever serving the Premises.

8.05 Inspection of Premises. Upon advance reasonable notice by Landlord to Tenant, Landlord may enter the Premises to maintain, repair and replace, to inspect the performance by Tenant of the terms and conditions hereof, show the Premises to prospective purchasers, tenants (but tenants only during the last twelve (12) months of the Lease Term and/or after exercise of Tenant of its Option to Terminate pursuant to Subsection 4.04) and lenders and for any other purpose required for Landlord to fulfill its obligations hereunder; provided, that Landlord (and its agents, contractors or employees) shall at all times be accompanied by a representative of Tenant and Landlord shall use reasonable efforts not to interfere with Tenant's business in exercise of Landlord's rights hereunder which shall include the scheduling of any work, which would disrupt Tenant's normal business operations, to after normal business hours. Landlord shall not be liable for any interference with Tenant's business or loss of occupancy or quiet enjoyment arising from Landlord's exercise of its rights under this Subsection.

8.06 Interruption of Services. In the event Tenant cannot reasonably use all or any material portion of the Premises for Tenant's intended business operations by reason of any interruption in the services to be provided by Landlord pursuant to this Lease or Landlord's failure to properly maintain the Premises and Building as required hereunder, and such condition (a) results from causes within Landlord's reasonable control, and (b) exists in excess of three (3) consecutive business days after Landlord has been allowed access to the Building as necessary to make the required repairs or improvements, then Tenant's Base Rent and Tenant's Share of Operating Expenses shall be equitably abated thereafter for that portion of the Premises that Tenant is unable to use for Tenant's intended business operations until such service is restored to the Premises or such repair or maintenance is completed by Landlord. At the time of the loss or interruption of service or failure by Landlord to maintain or repair the Premises or the Building, Tenant must give written notice promptly to Landlord of such fact(s) and its claim for abatement and Tenant only shall be entitled to abatement of Base Rent and Tenant's Share of Operating Expenses in proportion to the area rendered unusable and only after expiration of the cure periods set forth above. Landlord may prevent or stop abatement by providing substantially the same service in similar quality and quantity by temporary or alternative means until the cause of the loss of service can be corrected. If any such interruption in services or failure by Landlord to maintain or repair the Premises or the Building, renders all or substantially all of the Premises unusable for one hundred twenty (120) or more days then such interruption of service shall constitute a casualty under Section 11.03 and Landlord and Tenant shall have all rights set forth in Section 11.03 at any time prior to the restoration of such services by Landlord (including the pertinent time frames set forth in said Subsection 11.03). Tenant shall not be entitled to the rent abatement and termination rights set forth above if the service interruption is caused by the act of omission of Tenant, its agents or employees.

ARTICLE IX: FIXTURES, PERSONAL PROPERTY AND ALTERATIONS

9.01 Fixtures and Personal Property. Tenant, at Tenant's expense, may install trade fixtures, equipment and furniture in the Premises, provided that such items are installed and are removable without damage to the structure of the Building. Landlord reserves the right to approve or disapprove of any interior improvements which are visible from outside the Premises or which violate the CCRs in effect as of the date of this Lease. Such improvements must be submitted for Landlord's written approval prior to installation, which approval shall not be unreasonably withheld. Said trade fixtures, equipment and furniture shall remain Tenant's property and shall be maintained in good condition while on the Premises and shall be removed by Tenant upon the expiration or earlier termination of the Lease. As a covenant which shall survive the expiration or earlier termination of the Lease, Tenant shall repair, at Tenant's sole expense, all damage caused by the removal of said trade fixtures, equipment, furniture or temporary improvements. If Tenant fails to remove the foregoing items on or before the expiration or earlier termination of this Lease, Landlord, at its option and without liability to Tenant for loss thereof, may keep and use them or remove any or all of them and cause them to be stored or sold in accordance with applicable law, and Tenant shall, upon demand of Landlord, pay to Landlord as Additional Rent hereunder all reasonable costs and expenses incurred by Landlord in so storing and/or selling said items. In the event any such fixtures, equipment, and/or furniture of Tenant are sold by Landlord, the proceeds of such sale shall be applied, first, to all expenses of Landlord incurred in connection with storage and sale; second, to any amounts owed by Tenant to Landlord under this Lease or otherwise, and, third, the remainder, if any, shall be paid to Tenant.

9.02 Alterations. Tenant shall not make or allow to be made any material alterations, additions or improvements to the Premises (defined as alterations, additions or improvements costing in excess of \$25,000.00 individually or in the aggregate with respect to separate items relating to the same improvement or alteration) (collectively "Alterations"), or Alterations, which affect the structural components or mechanical systems of the Building, during the Term, without obtaining the prior written consent of Landlord which consent shall not be unreasonably withheld. Tenant shall deliver to Landlord the contractor's name, references and state license number and a certificate of insurance for said contractor, as well as full and complete plans and specifications of all such Alterations, and any subsequent modifications or additions to such plans and specifications, and no proposed work shall be commenced or continued by Tenant until Landlord has received and given its written approval of each of the foregoing. Landlord shall either approve or disapprove any proposed alteration, addition or improvement on or before the date twenty (20) days following receipt of all of the foregoing items. Landlord does not expressly or implicitly covenant or warrant that any plans or specifications submitted by Tenant are accurate, safe or sufficient or that the same comply with any applicable laws, ordinances, building codes, or the like. Further, Tenant shall indemnify and hold Landlord and the Building harmless from any loss, cost or expense, including attorneys' fees and costs, incurred by Landlord as a result of any defects in design, materials or workmanship resulting from Tenant's Alterations to the Premises. All Alterations, telephone or telecommunications lines, cables, conduits and equipment and all other additions or improvements to the Premises made by Tenant shall remain the property of Tenant. Landlord may, as a condition to approval of any such

Alterations, require Tenant to remove all or any portion of such Alterations installed by Tenant during the Term, and Tenant shall repair all damage resulting from such removal or, at Landlord's option, shall pay to Landlord all costs arising from such removal. All repairs, alterations, additions and restorations by Tenant hereinafter required or permitted shall be done in a good and workmanlike manner and in compliance with all applicable laws and ordinances, building codes, by-laws, regulations and orders of any federal, state, county, municipal or other public authority and of the insurers of the Premises. If required by Landlord, Tenant shall secure at Tenant's cost a completion and lien indemnity bond or other adequate security in form and substance reasonably acceptable to Landlord. Tenant shall reimburse Landlord for Landlord's reasonable charges (including any professional fees incurred by Landlord and a reasonable administrative fee to compensate Landlord for burdened labor expenses incurred) for reviewing and approving or disapproving plans and specifications for any proposed Alterations.

9.03 Liens. Tenant shall promptly file and/or record, as applicable, all notices of completion provided for by law, and shall pay and discharge all claims for work or labor done, supplies furnished or services rendered at the request of Tenant or at the request of Landlord on behalf of Tenant, and shall keep the Premises, the Property and the Project free and clear of all mechanics' and materialmen's liens in connection therewith. Landlord shall have the right, and shall be given ten (10) business days written notice by Tenant prior to commencement of the work, to post or keep posted on the Premises, or in the immediate vicinity thereof, any notices of non-responsibility for any construction, alteration, or repair of the Premises by Tenant. If any such lien is filed, Tenant shall cause same to be discharged of record within ten (10) business days following written notice thereof, or if Tenant disputes the correctness or validity of any claim of lien, Landlord may, in its reasonable discretion, permit Tenant to post or provide security in a form and amount acceptable to Landlord to insure that title to the Property remains free from the lien claimed. If said lien is not timely discharged Landlord may, but shall not be required to, take such action or pay such amount as may be necessary to remove such lien and Tenant shall pay to Landlord as Additional Rent any such amounts expended by Landlord, together with interest thereon at the Default Rate, within five (5) days after notice is received from Landlord of the amount expended by Landlord.

ARTICLE X: USE AND COMPLIANCE WITH LAWS

10.01 General Use and Compliance with Laws. Tenant shall only use the Premises for the uses described in Section 1.01(e) above, and uses customarily incidental thereto and for no other use without the prior written the consent of Landlord. Tenant shall, at Tenant's sole cost and expense, comply with all requirements of municipal, county, state, federal and other applicable governmental authorities now or hereafter in force pertaining to Tenant's business operations, alterations and/or specific use of the Premises, and shall secure any necessary permits therefore and shall faithfully observe in the use of the Premises and the Project, all municipal, county, state, federal and other applicable governmental entities' requirements which are now or which may hereafter be in force. Tenant, in Tenant's use and occupancy of the Premises, shall not subject or permit the Premises to be used in any manner which would tend to damage any portion thereof. Tenant shall not do or permit anything to be done in or about the Premises, the Common Areas and/or the Property which will in any way obstruct or interfere with the rights of other tenants or occupants of the Common Areas and/or the Project or use or allow the Premises

or any portion of the Project to be used for any improper, immoral, unlawful or objectionable purpose, nor shall Tenant cause, maintain or permit a nuisance in, on or about the Premises or the Common Areas. Landlord hereby acknowledges that Tenant, Tenant's employees and/or employees of subsidiaries of Tenant may occupy portions of the Premises from time to time under this Lease.

10.02 Hazardous Materials. Tenant shall not cause or permit any Hazardous Materials (as defined hereinbelow) to be brought upon, kept or used in or about the Building, the Property, the Common Areas and/or the Project by Tenant, its agents, employees, contractors, or licensees, except such Hazardous Materials that are typical in Tenant's business and that are at all times, used, kept and stored in the manner that complies with all laws, rules, regulations and ordinances now or hereafter regulating any such Hazardous Materials. If Tenant breaches the covenants and obligations set forth herein or, if the presence of Hazardous Materials on, in or about the Building, the Premises, the Project, the Property and/or the Common Areas, as the case may be, caused by Tenant, its agents, employees, contractors, licensees or invitees results in contamination of all or any portion of the Project or any other property, whether or not adjacent thereto, then Tenant shall indemnify, defend and hold Landlord free and harmless from and against any and all claims, judgments, damages, penalties, fines, costs, liabilities and losses (including, without limitation, sums paid in settlement of claims, attorneys' fees, consultant fees and expert fees) which arise during or after the Term as a result of such contamination. This indemnification by Tenant of Landlord shall include, without limitation, any and all costs incurred with any investigation of site conditions and any cleanup, remedial, removal or restoration work required by any federal, state or local governmental agency or political subdivision because of the presence of such Hazardous Materials caused by Tenant, its agents, employees, contractor, licensees and/or invitees in, on or about the Building, the Common Areas or the soil or ground water on or under the Property. The provisions of this Section 10.02 shall survive the expiration or earlier termination of this Lease. For purposes of the Lease, the term "Hazardous Materials" shall mean the following: (a) those substances included within the definitions of "hazardous substances," "pollutant," or "contaminant" in the Comprehensive Environmental Response, Compensation and Liability Act of 1980, 42 U.S.C. Sections 9601 et. seq. as heretofore or hereafter amended, the regulations promulgated pursuant to such Act and state laws and regulations similar to or promulgated pursuant to such Act; (b) any material, waste or substance which is (i) petroleum, (ii) asbestos, (iii) flammable explosive, or (iv) radioactive; and (c) such other substances, materials and wastes which are or become regulated as hazardous or toxic under federal, state or local law. Without limiting the foregoing, Tenant shall be responsible for any leaks or spills associated with Tenant's use of the back-up generator (which is being installed at Tenant's request). Likewise, Landlord covenants that Landlord shall not cause or permit any Hazardous Materials to be brought upon, kept or used in or about the Building or Project by Landlord, its agents, employees, contractors or licensees in violation of any applicable laws or regulations. Further, Landlord shall indemnify, defend and hold Tenant free and harmless from and against any and all claims, judgments, damages, penalties, fines, costs, liabilities and losses (including without limitation, sums paid in settlement of claims, attorneys' fees, consultant fees and expert fees) which arise during or after the Lease Term as a result of either a breach by Landlord of the foregoing covenant or otherwise due to the presence of Hazardous Materials existing upon commencement of the Lease Term by no fault of Tenant.

10.03 Signs.

(a) The Tenant shall not paint, display, inscribe, place or affix any sign, picture, advertisement, notice, lettering, or direction on any part of the outside of the Building or the Project or visible from the outside of the Premises, the Building or the Project, except as first approved by Landlord (except as otherwise expressly allowed by this Lease) and the City of Issaquah.

(b) During the Term of this Lease and provided that Tenant remains the sole tenant of the Building, Tenant shall have the exclusive right (i.e. neither Landlord nor any other tenant shall have signs on the Building exterior or on the parking facility except any reasonably sized address signs at street level identifying the name, address or location of the Building) to install and maintain, at its sole cost and expense, exterior signage on two (2) of the four (4) sides near the top of the Building (the "Building Signs") subject to the following terms and conditions:

(i) The location, design, construction, size and other aspects of such Building Signs and all modifications, replacements or alterations thereto shall be subject to Landlord's prior written consent, which consent shall not be unreasonably withheld or delayed.

(ii) The expense of installing, constructing, maintaining and removing the Building Signs (and repair of the Building exterior upon such removal) shall be the sole cost and expense of Tenant and shall be paid directly by Tenant.

(c) For such period as Tenant is the sole tenant of the Building, Tenant shall have the exclusive right at its sole cost and expense, to install and maintain its name on the monument signage adjacent to the Building to be constructed by Landlord (the "Monument Signage"), subject to the following terms and conditions:

(i) Landlord, at its sole cost and expense, shall install a monument sign adjacent to the main entrance of the Building. The design, construction, size, Tenant's identification and other aspects of such monument signage shall be generally as described on Exhibit C-2. Otherwise, all other aspects of Tenant's Signage including, without limitation, all modifications, replacements or alterations shall be subject to Landlord's prior written consent, which consent shall not be unreasonably withheld or delayed.

(ii) The expense of installing, constructing, maintaining and removing Tenant's Signage shall be the sole cost and expense of Tenant and shall be paid directly to Landlord by Tenant. Tenant shall be responsible for all costs and expenses associated with Tenant's Signage (i.e., Tenant's name on the monument sign).

ARTICLE XI: DAMAGE AND DESTRUCTION

11.01 Reconstruction. If the Building is damaged or destroyed during the Term, Landlord shall, except as hereinafter provided, diligently repair or rebuild it to substantially the

condition in which it existed immediately prior to such damage or destruction. If Landlord is obligated or elects to repair or restore as herein provided, Landlord shall be obligated to make repair or restoration of only those portions of the Premises which were initially provided at Landlord's expense or as part of the original installation by Landlord for Tenant and the repair and/or restoration of other items within the Premises (i.e., Tenant's furniture, fixtures, equipment and any Alterations) shall be the obligation of the Tenant.

11.02 Rent Abatement. Rent due and payable hereunder shall be equitably abated during any period in which, by reason of any such damage or destruction, there is interference with the operation of Tenant's business in the Premises, unless Landlord is able to relocate Tenant (or affected portion of Tenant's operations) to substitute premises reasonably acceptable to Tenant. Such abatement shall continue for the period commencing with such damage or destruction and ending with a substantial completion by Landlord of the work of repair or reconstruction which Landlord is obligated or undertakes, plus a thirty (30) day fixturing period. Tenant shall not be entitled to any claim, compensation or damages for loss in the use in the whole or any part of the Premises (including loss of business) and/or any inconvenience or annoyance occasioned by such damage, repair, reconstruction or restoration.

11.03 Excessive Damage or Destruction. If the Building or the Premises is damaged or destroyed to the extent that it cannot with reasonable diligence, be fully repaired or restored by Landlord (as certified by Landlord's architect) within two hundred seventy (270) days after the date of the damage or destruction, either Landlord or Tenant may terminate this Lease by written notice to the other within thirty (30) days of the date of the damage or destruction. If neither party terminates this Lease, this Lease shall remain in full force and effect and Landlord shall diligently repair and restore the damage as soon as reasonably possible; provided, however, if neither party elects to terminate this Lease, then if such repair and restoration takes more than three hundred sixty (360) days from the date of casualty, for any reason other than Tenant's fault or delay, Tenant again shall have the right to terminate this Lease.

11.04 Uninsured Casualty. Notwithstanding anything contained herein to the contrary, in the event of damage to or destruction of all or any portion of the Building, which damage or destruction is not fully covered by the insurance proceeds received by Landlord under the insurance policies required under Article 7.01 hereinabove, Landlord may terminate this Lease by written notice to Tenant given within sixty (60) days after the date of notice to Landlord that said damage or destruction is not so covered. If Landlord does not elect to terminate this Lease, the Lease shall remain in full force and effect and the Building shall be repaired and rebuilt in accordance with the provisions for repair set forth in Section 11.01 hereinabove.

11.05 Waiver. With respect to any damage or destruction which Landlord is obligated to repair or may elect to repair under the terms of this Article 11, and to the extent permitted by law, Tenant hereby waives any rights to terminate this Lease pursuant to rights otherwise accorded by law to tenants, except as expressly otherwise provided herein.

11.06 Mortgagee's Right. Notwithstanding anything herein to the contrary, if the holder of any indebtedness secured by a mortgage or deed of trust covering the Property, the Building and/or the Project requires that the insurance proceeds be applied to such indebtedness, then

Landlord shall have the right to terminate this Lease by delivering written notice of termination to Tenant within fifteen (15) days after such requirement is made. Upon any termination of this Lease under the provisions hereof, the parties shall be released without further obligation to the other from date possession of the Premises is surrendered to Landlord, except for items which are theretofore accrued and are then unpaid.

11.07 Damage Near End of Term. Notwithstanding anything to the contrary contained in this Article XI, in the event the Premises or the Building are subject to excessive damage (as defined in Section 11.03) during the last twenty-four (24) months of the Term or any applicable extension periods, either Landlord or Tenant may elect to terminate this Lease by written notice to the other within thirty (30) days after the date of such damage; provided however, Tenant shall have the right to exercise its Option to Extend (if and to the extent available pursuant to Subsection 4.03) by written notice to Landlord within thirty (30) days after the date of casualty in which case neither party shall have the right to terminate this Lease solely on the basis of the timing of the casualty during the last 24 months of the Term.

ARTICLE XII: EMINENT DOMAIN

12.01 Eminent Domain. In the event the whole of the Premises, Building, Project and/or Common Areas, as the case may be, and/or such part thereof as shall unreasonably interfere with Tenant's use and occupation thereof, including without limiting the foregoing, the taking of more than ten percent (10%) of the parking stalls allocated to Tenant pursuant to Subsection 1.01(q) above in the parking areas serving the Building as required by Subsection 18.16, shall be taken for any public or quasi-public purpose by any lawful power or authority by exercise of the right of appropriation, condemnation or eminent domain, or is sold in lieu of or to prevent such taking, then Tenant shall have the right to terminate this Lease effective as of the date possession is required to be surrendered to said authority. In the event the whole of the Premises, Building, Project, Common Areas and/or Property, as the case may be, or such part thereof as shall substantially interfere with Landlord's use and occupation thereof, or if any access points to adjoining streets, shall be taken for any public or quasi-public purpose by any lawful power or authority by exercise of the right of appropriation, condemnation or eminent domain, or is sold in lieu of or to prevent such taking, then Landlord shall have the right to terminate this Lease effective as of the date possession is required to be surrendered to said authority. Except as provided below, Tenant shall not assert any claim against Landlord or the taking authority for any compensation because of such taking, and Landlord shall be entitled to receive the entire amount of any award without deduction for any estate or interest of Tenant in the Premises. Nothing contained in this Section 12.01 shall be deemed to give Landlord any interest in any separate award made to Tenant for the value of any Alterations made by Tenant, the taking of personal property and fixtures belonging to Tenant and for Tenant's moving expenses to the extent such claim is available as a separate claim by Tenant pursuant to applicable law. In the event the amount of property or the type of estate taken shall not substantially interfere with the conduct of Tenant's business, Landlord shall be entitled to the entire amount of the award without deduction for any estate or interest of Tenant, Landlord shall promptly proceed to restore the Building to substantially their same condition prior to such partial taking less the portion thereof lost in such condemnation, and the Base Rent shall be proportionately reduced by the time during which, and the portion of the Premises which, Tenant shall have been deprived of possession on account of said taking and restoration.

ARTICLE XIII: DEFAULT

13.01 Events of Default. The occurrence of any of the following events shall constitute an "Event of Default" on the part of the Tenant with or without notice from Landlord:

(a) Tenant shall fail to pay on or before five (5) business days after written notice from Landlord to Tenant that Tenant has failed to pay on or before the due date any installment of Rent or other payment required pursuant to this Lease; or

(b) Tenant shall fail to comply with any term, provision, or covenant of this Lease, other than the payment of Rent or other sums of money due hereunder, and such failure is not cured within twenty (20) days after written notice thereof to Tenant (said notice being in lieu of, and not in addition to, any notice required as a prerequisite to an unlawful detainer or similar action for possession of the Premises); provided that if the nature of such cure is such that a longer cure period is necessary, Tenant shall only be in default if Tenant shall have failed to commence such cure within said 20-day period and thereafter to have diligently prosecuted such cure to completion.

(c) Tenant shall file a petition or be adjudged a debtor or bankrupt or insolvent under the United States Bankruptcy Code, as amended, or any similar law or statute of the United States or any State; or a receiver or trustee shall be appointed for all or substantially all of the assets of Tenant and such appointment or petition, if involuntary, is not dismissed within sixty (60) days of filing;

(d) Tenant shall make an assignment for the benefit of creditors; or

(e) There shall be an "Event of Default" by Tenant under the Lease of even date hereof, between Landlord and Tenant with respect to Tenant's lease of Building B of the Project.

13.02 Remedies.

(a) Upon the occurrence of any Event of Default set forth in this Lease, in addition to any other remedies available to Landlord at law or in equity, Landlord shall have the immediate option to terminate this Lease and all rights of Tenant hereunder. In the event that Landlord shall elect to so terminate this Lease, then Landlord may recover from Tenant: (i) any unpaid rent which as been earned at the time of such termination plus interest at the rates contemplated by this Lease; plus (ii) the worth at the time of award of the amount by which the unpaid rent for the balance of the Term after the date of termination exceeds the amount of such rental loss that Tenant proves could be reasonably avoided; plus (iii) any other amount necessary to compensate Landlord for all the damage proximately caused by Tenant's failure to perform Tenant's obligation under this Lease or which in the ordinary course of things would be likely to result therefrom, including, but not limited to, costs to reimprove the

Premises, or portions thereof, for a new tenant, leasing commissions and incentives. As used in Subsections 13.02(a) (iii) above, the “worth at the time of award” is computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent (1%). Landlord hereby agrees to use commercially reasonable efforts to relet the Premises and otherwise mitigate its damages under this Lease.

(b) In the event of any such default by Tenant, Landlord shall also have the right with or without terminating this Lease, to re-enter the Premises in compliance with applicable laws and remove all persons and property from the Premises; such property may be removed and stored in a public warehouse or elsewhere at the cost of and for the account of the Tenant. No re-entry or taking possession of the Premises by Landlord pursuant to this Section 13.02(b) shall be construed as an acceptance of a surrender of the Premises or an election to terminate this Lease unless a written notice of such intention is given to Tenant or unless the termination thereof is decreed by a court of competent jurisdiction.

(c) In the event that Landlord shall elect to re-enter as provided above or shall take possession of the Premises pursuant to legal proceedings or pursuant to any notice provided by law, then if Landlord does not elect to terminate this Lease as provided above, Landlord may from time to time, without terminating this Lease, either recover all Rent as it becomes due or relet the Premises or any part thereof for the Term of this Lease on terms and conditions as Landlord at its reasonable discretion may deem advisable with the right to make alterations and repairs to the Premises.

(d) In the event that Landlord shall relet the Premises, the rents received by Landlord from such reletting shall be applied: first to the payment of any indebtedness other than Rent due hereunder from Tenant to Landlord; second to the payment of any costs of such reletting; third, to the payment of the cost of any alterations and repairs to the Premises; fourth, to the payment of Rent due and unpaid hereunder; and the residual, if any, shall be held by Landlord and applied to payment of future Rent as the same shall become due and payable hereunder. Should that portion of such rents received from such reletting during the month which is applied to the payment of Rent be less than the Rent payable during that month by Tenant hereunder, then Tenant shall pay any such deficiency to Landlord immediately upon demand therefor by Landlord. Such deficiency shall be calculated and paid monthly. Tenant shall also pay to Landlord, as soon as is certain, any of the reasonable costs and expenses incurred by Landlord in such reletting or in making such alterations and repairs not covered by the rents received from such reletting.

(e) All rights, options and remedies of Landlord contained in this Lease shall be construed and held to be cumulative, and no one of them shall be exclusive of the other, and Landlord shall have the right to pursue any one or all of such remedies or any other remedy or relief which may be provided by law, whether or not stated in this Lease. No waiver of any default of Tenant hereunder shall be implied from any acceptance by Landlord of any Rent or other payments due hereunder or any omission by Landlord to take any action on account of such default if such default persists or is repeated, and no express waiver shall affect defaults other than as specified in said waiver. The consent or approval of Landlord to or of any act by Tenant requiring Landlord’s consent or approval shall not be deemed to waive or render unnecessary Landlord’s consent or approval to or of any subsequent similar acts by Tenant.

13.03 Landlord Default and Tenant Remedies. If Landlord fails to pay any amounts due to Tenant under this Lease and shall not cure such failure within twenty (20) days following Tenant's notice to Landlord (and to the holder of any mortgage) or if Landlord fails to keep or perform any of its obligations under this Lease and shall not cure such failure within thirty (30) days following Tenant's notice to Landlord (and to the holder of any mortgage), Landlord shall be in default under this Lease; provided, however, if the failure is of a nature that it cannot be cured within thirty (30) days, Landlord shall not be in default so long as Landlord commences the cure within such thirty (30) day period and diligently and continuously pursues the cure to completion as soon as reasonably possible. In the event of a default by Landlord hereunder, Tenant shall be entitled to pursue any remedies available to Tenant at law or in equity; provided that, in no event shall Tenant have the right to terminate this Lease except upon order of a court of applicable jurisdiction ordering such termination. In the event of any default by Landlord in any of its non-monetary obligations under this Lease after the expiration of the notice and cure period described above, Tenant may pursue any action reasonably necessary to cure Landlord's default if Tenant's use of the Premises for normal business operations has been adversely effected and provided that no such action shall affect the structural or mechanical functions of the Property or the rights of other occupants. If Tenant does in fact undertake curative actions for and on behalf of Landlord then Landlord shall reimburse Tenant for the reasonable cost of such actions within ten (10) days after receipt of invoice and substantiation thereof from Tenant.

13.04 Consequential and Incidental Damages. Except as otherwise expressly allowed by this Lease, neither Landlord nor Tenant shall be liable to the other for consequential or incidental damages.

ARTICLE XIV: INSOLVENCY PROVISIONS

14.01 Tenant's Bankruptcy.

Landlord and Tenant (as either debtor or debtor-in-possession) agree that if a petition ("Petition") is filed by or against tenant under any chapter of Title 11 of the United States Code (the "Bankruptcy Code"), the following provisions shall apply:

(a) Adequate protection for Tenant's obligations accruing after filing of the Petition and before this Lease is rejected or assumed shall be provided within 15 days after filing in the form of a security deposit equal to three months' Base Rent and Additional Rent and other Lease charges, to be held by the court or an escrow agent approved by Landlord and the court.

(b) The sum of all amounts payable by Tenant to Landlord under this Lease constitutes reasonable compensation for the occupancy of the Premises by Tenant.

(c) Tenant or Trustee shall give Landlord at least 30 days written notice of any abandonment of the Premises or any proceeding relating to administrative claims. If Tenant abandons without notice, Tenant or Trustee shall stipulate to entry of an order for relief from stay to permit Landlord to reenter and relet the Premises.

(d) If Tenant failed to timely and fully perform any of its obligations under this Lease before the filing of the Petition, whether or not Landlord has given Tenant written notice of that failure and whether or not any time period for cure expired before the filing of the Petition, Tenant shall be deemed to have been in default on the date the Petition was filed for all purposes under the Bankruptcy Code.

(e) For the purposes of Section 365(b)(1) of the Bankruptcy Code, prompt cure of defaults shall mean cure within 30 days after assumption.

(f) For the purposes of Section 365(b)(1) and 365(f)(2) of the Bankruptcy Code, adequate assurance of future performance of this Lease by Tenant, Trustee or any proposed assignee will require that Tenant, Trustee or the proposed assignee deposit three months of Base Rent and Additional Rent into an escrow fund (to be held by the court or an escrow agent approved by Landlord and the court) as security for such future performance. In addition, if this Lease is to be assigned, adequate assurance of future performance by the proposed assignee shall require that: (i) the assignee have a tangible net worth not less than the net worth of Tenant as of the Commencement Date or that such assignee's performance be unconditionally guaranteed by a person or entity that has a tangible net worth not less than the net worth of Tenant as of the Commencement Date; (ii) the assignee demonstrate that it possesses a history of success in operating a business of similar size and complexity in a similar market as Tenant's business; and (iii) assignee assume in writing all of Tenant's obligations relating to the Premises or this Lease.

(g) If Tenant or Trustee intends to assume and/or assign this Lease, Tenant or Trustee shall provide Landlord with 30 days written notice of the proposed action, separate from and in addition to any notice provided to all creditors. Notice of a proposed assumption shall state the assurance of prompt cure, compensation for loss and assurance of future performance to be provided to Landlord. Notice of a proposed assignment shall state: (i) the name, address, and federal tax identification and registration numbers of the proposed assignee; (ii) all of the terms and conditions of the proposed assignment, and (iii) the assignee's proposed adequate assurance of future performance to be provided to Landlord.

(h) If Tenant is in default under this Lease when the Petition is filed, Landlord shall not be required to provide Tenant or Trustee with services or supplies under this Lease or otherwise before Tenant assumes this Lease, unless Tenant compensates Landlord for such services and supplies in advance.

ARTICLE XV: ASSIGNMENT AND SUBLETTING

15.01 Prohibition. Except as expressly set forth below, Tenant shall not assign, mortgage, pledge or otherwise transfer or encumber this Lease, in whole or in part, nor sublet, assign, or permit occupancy by any party other than Tenant of all or any part of the Premises, without the prior written consent of Landlord in each instance which consent shall not be unreasonably withheld or delayed. Tenant shall at the time the Tenant requests the consent of

Landlord, deliver to Landlord the following information in regarding the proposed assignee or subtenant: the name, address, nature of business, ownership, financial responsibility and standing of such proposed assignee or subtenant. Landlord shall have not less than ten (10) business days after receipt of all required information to elect one of the following: (a) consent to such proposed assignment, encumbrance or sublease, (b) refuse such consent, or (c) elect to terminate this Lease, in the case of a proposed assignment, or elect to terminate the Lease with respect to the portion of the Premises proposed to be subleased, as applicable; provided that Landlord may not exercise its right to terminate the Lease (or lease of the applicable portion of the Premises) pursuant to Subsection 15.01(c) above in the case of a requested sublease of the Premises except in the event the cumulative total area of the Premises subleased exceeds 50% of the total area of the Premises. In addition, as a condition to Landlord's consent to any assignment, sublease or encumbrance of this Lease shall be the delivery to Landlord of a true copy of the fully executed instrument of assignment, transfer or encumbrance and an agreement executed by the assignee, sublessee or other transferee in form and substance satisfactory to Landlord and expressly enforceable by Landlord, whereby the assignee assumes and agrees to be bound by the terms and provisions of this Lease and perform all the obligations of Tenant hereunder with respect to the assigned or subleased portion of the Premises. No assignment or subletting by Tenant shall relieve Tenant of any obligation under this Lease, including Tenant's obligation to pay Base Rent and Additional Rent hereunder. Except as expressly set forth below, any purported assignment or subletting contrary to the provisions hereof without consent shall be void. The consent by Landlord to any assignment or subletting shall not constitute a waiver of the necessity for such consent to any subsequent assignment of subletting. Tenant shall pay Landlord's reasonable actual third party costs and attorneys' fees incurred in reviewing any proposed assignment or sublease (not to exceed \$1,000 per assignment or sublease).

15.02 Excess Rental. If pursuant to any assignment or sublease, Tenant receives rent, either initially or over the term of the assignment or sublease, in excess of the Rent called for hereunder, or in the case of this sublease of a portion of the Premises in excess of such Rent equitably allocable to such portion, after appropriate adjustments to assure that all other payments called for hereunder are appropriately taken into account, Tenant shall pay to Landlord, as Additional Rent hereunder, fifty percent (50%) of the excess of each such payment of rent received by Tenant after its receipt.

15.03 Scope. The prohibition against assigning or subletting contained in this Article XIV shall be construed to include a prohibition against any assignment or subletting by operation of law, except as set forth above. If this Lease be assigned, or if the underlying beneficial interest of Tenant is transferred, or if the Premises or any part thereof be sublet or occupied by anybody other than Tenant, Landlord may collect rent from the assignee, subtenant or occupant and apply the net amount collected to the Rent herein reserved and apportion any excess rent so collected in accordance with the terms of the immediately preceding paragraph, but no such assignment, subletting, occupancy or collection shall be deemed a waiver of this covenant, or the acceptance of the assignee, subtenant or occupant as tenant, or a release of Tenant from the further performance by Tenant of covenants on the part of Tenant herein contained. No assignment or subletting shall affect the continuing primary liability of Tenant (which, following assignment, shall be joint and several with the assignee), and Tenant shall not be released from performing any of the terms, covenants and conditions of this Lease.

15.04 Waiver. Notwithstanding any assignment or sublease, or any indulgences, waivers or extensions of time granted by Landlord to any assignee or sublessee or failure of Landlord to take action against any assignee or sublease, Tenant hereby agrees that Landlord may, at its option, and upon not less than ten (10) days' notice to Tenant, proceed against Tenant without having taken action against or joined such assignee or sublessee, except that Tenant shall have the benefit of any indulgences, waivers and extensions of time granted to any such assignee or sublessee.

15.05 Change in Control/Permitted Transfers. Except as expressly allowed below, if Tenant is a partnership, a withdrawal of or change in partners, in one or more transfers, owning more than a fifty percent (50%) interest in the partnership, shall constitute a voluntary assignment and shall be subject to the provisions of this Article XV. If the Tenant is a corporation, a transfer of fifty percent (50%) or more of the corporation's stock or assets in one or more transfers to a single party and/or its affiliates, or a change in the control of such company pursuant to a merger, consolidation, sale of assets or otherwise, shall be deemed for the purposes hereof to be an assignment of this Lease, and shall be subject to the provisions of this Article XV. Notwithstanding any provision to the contrary, Tenant may assign this Lease or sublet the Premises without Landlord's consent (i) to any corporation or other entity that controls, is controlled by or is under common control with Tenant; (ii) to any corporation or other entity resulting from a merger, acquisition, consolidation or reorganization of or with Tenant; (iii) in connection with the sale of all or substantially all of the assets of Tenant (all such transfers, assignments and subleases collectively hereinafter referred to as "Permitted Transfers" and all such transferees, assignees and sublessees are collectively hereinafter referred to as "Permitted Transferees"); provided that (a) Tenant provides evidence to Landlord in writing that such assignment or sublease complies with the criteria set forth in (i), (ii) or (iii) above, (b) such assignee, subtenant or successor-in-interest expressly assumes Tenants' obligations and liabilities hereunder; and (c) the combined tangible net worth and debt to equity ratios of said assignee and Tenant after the transfer is equal to or better than that of Tenant as set forth in Tenant's 2001 10K financial statements. No such assignment, sublease or transfer shall release Tenant from any covenant, liability or obligation under this Lease.

ARTICLE XVI: ESTOPPEL CERTIFICATE, ATTORNMENT AND SUBORDINATION

16.01 Estoppel Certificates. Within ten (10) business days after receipt by Tenant of a request therefor by Landlord, or if on any sale, assignment or hypothecation by Landlord of Landlord's interest in the Property, the Project and/or the Premises, or any part thereof, an estoppel certificate shall be required from Tenant, Tenant shall deliver, in recordable form, a certificate in the form attached hereto as Exhibit F, or in such other form as reasonably requested by Landlord (the form of which is acceptable to Tenant), to any proposed mortgagee or purchaser, and to Landlord, certifying (if such be the case) that this Lease is in full force and effect, the date of Tenant's most recent payment of Rent, and that Tenant has no defenses or offsets outstanding, or stating those claimed by Tenant, and any other information contained in such Exhibit F or reasonably requested by Landlord or such proposed mortgagee or purchaser. Tenant's failure to deliver said statement within said period shall, at Landlord's option be an Event of Default hereunder and shall in any event be conclusive upon Tenant that: (i) this Lease

is in full force and effect, without modification except as may be represented by Landlord; (ii) there are no uncured defaults in Landlord's performance and Tenant has no right to offset, counterclaim or deduction against Rent hereunder; and (iii) no more than one period's Base Rent has been paid in advance.

16.02 Attornment. Subject to the condition below, Tenant shall, in the event any proceedings are brought for the foreclosure of, or in the event of exercise of the power of sale under, any mortgage or deed of trust made by Landlord, its successors or assigns, encumbering the Building, or any part thereof or in the event of termination of a ground lease, if any, and if so requested, attorn to the purchaser upon such foreclosure or sale or upon any grant of a deed in lieu of foreclosure and recognize such purchaser as Landlord under this Lease; provided, that such purchaser recognizes Tenant's rights under this Lease and agrees not to disturb Tenant's quiet possession of the Premises for so long as Tenant is not in default hereunder past any applicable notice and cure periods.

16.03 Subordination. The rights of Tenant hereunder are and shall be, at the election of any mortgagee or the beneficiary of a deed of trust encumbering the Property (or the portion thereof on which the Building is located) and/or Building, subject and subordinate to the lien of such mortgage or deed of trust, or the lien resulting from any other method of financing or refinancing, now or hereafter in force against the Property (or the portion thereof on which the Building is located) and/or the Building, and to all advances made or hereafter to be made upon the security thereof; provided, however, that notwithstanding such subordination, so long as Tenant is not in default under any of the terms, covenants and conditions of the Lease past any applicable notice and cure periods, neither the Lease nor any of the rights of Tenant hereunder shall be terminated or subject to termination by any trustee's sale, any action to enforce the security, or by any proceeding or action in foreclosure. If requested, Tenant agrees to execute and deliver to Landlord or its mortgagee within ten (10) days after written notice, a subordination, nondisturbance and attornment agreement as may be required by Landlord or its mortgagee to further effect the provisions of this Article.

16.04 Recording. Tenant covenants and agrees with Landlord that Tenant shall not record this Lease but Landlord and Tenant shall execute and record a memorandum thereof in the form attached hereto as Exhibit H. Notwithstanding the provisions of Section 16.03, in the event that Landlord or its lender requires this Lease or a memorandum thereof to be recorded in priority to any mortgage, deed of trust or other encumbrance which may now or at any time hereafter affect in whole or in part the Building, the Property (or the portion thereof on which the Building is located) or the Project, and whether or not any such mortgage, deed of trust or other encumbrance shall affect only the Building, the Property (or the portion thereof on which the Building is located) or the Project, or shall be a blanket mortgage, deed of trust or encumbrance affecting other premises as well, the Tenant covenants and agrees with Landlord that the Tenant shall execute promptly upon request from Landlord any certificate, priority agreement or other instrument which may from time to time be requested to give effect thereto so long as Tenant reasonably approves the form thereof.

ARTICLE XVII: LANDLORD'S AGREEMENTS

17.01 Landlord hereby represents, warrants and covenants with Tenant as follows:

(a) Landlord is not aware of any Hazardous Materials with respect to the Property except as disclosed in that certain Phase I Environmental Audit prepared by URS Corporation, dated February 15, 2001 (the "Report") and has not received written notice of any violation of any environmental laws.

(b) The Property and Building is subject to the exceptions and encumbrances as shown in the Title Commitment issued by Chicago Title Insurance Company under Order No. 1006033, dated July 10, 2001 (the "Title Commitment") and that, to the best of Landlord's knowledge, the Property is not subject to any other matter of record which might affect this Lease or the terms and conditions hereof.

ARTICLE XVIII: MISCELLANEOUS

18.01 Notices. All notices required to be given hereunder shall be in writing and mailed postage prepaid by certified or registered mail, return receipt requested, or by personal delivery or nationally recognized courier service, to the appropriate address indicated in Section 1.01(b) or Section 1.01(d), as appropriate, at such street address or street addresses (but not more than three such addresses) as either Landlord or Tenant may, from time to time, respectively, designate in a written notice given to the other. Notices shall be deemed sufficiently served upon the earlier of actual receipt or the expiration of three (3) days after the date of mailing thereof sent by certified mail, return receipt requested.

18.02 Successors Bound. This Lease and each of its covenants and conditions shall be binding upon and shall inure to the benefit of the parties hereto and their respective assignees, subject to the provisions hereof. Whenever in this Lease a reference is made to Landlord, such reference shall be deemed to refer to the person in whom the interest of Landlord shall be vested, and Landlord shall have no obligation hereunder as to any claim arising after the transfer of its interest in the Building but Landlord shall not be released from any duties, obligations or liabilities accruing prior to the date of transfer or arising out of events that occur prior to the date of transfer, unless such duties, obligations, or liabilities are expressly assumed by Landlord's transferee. Any successor or assignee of the Tenant who accepts an assignment of the benefit of this Lease and enters into possession or enjoyment hereunder shall thereby assume and agree to perform and be bound by the covenants and conditions thereof. Nothing herein contained shall be deemed in any manner to give a right of assignment without the prior written consent of Landlord pursuant to, or otherwise as provided in, Article XV hereof.

18.03 Waiver. No waiver of any default or breach of any covenant by either party hereunder shall be implied from any omission by either party to take action on account of such default if such default persists or is repeated, and no express waiver shall affect any default other than the default specified in the waiver and said waiver shall be operative only for the time and to the extent therein stated. Waivers of any covenant, term or condition contained herein by either party shall not be construed as a waiver of any subsequent breach of the same covenant,

term or condition. The consent or approval by either party to or of any act by either party requiring further consent or approval shall not be deemed to waive or render unnecessary their consent or approval to or of any subsequent similar acts.

18.04 Subdivision and Easements. Landlord reserves the right to: (a) subdivide the Project (but not the Property); and (b) grant easements on the Project and the Property and dedicate portions of the Project (but not the Property) for public use; provided, however, that no such grant or dedication shall materially interfere with Tenant's use of the Premises. Tenant hereby consents to such subdivision and/or grant or dedication of easements and agrees from time to time, at Landlord's request, to execute, acknowledge and deliver to Landlord, in accordance with Landlord's instructions, any and all documents, instruments, maps or plats necessary to effectuate Tenant's consent thereto.

18.05 Common Areas. Landlord reserves the right from time to time, provided that Tenant's use and enjoyment of the Premises is not materially and adversely affected thereby, to: (a) install, use, maintain, repair and replace pipes, ducts, conduits, wires and appurtenant meters and equipment for service to other parts of the Building above the ceiling surfaces, below the floor surfaces, within the walls and in the central core areas, and to relocate any pipes, ducts, conduit, wires and appurtenant meters in the Building which are so located or located elsewhere outside the Building; (b) make changes to the Common Areas and/or the parking facilities located thereon, including, without limitation, changes in the location, size, shape and number of driveways, entrances, parking spaces, parking areas, loading and unloading areas, ingress, egress, direction of traffic, landscaped areas and walkways; (c) close temporarily all or any portion of the Common Areas and/or the Building in order to perform any of the foregoing or any of Landlord's obligations under this Lease, so long as reasonable access to the Building remains available during normal business hours; and (d) alter, relocate or expand, and/or to add additional structures and improvements to, or remove same from, all or any portion of the Common Areas or other portions of the Project; provided, that Landlord shall repair any damage to the Premises resulting from the exercise by Landlord of its rights hereunder and provided, further that no such changes shall materially affect the usability of the Premises by Tenant, the visibility of or access to the Premises or reduce available parking provided to the Premises pursuant to Section 1.01(q).

18.06 Accord and Satisfaction. No payment by Tenant or receipt by Landlord of a lesser amount than the Rent herein stipulated shall be deemed to be other than on account of the Rent, nor shall any endorsement or statement on any check or any letter accompanying any check or payment as Rent be deemed an accord and satisfaction, and Landlord may accept such check or payment without prejudice to Landlord's right to recover the balance of such Rent or pursue any other remedy provided in this Lease.

18.07 Limitation of Landlord's Liability. The obligations of Landlord under this Lease do not constitute personal obligations of the individual partners, directors, officers, members, employees or shareholders of Landlord or its partners, and Tenant shall look solely to the Property, and the rents, issues, proceeds (including insurance proceeds) and profits therefrom, for satisfaction of any liability in respect of this Lease and will not seek recourse against the individual partners, directors, officers, members, employees or shareholders of Landlord or its partners or any of their personal assets for such satisfaction.

18.08. Intentionally Deleted.

18.09 Attorneys' Fees. In the event either party requires the services of an attorney in connection with enforcing the terms of this Lease or in the event suit is brought for the recovery of any Rent due under this Lease or the breach of any covenant or condition of this Lease, or for the restitution of the Premises to Landlord and/or eviction of Tenant during the Term of this Lease, or after the expiration thereof, the substantially prevailing party will be entitled to a reasonable sum for attorneys' fees, witness fees and other court costs, both at trial and on appeal.

18.10 Captions and Article Numbers. The captions, article, paragraph and section numbers and table of contents appearing in this Lease are inserted only as a matter of convenience and in no way define, limit, construe or describe the scope or intent or such sections or articles of this Lease nor in any way affect this Lease.

18.11 Severability. If any term, covenant, condition or provision of this Lease, or the application thereof to any person or circumstance, shall to any extent be held by a court of competent jurisdiction to be invalid, void or unenforceable, the remainder of the terms, covenants, conditions or provisions of this Lease, or the application thereof to any person or circumstance, shall remain in full force and effect and shall in no way be affected, impaired or invalidated.

18.12 Applicable Law. This Lease, and the rights and obligations of the parties hereto, shall be construed and enforced in accordance with the laws of the state in which the Building is located.

18.13 Submission of Lease. The submission of this document for examination and negotiation does not constitute an offer to lease, or a reservation of or option for leasing the Premises. This document shall become effective and binding only upon execution and delivery hereof by Landlord and Tenant. No act or omission of any officer, employee or agent of Landlord or Tenant shall alter, change or modify any of the provisions hereof.

18.14 Holding Over. Should Tenant, or any of its successors in interest, hold over the Premises or any part thereof after the expiration or earlier termination of this Lease without Landlord's prior written consent, such holding over shall constitute and be construed as tenancy at sufferance only, at a monthly rent equal to one hundred fifty percent (150%) of the Base Rent owed during the final month of the Term of this Lease and otherwise upon the terms and conditions in the Lease, so far as applicable. The acceptance by Landlord of Rent after such expiration or early termination shall not result in a renewal or extension of this Lease. The foregoing provisions of this Section 18.14 are in addition to and do not affect Landlord's right of re-entry or any other rights of Landlord hereunder or as otherwise provided by law. Tenant shall indemnify and hold Landlord harmless from and against all loss or liability, including without limitation, any claim made by any succeeding tenant resulting from such failure to surrender by Tenant and any attorneys' fees and costs incurred by Landlord with respect to any such claim.

18.15 Rules and Regulations. At all times during the Term, Tenant shall comply with Rules and Regulations for the Building and the Project, as set forth in Exhibit G attached hereto, together with such amendments thereto as Landlord may from time to time reasonably adopt and enforce in a non-discriminatory fashion, which amendments shall not affect Tenant's rights hereunder.

18.16 Parking. During the Term of this Lease, Tenant shall have the non-exclusive use of the number of vehicle parking spaces designated in Subsection 1.01(q) above for Tenant, its employees, visitors and customers, without fee or charge. Notwithstanding the non-exclusive nature of such parking rights, Tenant shall, at all times during the term of this Lease, have the ability to park vehicles in the minimum number of stalls provided in Subsection 1.01(q) above (as may be adjusted based upon contraction or recapture of any portion of the Premises). Landlord represents and warrants that the parking facility serving the Building shall contain at least the number of stalls required by Subsection 1.01(q) above (subject to reduction due to an action of governmental authority which action shall be controlled by the provisions of Subsection 12.01 above). Tenant shall have the right to designate parking spaces in the first row immediately adjacent to the Premises as reserved spaces for certain employees, for designated visitors or for other purposes.

18.17 No Nuisance. Tenant shall conduct its business and control its agents, employees, invitees and visitors in such a manner as not to create any nuisance, or interfere with, annoy or disrupt any other tenant or Landlord in its operation of the Project.

18.18 Broker; Agency Disclosure.

(a) Each of Tenant and Landlord warrant that it has had no discussions, negotiations and/or other dealings with any appraiser or agent in connection with the negotiation of this Lease other than the Broker(s) identified in Section 1.01(r) ("Brokers"), and that it knows of no other appraiser or agent who is or may be entitled to any commission or finder's fee in connection with this Lease. Landlord shall pay Brokers a commission pursuant to separate agreements. Brokers shall be obligated to pay any co-brokers a portion of the commission received by such Broker. Each Tenant and Landlord agrees to indemnify the other and hold the other harmless from and against any and all claims, demands, losses, liabilities, lawsuits, judgments, costs and expenses (including without limitation, attorneys' fees and costs) with respect to any leasing commission or equivalent compensation alleged to be owing on account of such party's discussions, negotiations and/or dealings with any appraiser or agent. This Section 18.18 is not intended to benefit any third parties and shall not be deemed to give any rights to brokers or finders. No commission(s) or finders fee(s) shall be paid to Tenant, employee(s) of Tenant or any unlicensed representative of Tenant.

(b) At the signing of this Lease Tenant's Broker represented Tenant.

18.19 Landlord's Right to Perform. Upon Tenant's failure to perform any obligation of Tenant hereunder after notice from Landlord pursuant to Section 13.01 above, including without limitation, payment of Tenant's insurance premiums, charges of contractors who have supplied materials or labor to the Premises, etc., Landlord shall have the right to perform such obligation

of Tenant on behalf of Tenant and/or to make payment on behalf of Tenant to such parties. Tenant shall reimburse Landlord the reasonable cost of Landlord's performing such obligation on Tenant's behalf, including reimbursement of any amounts that may be expended by Landlord, plus interest at the Default Rate, as Additional Rent.

18.20 Assignment by Landlord. In the event of a sale, conveyance, or other transfer by Landlord of the Building, the Property, or portion thereof on which the Building is located, or the Project or in the event of an assignment of this Lease by Landlord, the same shall operate to release Landlord from any further liability upon any of the covenants or conditions, express or implied, herein contained on the part of Landlord, and from any and all further liability, obligations, costs and expenses, demands, causes of action, claims or judgments arising out of this Lease from and after the effective date of said release. In such event, Tenant agrees to look solely to the successor in interest of transferor so long as such successor has expressly assumed the obligations of Landlord hereunder. Landlord shall transfer such Security Deposit to any purchaser and thereupon Landlord shall be discharged from any further liability in reference thereto.

18.21 Entire Agreement. This Lease sets forth all covenants, promises, agreements, conditions and understandings between Landlord and Tenant concerning the Building and the Project, and there are no covenants, promises, agreements, conditions or understandings, either oral or written, between Landlord and Tenant other than as are herein set forth. No subsequent alteration, amendment, change or addition to the Lease shall be binding upon Landlord or Tenant unless reduced to writing and signed by Landlord and Tenant.

18.22 Financial Covenants. Landlord acknowledges and agrees that Tenant, or Tenant's parent and/or the Guarantor, is/are a publicly traded corporation and as such, Landlord has access to all public information regarding Tenant. If at any time such information regarding Tenant or an assignee or successor of Tenant is not readily available to Landlord, then at Landlord's request, Tenant shall provide Landlord with current annual audited financial statements and quarterly unaudited financial statements setting forth Tenant's financial position (all such statements shall be prepared in compliance with GAAP standards), but only to the extent the providing of such financial information is not prohibited by applicable security laws or regulations.

18.23 Consents. Whenever the approval or consent of Landlord or Tenant is required under the terms of this Lease, such consent shall not be unreasonably withheld or delayed unless a different standard of approval is specifically set forth in the particular Section containing that particular consent requirement.

18.24 Intentionally Deleted.

18.25 Exhibits. Exhibits A through J are attached to this Lease after the signatures after the signatures and by this reference incorporated herein.

18.26 Submission of Lease. Submission of this instrument for examination or signature by Tenant does not constitute a reservation of or option for lease, and it is not effective as a lease or otherwise until execution and delivery to both Landlord and Tenant.

18.27 Time. Time is of the essence with respect to the performance of every provision of this Lease in which time of performance is a factor.

18.28 Prior Agreement or Amendment. This Lease contains all of the agreements of the parties hereto with respect to any matter covered or mentioned in the Lease, and no prior agreement or understanding pertaining to any such matter shall be effective for any purpose. No provisions of this Lease may be amended or added to except by an agreement in writing signed by the parties hereto or their respective successors-in-interest.

18.29 Independently Provided Services.

(a) This Lease is entirely separate and distinct from and independent of any and all agreements that Tenant may at any time enter into with any third party for the provision of services, which include, but are not limited to, telecommunications, office automation, repair, maintenance services, computer, and photocopying ("Independent Services"). Tenant acknowledges that Landlord has no obligation of any type concerning the provision of Independent Services, and agrees that any cessation or interruption of Independent Services or any other act or neglect by the third party providing the Independent Services shall not constitute a default or constructive eviction by Landlord.

(b) Tenant agrees, except to the extent of the negligence of Landlord, its partners, employees, agents and/or assigns, to hold harmless and defend Landlord, its partners, employees, agents and assigns from any claim Tenant may have arising in any way out of the provision (or lack thereof) of the Independent Services which Tenant has contracted to receive from the third parties.

(c) In no event shall Landlord be liable to Tenant for incidental, consequential, indirect or special damages (including lost profits) which may arise in any way out of a claim concerning Independent Services.

18.30 Authority to Bind Landlord. Landlord has the right, power and authority to enter into this Lease and the individuals signing this Lease on behalf of Landlord hereby represent and warrant that they are empowered and duly authorized to bind Landlord to this Lease.

18.31 Authority to Bind Tenant. The individuals signing this Lease on behalf of Tenant hereby represent and warrant that they are empowered and duly authorized to bind Tenant to this Lease. If Tenant is a corporation, limited liability company or limited or general partnership, each individual executing this Lease on behalf of Tenant represents and warrants that he or she is duly authorized to execute and deliver this Lease on behalf of Tenant, in accordance with a duly adopted resolution or consents of all appropriate persons or entities required therefor and in accordance with the formation documents of tenant, and that this Lease is binding upon Tenant in accordance with its terms. At Landlord's request, tenant shall, prior to Landlord's execution of this Lease, deliver to Landlord a copy of the appropriate resolution or consent, certified by an appropriate officer, partner or manager of Tenant, authorizing or ratifying the execution of this Lease.

18.32 No Usury. No interest charged, or chargeable by Landlord under this Lease (including but not limited to the interest chargeable under Section 5(a) and/or any late charge, fee or other sum charged or withheld by Landlord and which is deemed to be interest) shall exceed the maximum amount of interest permitted by any applicable law. If any such interest, fee or charge would exceed such maximum, then such interest, fee or charge shall be automatically reduced to the maximum amount allowed by law and any sums already collected in excess of such maximum amount shall be refunded by Landlord in cash or by granting Tenant a credit in the applicable amount which credit shall be applied against the next Base Rent coming due.

18.33 Interpretation. The parties hereto specifically acknowledge and agree that the terms of this Lease have been mutually negotiated and the parties hereby specifically waive the rule or principle of contract construction which provides that any ambiguity in any term or provision of a contract will be interpreted or resolved against the party which drafted such term or provision.

18.34 Excused Delays. Except as otherwise set forth in this Section 18.34, neither party shall have liability to the other on account of the following acts (each of which is an "Excused Delay" and jointly all of which are "Excused Delays") which shall include: (a) the inability to fulfill, or delay in fulfilling, any obligations under this Lease by reason of strike, lockout, other labor trouble, dispute or disturbance; (b) governmental regulation, moratorium, action, preemption or priorities or other controls; (c) shortages of fuel, supplies or labor; (d) any failure or defect in the supply, quantity or character of electricity or water furnished to the Premises by reason of any requirement, act or omission of the public utility or others furnishing the Building with electricity or water; or (e) for any other reason, whether similar or dissimilar to the above, or for act of God beyond a party's reasonable control. If this Lease specifies a time period for performance of an obligation of a party, that time period shall be extended by the period of any delay in the party's performance caused by any of the events of Excused Delay described herein; provided, that notwithstanding anything to the contrary above, no payment of money (whether as Base Rent, Tenant's Percentage of Taxes or Operating Costs, or any other payment due under this Lease) shall be postponed, delayed or forgiven by reason of any of the foregoing events of Excused Delay.

18.35 Antennae Equipment. During the Term of this Lease, Tenant shall have the exclusive right to install, maintain and operate, free of charge, satellite dishes and related equipment (the "Equipment") on the roof of the Building subject to the following terms and conditions:

(a) The location of all Equipment shall be approved by Landlord prior to Tenant's installation of the Equipment, together with appropriate screening.

(b) Tenant shall operate the Equipment in compliance with all applicable laws, rules, regulations and ordinances.

(c) Tenant shall have the right, subject to the reasonable supervision of the Building engineer, to use the Building risers to install cabling to connect the Equipment to the Premises.

(d) Tenant shall remove any such Equipment and repair any damage resulting from the same, upon expiration or earlier termination of this Lease.

18.36. Letter of Credit.

(a) Concurrently with the execution of this Lease, Tenant shall deliver to Landlord an unconditional, irrevocable standby letter of credit ("Letter of Credit") which conforms in form and substance to the form attached as Exhibit "P" (or is otherwise acceptable to Landlord) and which:

(i) is issued by a United States federal or state chartered bank ("Issuer") that is a member of the New York Clearing House Association or is a commercial bank or trust company, all as reasonably acceptable to Landlord;

(ii) names Landlord as beneficiary thereunder;

(iii) has a term ending not less than one year after the date of issuance;

(iv) automatically renews for one-year periods unless Issuer notifies beneficiary in writing, at least 60 days prior to the expiration date, that Issuer elects not to renew the Letter of Credit;

(v) provides for payment to beneficiary of immediately available funds (denominated in United States dollars) in the amount of Two Million Five Hundred Thousand Dollars (\$2,500,000.00) upon presentation of the Sight Draft substantially conforming to the form attached as Schedule "A" to the Letter of Credit and the certification required under the Letter of Credit;

(vi) provides that draws may be presented, and are payable at the Issuer's letterhead office or other office designated by the Issuer in writing (as reasonably acceptable to Landlord);

(vii) is payable in sight drafts which only require the beneficiary to state that the draw is payable to the order of beneficiary;

(viii) permits partial and multiple draws;

(ix) permits multiple transfers by beneficiary;

(x) waives any rights Issuer may have, at law or otherwise, to subrogate to any claims beneficiary may have against applicant or applicant may have against beneficiary; and

(xi) is governed by the International Standby Practices 1998, published by the International Chamber of Commerce.

Except as expressly provided in Subsection 18.36(f) and (k) below, the Letter of Credit (as transferred, extended, renewed or replaced) must be maintained during the entire Lease Term, as extended or renewed, and for a period of 45 days thereafter.

(b) Transfer; Fees. Landlord may freely transfer the Letter of Credit in connection with an assignment of this Lease without (i) Tenant's consent, (ii) restriction on the number of transfers, or (iii) any condition, other than presentment to Issuer of the original Letter of Credit and a duly executed transfer document conforming to the form attached as Schedule "B" to the Letter of Credit. Tenant is solely responsible for any bank fees or charges imposed by Issuer in connection with the issuance of the Letter of Credit or any transfer, renewal, extension or replacement thereof. If Tenant fails to timely pay such transfer fee, Landlord may, at its option and without notice to Tenant, elect to pay any transfer fees to Issuer when due, and upon payment, such amount will become immediately due and payable from Tenant to Landlord as Additional Rent under this Lease.

(c) Definition of Draw Event. "Draw Event" means the occurrence of any of the following events:

(i) Tenant fails to pay fully any item of Rent as and when due, and such failure continues for a period of five (5) days after written notice from Landlord to Tenant;

(ii) Tenant (i) breaches or fails to timely perform any of its other obligations under this Lease, (ii) the breach or failure continues for a period of thirty (30) days without regard to any cure period granted under this Lease and without regard to whether such breach or failure is determined (upon occurrence or at any later time) to be an Event of Default and (iii) Tenant has either failed to commence cure of the breach or failure or, if cure has been commenced, is not diligently pursuing such cure;

(iii) There is an Event of Default under this Lease, pursuant to Subsection 13.01 above;

(iv) Subject to Subsection 18.36(k) below, Tenant fails to timely cause the Letter of Credit to be renewed or replaced as required in Subsection 18.36(f) below; or

(v) an Issuer Quality Event as described in Subsection (g) below.

(d) Draw and Use of Draw Proceeds. Immediately upon the occurrence of any one or more Draw Events, and at any time thereafter, Landlord may draw on the Letter of Credit, in whole or in part (if partial draw is made, Landlord may make multiple draws), as Landlord may determine in Landlord's sole and absolute discretion (subject to application as contemplated in Subsection 18.36(d) below). The term "Draw Proceeds" means the cash proceeds of any draw or draws made by Landlord under the Letter of Credit. Any delays by Landlord in drawing on the Letter of Credit or using the Draw Proceeds will not constitute a waiver by Landlord of any of its rights hereunder with respect to the Letter of Credit or the Draw Proceeds. Landlord will hold the Draw Proceeds in its own name and may co-mingle the Draw Proceeds with other accounts of Landlord or invest them as Landlord may determine in its sole and absolute discretion.

(e) Application of Draw Proceeds. In addition to any other rights and remedies Landlord may have, Landlord may in its sole and absolute discretion and at any time, use and apply all or any portion of the Draw Proceeds to pay Landlord for any one or more of the following:

(i) Rent or any other sum which is past due, due or becomes due, or to which Landlord is otherwise entitled under the terms of this Lease, whether due to the passage of time, the existence of a default or otherwise (including, without limitation, late payment fees or charges and any amounts which Landlord is or would be allowed to collect under this Lease, and without deducting therefrom any offset for proceeds of any potential reletting or other potential mitigation which has not in fact occurred at the time of the draw);

(ii) any and all amounts incurred or expended by Landlord in connection with the exercise and pursuit of any one or more of Landlord's rights or remedies under this Lease, including, without limitation, reasonable attorneys' fees and costs;

(iii) any and all amounts incurred or expended by Landlord in obtaining the Draw Proceeds, including, without limitation, reasonable attorneys' fees and costs; or

(iv) any and all other damage, injury, expense or liability caused to or incurred by Landlord as a result of any Event of Default, Draw Event or other breach, failure or default by Tenant under this Lease.

To the extent that Draw Proceeds exceed the amounts so applied, such excess Draw Proceeds will be deemed paid to Landlord to establish a credit on Landlord's books in the amount of such excess, which credit may be applied by Landlord thereafter (in Landlord's sole and absolute discretion), to any of Tenant's obligations to Landlord under this Lease as and when they become due. Following any use or application of the Draw Proceeds, Tenant, if requested by Landlord in writing, must, within 10 days after receipt of Landlord's request, cause a replacement Letter of Credit complying with Subsection 18.36(a) above to be issued and delivered to Landlord; provided, however, that the amount of the replacement Letter of Credit will be an amount equal to the original amount of the Letter of Credit (as set forth in Section (e) above) less any unapplied Draw Proceeds on the date the replacement Letter of Credit is issued. Upon Landlord's receipt of the replacement Letter of Credit, Landlord will deliver the prior original Letter of Credit to Issuer for cancellation (if not theretofore fully drawn) and any unapplied Draw Proceeds will be applied in accordance with the above provisions.

If it is determined or adjudicated by a court of competent jurisdiction that Landlord was not entitled to draw on the Letter of Credit, Tenant may, as its sole and exclusive remedy, cause Landlord to (i) deliver the prior original Letter of Credit to Issuer for cancellation (if not theretofore fully drawn), (ii) return to Issuer the amount of the Draw Proceeds which the court

determines Landlord was not entitled to draw and (iii) reimburse Tenant for all out-of-pocket fees, costs and interest expenses actually incurred by Tenant as a direct result of Landlord's draw on the Letter of Credit; provided, however, Tenant may exercise its exclusive remedy only after Tenant has (y) cured all defaults under this Lease and (z) caused a replacement Letter of Credit complying with Subsection 18.36(a) above to be issued and delivered to Landlord. Landlord will not be liable for any other actual damages or any indirect, consequential, special or punitive damages incurred by Tenant in connection with either a draw by Landlord on the Letter of Credit or the use or application by Landlord of the Draw Proceeds. Nothing in this Lease or in the Letter of Credit will confer upon Tenant any property right or interest in any Draw Proceeds.

(a) Renewal and Replacement. The Letter of Credit must provide that it will be automatically renewed unless Issuer provides written notice of nonrenewal to Landlord at least 60 days prior to the expiration date of the Letter of Credit. If written notice of nonrenewal is received from Issuer, Tenant must renew the Letter of Credit or replace it with a new Letter of Credit, at least 30 days prior to the stated expiration date of the then-current Letter of Credit. Any renewal or replacement Letter of Credit must meet the criteria set forth in Subsection 18.36(a) above, and must have a term commencing at least one day prior to the stated the expiration date of the immediately prior Letter of Credit. Failure to provide a renewal or replacement Letter of Credit as provided above will, at Landlord's election, be an Event of Default under this Lease.

(b) Issuer Quality Event. If an Issuer Quality Event occurs, Tenant, upon 30 days advance written notice from Landlord, must, at its own cost and expense, provide Landlord with a replacement Letter of Credit meeting all of the requirements of Section 18.36(a) above. The term "Issuer Quality Event" means the financial strength and/or quality of reputation materially decreases from that at the time of original issuance of the Letter of Credit by Issuer, as reasonably determined by Landlord. An Issuer Quality Event will, at Landlord's election, be an Event of Default under this Lease.

(c) Additional Agreements of Tenant. Tenant expressly acknowledges and agrees that:

- (i) the Letter of Credit constitutes a separate and independent contract between Landlord and Issuer, and Tenant has no right to submit a draw to Issuer under the Letter of Credit;
- (ii) Tenant is not a third-party beneficiary of such contract, and Landlord's ability to either draw under the Letter of Credit for the full or any partial amount thereof or to apply Draw Proceeds may not, in any way, be conditioned, restricted, limited, altered, impaired or discharged by virtue of any Laws to the contrary, including, but not limited to, any Laws that restrict, limit, alter, impair, discharge or otherwise affect any liability that Tenant may have under this Lease or any claim that Landlord has or may have against Tenant;
- (i) neither the Letter of Credit nor any Draw Proceeds will be or become the property of Tenant, and Tenant does not and will not have any property right or interest therein;

- (ii) Tenant is not entitled to any interest on any Draw Proceeds;
- (iii) neither the Letter of Credit nor any Draw Proceeds constitute an advance payment of Rent, security deposit or rental deposit;
- (iv) neither the Letter of Credit nor any Draw Proceeds constitute a measure of Landlord's damages resulting from any Draw Event, Event of Default or other breach, failure or default (past, present or future) under this Lease; and
- (v) Tenant will cooperate with Landlord, at Tenant's own expense, in promptly executing and delivering to Landlord all modifications, amendments, renewals, extensions and replacements of the Letter of Credit, as Landlord may reasonably request to carry out the terms and conditions of this Subsection.

(d) Restrictions on Tenant Actions. Tenant hereby irrevocably waives any and all rights and claims that it may otherwise have at law or in equity, to contest, enjoin, interfere with, restrict or limit, in any way whatsoever, any requests or demands by Landlord to Issuer for a draw or payment to Landlord under the Letter of Credit; provided that such requested or demanded draw and/or payment are made in accordance with this Subsection 18.36 and the Letter of Credit.

(e) Cancellation After End of Term. Provided that no Draw Event, Event of Default, or other breach or default under this Lease then exists, Landlord will deliver the Letter of Credit to the Issuer for cancellation within 45 days after the expiration or termination of this Lease and surrender of the Premises by Tenant to Landlord.

(f) Tenant shall, on or before the date thirty (30) days after the closing of the acquisition of Tenant by Instrumentarium Corporation, a Finnish corporation, provide Landlord with a Guaranty from Instrumentarium Corporation, in the form attached to this Lease as Exhibit J, (and with evidence of due execution and authorization of the Guaranty by Guarantor acceptable to Landlord in its reasonable discretion). In the event such Guaranty and the evidence of due execution and authorization is so provided, Landlord shall cause the Letter of Credit to be returned to Issuer for cancellation within thirty (30) days after receipt by Landlord of such Guaranty. Notwithstanding the above, in the event (A) the acquisition of Tenant by Instrumentarium Corporation does not occur by the date twelve (12) months after the date of mutual execution of this Lease, and/or (B) the financial strength of Instrumentarium Corporation at the time of the proposed substitution of the Guaranty is materially less than the financial strength of such corporation as shown on its fiscal year 2001 audited financial statement, Landlord shall have no obligation to allow substitution of the Guaranty for the Letter of Credit and may require the Letter of Credit to be maintained pursuant to this Subsection 18.36 for the entire Lease Term and any Extended Terms.

IN WITNESS WHEREOF, the parties have executed this Lease as of the date first above written.

“Landlord”

S/I SAMMAMISH I, LLC

By: _____

Its: _____

“Tenant”

SPACELABS
MEDICAL, INC.

By: _____

Its: _____

THIS LEASE ("Lease") dated as of the 24th day of June 2002, is made by and between S/I SAMMAMISH II, LLC, A WASHINGTON LIMITED LIABILITY COMPANY ("Landlord"), and SPACELABS MEDICAL, INC., A DELAWARE CORPORATION ("Tenant").

ARTICLE I: DEFINITIONS

1.01 Defined Terms. The following terms shall have the meanings specified in this Section, unless otherwise specifically provided. Other terms may be defined in other parts of the Lease.

- (a) Landlord: S/I SAMMAMISH II, LLC
- (b) Landlord's Address: c/o Schnitzer Northwest
225 – 108th Avenue NE, Suite 400
Bellevue, Washington 98004
Telephone: (425) 452-3700
Facsimile: (425) 454-1505
- With a Copy to: Jameson Babbitt Stites &
Lombard, P.L.L.C.
999 Third Avenue, Suite 1900
Seattle, Washington 98104
Attn: Jennifer Cobb
Telephone: (206) 292-1994
Facsimile: (206) 292-1995
- (c) Tenant: SPACELABS MEDICAL, INC., a
Delaware corporation
- (d) Tenant's Address: Prior to Lease Commencement:
15220 N.E. 40th Street
Redmond, Washington 98052
Attn: Karyn Beckley
Telephone (425) 882-3753
Facsimile (425) 702-2310
- After Lease Commencement:
At the Premises
5150 – 220th Avenue S.E.
Issaquah, Washington 98027

-
- with a copy to: Spacelabs Medical, Inc.
5150 – 220th Avenue S.E.
Issaquah, WA 98027
Attn: General Counsel
- (e) Tenant’s Use: Corporate offices, warehouse/distribution and related uses for medical electronics development and ancillary uses consistent with a Class A business park, including, without limitation, an internal food service for Tenant’s employees and guests.
- (f) Project: SAMMAMISH PARK PLACE, including all buildings and Common Areas (as hereinafter defined) thereon and related thereto.
- (g) Property: The real property described in Exhibit “A” and depicted on the Project Site Plan attached as Exhibit “B.”
- (h) Building: That certain 4 -story office building designated as Building B on the Project Site Plan attached hereto as Exhibit B with a rentable area of approximately 106,944.
- (i) Premises: Approximately 106,944 rentable square feet consisting of the entire rentable area of the Building, as shown on the Tenant Improvement Turn-Key Floor Plan(s) attached as Exhibit “C-1”.
- (j) Term: Commencing upon the Commencement Date (as defined in Section 4.01) and expiring on the Expiration Date determined pursuant to Section 4.01 (approximately ten (10) years) (subject to extension, if applicable, pursuant to Section 4.03 below).
- (k) Scheduled Commencement Date: January 1, 2003. The actual Commencement Date is subject to determination pursuant to Subsection 4.01 below.

(l) Base Rent:

<u>Ten (10) Year Rent Schedule</u>	<u>Mo. Rate Per RSF</u>	<u>Annual Rate Per RSF</u>	<u>Monthly Total</u>
Months 1-12	\$0.0000	\$ 0.00	\$ 0
Months 13-24	\$1.4125	\$ 16.95	\$ 151,058
Months 25-36	\$1.4542	\$ 17.45	\$ 155,514
Months 37-48	\$1.5000	\$ 18.00	\$ 160,416
Months 49-60	\$1.5500	\$ 18.60	\$ 165,763
Months 61-72	\$1.6017	\$ 19.22	\$ 171,289
Months 73-84	\$1.6550	\$ 19.86	\$ 176,992
Months 85-96	\$1.7100	\$ 20.52	\$ 182,874
Months 97-108	\$1.7667	\$ 21.20	\$ 188,934
Months 109-120	\$1.8250	\$ 21.90	\$ 195,173

- (m) Prepaid Rent: \$151,058.00 applicable to Month 13
- (n) Security Deposit: \$195,173.00 subject to the terms of Section 5.04.
- (o) Tenant's Share of Building: 100%
- (p) Tenant's Share of Project: 52.50%
- (q) Surface Parking Spaces: 413 uncovered surface parking spaces adjacent to the Building shall be provided for the use of Tenant, its employees and visitors, subject to a decrease resulting from Tenant requested site improvements/equipment.
- (r) Broker(s): Pacific Real Estate Partners, representing Landlord Broderick Group, Inc., representing Tenant
- (s) Guarantor: Instrumentarium Corporation, a Finnish corporation

(t)	Exhibits:	Exhibit A:	Legal Description of Property
		Exhibit B:	Project Site Plan
		Exhibit C-1:	Tenant Improvement Turn-Key Floor Plans
		Exhibit C-2:	Outline Specifications for Turn-Key Tenant Improvements
		Exhibit D:	Work Schedule
		Exhibit E:	Lease Confirmation
		Exhibit F:	Estoppel Certificate
		Exhibit G:	Rules and Regulations
		Exhibit H:	Memorandum of Lease
		Exhibit I:	Letter of Credit Form
		Exhibit J:	Form of Guaranty

2.01 Premises.

(a) Landlord hereby leases to Tenant, and Tenant hereby leases from Landlord, subject to the provisions of this Lease, certain premises ("Premises") to be located within that certain building ("Building") described in Subsection 1.01(h) above and situated on the real property ("Property") legally described in Exhibit A attached hereto and by this reference incorporated herein, which Property is a portion of the "Project" identified in Section 1.01(f). The location of the Property, the Building and the Premises are more particularly shown on the Project Site Plan and the Tenant Improvement Turn-Key Floor Plan(s) attached hereto as Exhibit B and Exhibit C-1, respectively.

(b) The term "Rentable Area of the Premises," "rentable square feet" "actual square footage" and words of similar import (whether or not spelled with initial capitals) as used in this Lease will be determined using the "Standard Method of Measuring Floor Area in Office Buildings" (approved June 7, 1996) by BOMA International for a single-tenant occupied building with the exception that Rentable Area shall be calculated by the BOMA definition of gross measured area (as opposed to the BOMA definition of Gross Building Area) (the "BOMA Standard"). Landlord and Tenant agree that, for purposes of this Lease, the Rentable Area of the Premises as of the Commencement Date of the Lease will be that set forth in Subsection 1.01(i) above and that Landlord and Tenant have both confirmed such area. Tenant acknowledges that, except as otherwise expressly set forth in this Lease, neither Landlord nor any agent of Landlord has made any representation or warranty with respect to the Premises, the Building, the Common Areas or the Project or their suitability for the conduct of Tenant's business.

2.02 Exclusive Areas; Common Areas.

(a) Subject to the terms of Section 8.05 below and/or except as otherwise expressly allowed by this Lease, Landlord agrees that Tenant shall have the exclusive right to possess and use the Building and all areas within the Building, Landlord acknowledges that the Building is a single tenant building and all of the space within constitutes the Premises. For so long as Tenant leases the entire Building pursuant to this Lease, Tenant shall have the exclusive right to control access to and from the Building utilizing any and all security and or access control, protocols or mechanisms as Tenant shall deem necessary in Tenant's sole and absolute discretion.

(b) In addition to the facilities located within the Property, Tenant shall have the non-exclusive right to use in common with other tenants and/or occupants of the Project, the following areas appurtenant to the Building: parking areas and facilities, roadways, sidewalks, walkways, parkways, plazas, driveways and landscaped areas and similar areas and facilities situated within the exterior areas of the Project and not otherwise designated for the exclusive or restricted use by Landlord and/or individual tenants of other buildings located within the Project (the "Common Areas"). Tenant acknowledges that Landlord shall have no obligation to construct or complete any additional buildings within the Project or improvements to the Common Areas other than Landlord's obligation to complete the construction of the sitework and

Common Areas of the Property pursuant to Article III below. Tenant's right to utilize the Common Areas shall at all times be subject to Landlord's reserved rights therein as described in Section 18.05 hereof, the existing Rules and Regulations referred to in Section 18.15 hereof and all covenants, conditions and restrictions ("CC&Rs") now or hereafter affecting or encumbering the Project; provided that the same do not materially adversely affect the rights of Tenant under this Lease. To the extent of any inconsistency between the Rules and Regulations or CC&Rs enacted after the date of this Lease, the terms and conditions of this Lease shall control as between Landlord and Tenant.

2.03 Contraction Option. Tenant shall have the right, effective as of the first day of the seventy-third (73rd) month of the Lease Term ("Contraction Date"), to reduce the area of the Premises by up to two full floors by deleting from the Premises one of the following: (a) the entire 3rd and 4th floors, (b) the entire 3rd floor, (c) the entire 4th floor, (d) one-half of the 3rd floor, or (e) one-half of the 4th floor. To exercise its option to contract pursuant to this Subsection 2.03, Tenant shall provide Landlord with written notice of such election no later than the last day of the 60th month of the Lease Term, which notice shall state which portion of the Premises (one only of alternatives (a) – (e) above) Tenant elects to delete from the Premises. In the event Tenant elects to delete one-half of a floor pursuant to alternatives (d) or (e) above, Tenant's notice shall also state which one-half of the floor Tenant elects to delete from the Premises. In the event Tenant timely exercises its contraction rights hereunder, Landlord and Tenant shall enter into an amendment to this Lease reducing the area of the Premises as of the Contraction Date and reducing the Base Rent, Tenant's Share and parking stall allocation proportionately. Tenant shall be required to vacate the applicable portion of the Premises by no later than the Contraction Date. In the event the Premises are reduced by a half floor pursuant to alternatives (d) or (e) above, Tenant shall allow Landlord access to the Premises as reasonably necessary in order for Landlord to demise the portion of the Premises deleted pursuant to this Subsection.

ARTICLE III: IMPROVEMENTS

3.01 Construction of Building and Premises.

(a) Completion Schedule. Landlord hereby agrees to construct the tenant improvements to the Building and Premises in a commercially reasonable and diligent manner substantially in accordance with the Tenant Improvement Plans described hereinbelow. Attached hereto as Exhibit D is a schedule (the "Work Schedule") setting forth the estimated timetable for the planning, permitting, construction and completion of the Tenant Improvements to the Building and Premises. Notwithstanding the foregoing, Landlord and Tenant shall periodically update the Work Schedule to incorporate Tenant's intended FF&E activities into the Work Schedule so as to coordinate integration of the same into the schedule for completion of the Tenant Improvements by Landlord.

(b) Plans. A list of the Turn-Key Tenant Improvement Plans are attached hereto as Exhibit C-1 and Outline Specifications for Turn-Key Tenant Improvements are attached hereto as Exhibit C-2 (collectively "Preliminary Plans"). Landlord's architect, in cooperation with Tenant and Landlord, shall prepare final working drawings and specifications for the improvements to the office area of the Premises (the "Tenant Improvement Plans") which

shall be subject to the approval of Landlord and Tenant in accordance with the Work Schedule and shall not materially deviate from the Preliminary Plans referenced in Exhibits C-1 and C-2, respectively, unless Tenant agrees to pay for the costs, including design, permitting, construction and sales tax associated with such deviations. Tenant shall also have the right to request changes in the Tenant Improvement Plans and any such change shall be documented by Landlord's architect and subject to approval by Landlord, which approval shall not be unreasonably withheld, conditioned or delayed. Notwithstanding the above, it shall not be unreasonable for Landlord to disapprove a proposed change to the Preliminary Plans and/or Tenant Improvement Plans that results in a cumulative increase or decrease of more than 5% in the respective ratio between open office area, private office area and ancillary room area. Upon Landlord's receipt of Tenant's request for a change to the Preliminary Plans or Tenant Improvement Plans, Landlord shall, as soon as practicable, using diligence, but no later than five (5) business days after receipt of such request, notify Tenant in writing as to (a) the affect of such change on the cost of the Tenant Improvements, including without limitation construction costs, sales tax, design costs and permits and fees (either a cost increase or cost decrease, if any); and (b) whether or not the implementation of such change will affect the timing of the construction of the Tenant Improvements, including, without limitation, if the same will constitute a Tenant Delay (as defined below). Tenant shall have three (3) business days after Tenant's receipt of such notice and information from Landlord to elect to proceed with such change and to deposit with Landlord 100% of the sum of any increased cost resulting in connection with such change, thereby agreeing with any change in cost of the Tenant Improvements. Landlord and Tenant agree that, with respect to any Tenant-requested change to the Preliminary Plans and/or Tenant Improvement Plans, Tenant shall be solely responsible for all cost increases but Tenant shall also receive the benefit of any cost savings by way of the netting of such savings against cost increases resulting from other modifications requested by Tenant to the Preliminary Plans and/or Tenant Improvement Plans. If Tenant shall fail to respond during such 3-business day period (or to deposit the required cost increase amount), then Tenant shall be conclusively presumed to have elected to not institute the relevant change.

(c) Construction of Tenant Improvements. Landlord shall cause Pennon Construction or other contractor(s) chosen by Landlord and reasonably approved by Tenant (the "Contractor") to construct the tenant improvements to the Premises ("Tenant Improvements") pursuant to the Tenant Improvement Plans. The Landlord shall enter into a separate or supplemental guaranteed maximum price contract with Contractor for construction of the Tenant Improvements. Landlord shall supervise the completion of such work and shall use its good faith diligent efforts to secure substantial completion of the work in accordance with the Work Schedule. The cost of such work shall be paid as provided in Paragraph 3.01(d) below.

(d) Payment for Construction of Tenant Improvements.

(1) Subject to Sections 3.01(d)(2) and (3) below and subject to Tenant's obligation to pay for Tenant-initiated changes pursuant to Subsection 3.01(b) above, Landlord shall pay for all costs in connection with construction of the Tenant Improvements including, without limitation, the following:

(aa) Payment of the cost of preparing the Tenant Improvement Plans;

(bb) The payment of plan check, permit and license fees relating to construction of the Tenant Improvements (but specifically excluding permits, fees and other costs relating to Tenant's furniture, fixtures and/or equipment).

(cc) Construction of the Tenant Improvements pursuant to the Tenant Improvement Plans on a "turn-key" basis.

(2) Tenant shall pay any additional costs resulting from deviations from the Preliminary Plans contained in Exhibits C-1 and C-2 requested by Tenant and revisions to the Tenant Improvement Plans requested by Tenant, all of which shall be paid by Tenant upon approval of such deviations, as more particularly set forth in Subsection 3.01(b) above.

(3) Tenant will, at its sole cost and expense, pay for any improvements to the Premises not expressly included in the Tenant Improvement Plans, which are outside the scope of the Tenant Improvement Plans and which were expressly authorized or requested by Tenant, and shall arrange for the installation of all Tenant's furniture, fixtures, equipment and cabling associated with its business. Costs associated with Tenant's equipment, layout, design and construction coordination are also the sole responsibility of Tenant.

(e) Delay in Completion. If there shall be a delay in substantial completion of the Tenant Improvements or the issuance of a Certificate of Occupancy, or other approval to occupy the Building and Premises, as a result of:

(1) Tenant's failure to approve any item or perform any other obligation within five (5) business days after receipt of notice from Landlord;

(2) Changes in materials, finishes or installations other than those readily available, if requested by Tenant and the effect of which Landlord has notified Tenant as provided hereinabove and/or failure of Tenant to approve substitute materials, finishes or installations upon notice from Landlord that the same are unavailable within the timeframes required by the Work Schedule;

(3) Deviation from the Preliminary Plans or Tenant Improvement Plans, if requested by Tenant and the effect of which Landlord has notified Tenant as provided hereinabove;

(4) Tenant's material interference with Landlord's construction of the Tenant Improvements during Tenant's work within the Premises (whether such work is performed by Tenant or its contractor or by Landlord or its contractor on Tenant's behalf) after Landlord has notified Tenant in writing of the likelihood of a delay resulting from such interference and Tenant has failed to cease such interference; or

(5) Coordination or installation of cabling and/or furniture, fixtures or equipment by Tenant or Tenant's contractors;

(each of which shall be deemed a “Tenant Delay”) then the Commencement Date of the Term of the Lease shall be accelerated by the number of days of such Tenant Delay.

(f) Landlord Delay. If there shall be a delay in Landlord’s delivery of the Premises to Tenant in FF&E Ready Condition as required by Subsection 4.01 below by the Scheduled Delivery Date, then the Fixturing Period (as defined in Subsection 3.04 below) shall not commence until Landlord has so delivered the Premises to Tenant in FF&E Ready Condition and the Commencement Date shall likewise be extended as contemplated by Subsection 4.01.

3.02 Completion and Delivery. The terms “substantial completion,” “Substantial Completion,” “Substantially Complete,” “Substantially complete” and words of similar import (whether or not spelled with initial capitals) as used in the Lease shall mean the date of substantial completion of the Tenant Improvements pursuant to the Tenant Improvement Plans such that Tenant may occupy the Premises for the conduct of its business (subject to the completion of any additional construction to be performed by Tenant). The Premises shall be deemed substantially complete notwithstanding the fact that minor details of construction, mechanical adjustments or decorations which do not unreasonably interfere with Tenant’s use and enjoyment of the Premises (items normally referred to as “punch list” items) remain to be performed; provided, however, substantial completion shall not be achieved until and unless all of the following have occurred: (i) all primary Building operating systems serving the Premises and the Common Areas, as described in the Tenant Improvement Plans (including without limitation the vertical telephone risers or conduits to accommodate cables), are operational; (ii) at least one (1) passenger elevator is servicing the Premises from the ground floor lobby of the Building; (iii) the restrooms are fully operational and are substantially complete with all finishes installed therein, except for minor punch list items; (iv) Tenant has reasonably unimpeded and safe access for itself, its employees and invitees to the Building, parking facility and the Premises; (v) one of the Building elevators are operational and accessible by Tenant and Tenant’s furniture installers and movers; (vi) the ground floor lobby of the Building is substantially complete in accordance with the Tenant Improvement Plans, subject to normal and customary punch list items; (vii) the parking facility for the Building is substantially complete with safe and unimpeded vehicular access thereto reasonably available; and (viii) access between the parking facility and the Building is substantially complete with reasonable unimpeded and safe access from the parking facility to the Building. Notwithstanding the above, if and to the extent any of (i)-(viii) above involve systems requiring integral Tenant-provided components (such as data/voice cabling, cubical office partitions, data/phone room equipment, furniture, UPS, fume hoods, card access readers, etc.), the failure of such systems to be fully operable shall not delay the date of substantial completion, but Landlord shall diligently complete the same upon Tenant’s furnishing and/or installation of such Tenant-provided components. Certification by Landlord’s architect as to the substantial completion of the Premises together with a certificate of occupancy or other comparable approval to occupy issued by the City of Issaquah with respect to the Premises (temporary or permanent) shall be conclusive and binding upon Landlord and Tenant. By taking occupancy of the Premises, Tenant shall be deemed to have accepted the Premises and the Building as substantially complete, except that Tenant shall, within twenty (20) days after entering into possession of the Premises, provide Landlord with a list of punch list items remaining to be completed. Landlord shall diligently complete such punch list items, as

soon as reasonably possible (but in no event later than 30 days after Landlord's receipt of such punch list) except to the extent material or labor availability makes such 30 day period commercially unreasonable for an applicable punch list item, in which event such item shall be completed diligently and in a commercially reasonable time frame. The Commencement Date shall not be delayed because of the existence of uncorrected punch list items. If and to the extent required and requested by Tenant with respect to any applicable and discovered defect or deficiency required to be repaired by Tenant pursuant to this Lease, Landlord hereby agrees to assign to Tenant the benefit of any applicable warranties with respect to the Premises or any portion of thereof for which Tenant shall have repair or maintenance responsibility under this Lease which warranties, Landlord covenants and agrees, shall include a twelve (12) month warranty with respect to new systems associated with the Tenant Improvements. At Landlord's election, Landlord may, by written notice to Tenant, pursue any warranty claim and pursue such repairs covered by warranty notwithstanding that Tenant may be responsible for the applicable repair pursuant to this Lease.

3.03 Delay in Construction, Substantial Completion and/or Delivery.

(a) Delay Penalties. Notwithstanding the above, in the event the Premises are not tendered to Tenant in Tenant FF&E Ready Condition (as defined in Section 4.01) by December 1, 2002 (which such date is referred to herein as the "Scheduled Delivery Date"), Landlord shall pay Tenant (or, at Tenant's election Tenant shall receive as a credit against Base Rent payable under this Lease) an amount equal to \$2,500.00 per day for each of the first fifteen (15) days of delay beyond the Scheduled Delivery Date, and \$5,000.00 per day for the next one hundred and twenty (120) days of delay (after the first 15 days of delay beyond the Scheduled Delivery Date), up to and including one hundred thirty-five (135) days of total delay beyond the Scheduled Delivery Date; provided, however, the Scheduled Delivery Date shall be extended by a day for each day of delay in completion of the Premises resulting from any "Tenant Delay" (as defined in Section 3.01(e) above), inclement weather (defined as weather which delays critical path activities of construction of the Tenant Improvements), earthquake, flood, fire or other casualty, strike, work stoppages, acts of war or terrorism, slow-downs or other labor trouble caused by organized labor, governmental controls (other than failure to receive permits for the Tenant Improvements), or any similar causes, beyond Landlord's reasonable control (any of which delays are referred to herein as "delays beyond Landlord's reasonable control"). Except as expressly contemplated above in this Section 3.03, Landlord shall not be liable to Tenant or any other party, nor shall Tenant have any recourse against Landlord, for any direct or indirect damages as a result of Landlord's failure to deliver the Premises to Tenant within the time periods contemplated herein and/or in the Work Schedule.

(b) Termination Rights. In the event Landlord has not delivered the Premises to Tenant in FF&E Ready Condition on or before the date one hundred and thirty-five (135) days after the Scheduled Delivery Date (the "First Termination Milestone"), then either Landlord or Tenant may elect to terminate this Lease by written notice to the other within ten (10) days after said First Termination Milestone; provided, however, the First Termination Milestone shall be extended by a day for each day of delay in completion of the Premises to FF&E Ready Condition resulting from any "Tenant Delay" or other delays beyond Landlord's reasonable control (each as defined above). In addition, in the event Landlord has not delivered the Premises to Tenant in

FF&E Ready Condition on or before the date one hundred and ninety-five (195) days after the Scheduled Delivery Date (the "Second Termination Milestone"), then either Landlord or Tenant may elect to terminate this Lease by written notice to the other within ten (10) days after said Second Termination Milestone; provided, however, the Second Termination Milestone shall be extended by a day for each day of delay in completion of the Premises to FF&E Ready Condition resulting from any "Tenant Delay" (as defined above).

3.04 Early Access. Landlord agrees to allow Tenant limited access to the Premises not less than thirty (30) days prior to the Commencement Date for installation of Tenant's furniture, fixtures and equipment ("Fixturing Period"); provided, that such early entry by Tenant shall in no way materially interfere with or cause delays in Landlord's construction. Tenant shall be deemed to have waived and released Landlord, its agents, employees and contractors from and with respect to any personal injury or property damage resulting from, during or in connection with such early occupancy by Tenant. During the Fixturing Period, Landlord and Tenant agree to cause their respective contractors (and subcontractors) to reasonably cooperate with each other so as to minimize any potential Tenant Delay and or Landlord Delay resulting from Tenant's early access. Any such early access or occupancy by Tenant shall be subject to the terms and conditions of this Lease (including without limitation any required insurance coverage) except that Tenant shall not be required to pay Base Rent or Operating Expenses during or with respect to such early access or occupancy period.

ARTICLE IV: TERM

4.01 Term. The Term shall commence ("Commencement Date") on the latest to occur of (a) the date of substantial completion of the Tenant Improvements, or (b) the date of receipt of a temporary certificate of occupancy or other approval by the City of Issaquah allowing occupancy of the Premises by Tenant, or (c) the date thirty (30) days following Landlord's delivery of the Premises to Tenant in FF&E Ready Condition. "FF&E Ready Condition" shall be defined as the Premises being improved to a level of completeness that allows Tenant to commence installation of data/voice cabling, cubical office partitions, and data/phone room equipment and shall specifically require that carpet be installed at floor areas to receive cubical office furniture, walls to be painted that are to receive fixed office furniture systems, and that overhead work be complete except for final electrical/mechanical trim, acoustical tile and data/voice systems. Notwithstanding the foregoing, in the event the Commencement Date does not occur on the Scheduled Commencement Date, or any date thereafter, due to a Tenant Delay, then the Commencement Date shall be deemed to have occurred on the date on which the Commencement Date would have otherwise occurred but for the Tenant Delay. In the event Landlord is not able to deliver the Premises to Tenant in FF&E Ready Condition by the Scheduled Delivery Date or Landlord cannot substantially complete the Premises on or before the Scheduled Commencement Date, then Landlord shall notify Tenant in writing as soon as Landlord reasonably determines that it will not make such dates, which notice shall specify the new estimated Scheduled Delivery Date and/or the new Scheduled Commencement Date, as applicable. The Term shall expire upon the later to occur of (which later to occur date is referred to as the "Expiration Date"): (i) the date ten (10) years (120 months) after the Commencement Date, or (ii) the "Expiration Date" of Tenant's lease of Building A of the Project, unless sooner terminated as hereinafter provided.

4.02 Notice of Commencement Date/Lease Confirmation. Landlord shall use good faith efforts to inform Tenant of the estimated date of substantial completion at least ten (10) days prior to such date. Upon ascertaining the date of substantial completion and the Commencement Date, Landlord shall deliver to Tenant a written confirmation in the form attached hereto as Exhibit E ("Lease Confirmation") of said dates of substantial completion and the Commencement Date. The Lease Confirmation shall be binding upon Tenant unless Tenant objects to the same in writing delivered to Landlord within five (5) days of Tenant's receipt of said Lease Confirmation.

4.03 Option to Extend. Landlord hereby grants Tenant the right to extend the term of the Lease for one (1) period of five (5) years (such extended period is hereinafter referred to as the "Extended Term") on the same terms and conditions contained in the Lease, except that (i) Base Rent for the Extended Term shall be as set forth hereinbelow, and (ii) no additional options to extend shall apply following the expiration of the Extended Term. Written notice of Tenant's exercise of its option to extend ("Option to Extend") the Term of this Lease for the Extended Term must be given to Landlord no less than twelve (12) months prior to the Expiration Date. If Tenant is in default under this Lease and all applicable notice and cure periods have run, then Tenant shall have no right to extend the Term of this Lease; provided, however that the period of time within which said option may be exercised shall not be extended or enlarged by reason of Tenant's inability to exercise said option because of such default. In the event Tenant validly exercises its Option to Extend the Term of this Lease as herein provided, Base Rent shall be adjusted as of the commencement date of the Extended Term as follows:

(a) Within thirty (30) days after exercise of its Option to Extend by Tenant, Landlord shall provide Tenant with Landlord's determination of the fair market Base Rent for the Extended Term, including periodic increases as dictated by the current market ("Landlord's Determination of Base Rent for Extended Term"). No later than the date thirty (30) days after Tenant's receipt of Landlord's Determination of Base Rent for Extended Term, Tenant shall provide notice to Landlord electing either: (i) to accept Landlord's Determination of Base Rent for Extended Term; or (ii) to withdraw Tenant's exercise of its Option to Extend, or (iii) to disapprove Landlord's Determination of Base Rent for Extended Term but to not withdraw its exercise of the Option to Extend. In the event Tenant fails to give Landlord notice of its election of (i), (ii), or (iii) in the preceding sentence, Tenant shall be deemed to have elected to disapprove Landlord's Determination of Base Rent and to have withdrawn its exercise of its Option to Extend and the Term shall expire at the end of the initial Term and Tenant shall have no further rights under this Subsection 4.03. In the event Tenant accepts Landlord's Determination of Base Rent for Extended Term, then the Landlord's Determination of Base Rent for Extended Term shall be the Base Rent for the Extended Term. In the event Tenant elects to withdraw its exercise of its Option to Extend for the applicable Extended Term by timely notice as required in (ii) above, then this Lease shall terminate at the expiration of the initial Term and neither party shall have any further rights or obligations pursuant to this Subsection 4.03. In the event Tenant gives notice that Tenant disapproves Landlord's Determination of Base Rent for Extended Term without withdrawing its exercise of its Option to Extend, as contemplated by (iii) above, then Landlord and Tenant shall be bound to extend the Term of the Lease for the Extended Term and the Base Rent for the Extended Term shall be determined as set forth below.

(b) Within thirty (30) days after the election of the alternative set forth in Subsection 4.03(a)(iii) above, each party, at its own cost and by giving notice to the other party, shall appoint a real estate appraiser with at least ten (10) years full-time commercial real estate appraisal experience in the area in which the Premises are located to appraise and set Base Rent for the Extended Term. If a party does not appoint an appraiser by the later to occur of (i) the expiration of such thirty (30) day period or, (ii) the date ten (10) days after the other party has given notice of the name of its appraiser, the single appraiser appointed shall be the sole appraiser and shall set Base Rent for the Extended Term. If each party shall have so appointed an appraiser, the two appraisers shall meet promptly and attempt to set the Base Rent for the Extended Term. If the two appraisers are unable to agree within thirty (30) days after the second appraiser has been appointed, they shall attempt to select a third appraiser meeting the qualifications herein stated within ten (10) days after the last day the two appraisers are given to set Base Rent. If the two appraisers are unable to agree on the third appraiser within such ten (10) day period, either of the parties to this Lease, by giving five (5) days notice to the other party, may apply to the then presiding judge of the Superior Court of King County for the selection of a third appraiser meeting the qualifications stated in this paragraph. Each of the parties shall bear one-half (1/2) of the cost of appointing the third appraiser and of paying the third appraiser's fee. The third appraiser, however selected, shall be a person who has not previously acted in any capacity for either party.

(c) Within thirty (30) days after the selection of the third appraiser, a majority of the appraisers shall set Base Rent for the Extended Term. If a majority of the appraisers are unable to set Base Rent within the stipulated period of time, the three appraisals shall be added together and their total divided by three (3). The resulting quotient shall be the Base Rent for the Premises during the Extended Term. If, however, the low appraisal and/or the high appraisal is/are more than ten percent (10%) lower and/or higher than the middle appraisal, the low appraisal and/or the high appraisal shall be disregarded. If only one (1) appraisal is disregarded, the remaining two (2) appraisals shall be added together and their total divided by two (2), and the resulting quotient shall be Base Rent for the Premises during the Extended Term.

(d) For purposes of the appraisal, the term “-fair market Base Rent-” shall mean the price that a ready and willing tenant would pay, as of the Extended Term commencement date, as a base rent to a ready and willing landlord of buildings of comparable size and quality (assuming improved as office space), if such premises were exposed for lease on the open market for a reasonable period of time; including any rent increases over the Extended Term to the extent normal under then current market conditions. In no event shall there be deducted from such fair market Base Rent, the value of any concessions, including without limitation tenant improvements, commissions, free rent and/or “downtime”. In no event shall the fair market Base Rent determined pursuant to this Section 4.03 be less than the Base Rent in effect during the last month of the initial Lease Term.

(e) In the event Tenant timely exercises its Option to Extend pursuant to this Subsection 4.03 (and Tenant does not withdraw its exercise pursuant to Subsection 4.03(a)(ii) above), then Landlord shall provide Tenant with an allowance for re-painting and re-carpeting of the Premises in an amount of \$6.40 per square foot of the Premises, to be used to reimburse Tenant for actual substantiated costs incurred by Tenant in re-painting and/or re-carpeting the Premises during the first twelve (12) months of the Extended Term.

4.04 Option to Terminate. Tenant shall have the one time only option to terminate this Lease (“Option to Terminate”) effective at the end of the sixtieth (60th) full calendar month (sometimes referred to as the “effective date of the Lease termination”) of the initial ten (10) year Lease Term. The Tenant’s Option to Terminate is subject to the following terms and provisions:

(a) Tenant shall provide written notice (the Tenant’s Notice”) of its election to exercise the Option to Terminate. The Tenant’s Notice shall be delivered to Landlord not later than the date eighteen (18) months prior to the last day of the sixtieth (60th) full calendar month of the initial ten (10) year Lease term.

(b) Tenant shall not be in default under the terms and provisions of this Lease when the Tenant gives Landlord the Tenant’s Notice or at the effective date of the Lease termination.

(c) On or before the date thirty (30) days prior to the effective date of the Lease termination, the Tenant shall pay to Landlord the cash sum of \$2,640,000.00 (the “Lease Termination Fee”).

(d) Tenant may only exercise its right to terminate this Lease pursuant to this Subsection 4.04 if Tenant also simultaneously terminates its Lease of Building A of the Project.

Failure of Tenant to timely meet the conditions set forth in Subsection 4.04(a)-(d) above shall, at Landlord’s election, render Tenant’ election to terminate hereunder null and void and the Lease shall continue to be in full force and effect for the entire Term.

ARTICLE V: RENT

5.01 Base Rent. The Base Rent (“Base Rent”) shall be as set forth in Section 1.01(l). The Base Rent shall be paid in advance on the first day of each and every month during the Term to Landlord at the address set forth in Section 1.01(b) hereof or at such other place as Landlord may direct in writing, without any prior demand therefor and without any abatement, deduction or setoff whatsoever, except as expressly set forth herein. If the Term commences on any day other than the first day of a calendar month and/or ends on any day other than the last day of a calendar month, Base Rent for the fraction(s) of a month at the commencement and/or upon the expiration of the Term shall be prorated based upon the actual number of days in such fractional month(s). Simultaneously with execution of this Lease, Tenant shall deposit with Landlord the Prepaid Rent identified in Section 1.01(m), which sum shall be applied by Landlord as indicated in said Section 1.01(m).

5.02 Additional Rent. In addition to Base Rent, Tenant shall pay to Landlord all sums of money or other charges required to be paid by the Tenant under this Lease (other than Base Rent and the Prepaid Rent), including but not limited to Tenant’s Share of Operating Expenses (as defined in Article VI hereof) (all such sums being herein deemed “Additional Rent”), and

whether or not the same are designated "Additional Rent" the same shall be payable in lawful money of the United States of America without deduction, set-off or abatement whatsoever, except as expressly set forth herein. Any Additional Rent provided for in this Lease shall become due with the next monthly installment of Base Rent unless otherwise provided. The term "Rent", as used in this Lease, shall refer collectively to "Base Rent" and "Additional Rent."

5.03 Late Payment. If any payment of Rent is not received by Landlord within five (5) days after written notice from Landlord to Tenant that the same is past due (provided, however, Tenant shall only be entitled to one (1) such notices in any twelve (12) month period; thereafter, Tenant shall pay a late fee if Tenant fails to pay within five (5) days after the same is due), Tenant shall pay to Landlord a late payment charge equal to five percent (5%) of the amount of such delinquent payment of Rent in addition to the installment of Rent then owing. In addition, Tenant shall pay interest on such late payment and late charge from and after the expiration of thirty (30) days following the due date of the late payment at an interest rate equal to the lesser of (a) the prevailing prime (reference) rate as published by Bank of America (or any successor bank) at its Seattle main branch office, or any successor rate of interest, plus three (3) percentage points, or (b) the maximum rate permitted by applicable law (hereafter the "Default Rate"), until such amounts are paid. Landlord and Tenant recognize that the damages which Landlord will suffer as a result of Tenant's failure to timely pay Rent are difficult or impracticable to ascertain, and agree that said interest and late charge are a reasonable approximation of the damages which Landlord will suffer in the event of Tenant's late payment. This provision shall not relieve Tenant from payment of Rent at the time and in the manner herein specified. Acceptance by Landlord of any such interest and late charge shall not constitute a waiver of Tenant's default with respect to said overdue amount, nor shall it prevent Landlord from exercising any other rights or remedies available to Landlord.

5.04. Security Deposit. Tenant will simultaneously with execution of this Lease, deposit with Landlord the sum specified in Section 1.01(n) of this Lease. This sum shall belong to Landlord and shall constitute partial consideration for the execution of this Lease. Landlord shall pay Tenant the remaining balance thereof, without any liability for interest thereon, within thirty (30) days after the expiration or prior termination of the Lease Term, or any extension thereof, if and only if Tenant has fully performed all of its obligations under the terms of this Lease. Landlord shall be entitled to withdraw from the deposit the amount of any unpaid Base Rent, Additional Rent or other charges not paid to Landlord when due, and Tenant shall immediately re-deposit an amount equal to that so withdrawn within ten (10) days of demand.

ARTICLE VI: ADDITIONAL RENT AND CHARGES

6.01 Operating Expenses. In addition to Base Rent and other sums payable by Tenant under this Lease, Tenant shall pay to Landlord, as Additional Rent, Tenant's Share of the Operating Expenses (as such term is defined below).

(a) Estimated Expenses.

(i) Prior to the Commencement Date, and thereafter prior to the commencement of each calendar year occurring wholly or partially within the Term, Landlord

shall estimate the annual Operating Expenses payable by Tenant pursuant to this provision, and Tenant shall pay to Landlord on the first day of each month in advance, one-twelfth (1/12th) of Tenant's Share of such estimated amount. In the event that during any calendar year of the Term, Landlord determines that the actual Operating Expenses for such year will exceed the estimated Operating Expenses, Landlord may revise such estimate by written notice to Tenant (but only once per year), and Tenant shall pay to Landlord, concurrently with the regular monthly rent payment next due following the receipt of the revised estimate, an amount equal to one monthly installment of such increase multiplied by the number of months expired during such calendar year to and including the month of such payment; provided, however, in the event any line item of Landlord's estimate for any calendar year increases by more than three percent (3%) over the prior calendar year, Landlord shall, at the time of the estimate revision, provide Tenant with reasonable substantiation of such increase. Subsequent installments shall be payable concurrently with the regular monthly Base Rent due for the balance of the calendar year and shall continue until the next calendar year's estimate is rendered. Notwithstanding the foregoing, at Tenant's request, Landlord agrees to meet with Tenant to discuss Landlord's budget and estimate of the next year's Operating Expenses.

(ii) Within ninety (90) days following the end of each calendar year falling wholly or partially during the Lease Term, Landlord shall provide Tenant with a written statement of the actual total Operating Expenses for such year and there shall be an adjustment made to account for any difference between Tenant's Share of the actual and the estimated Operating Expenses for the previous year. If Tenant has overpaid the amount of Operating Expenses owing pursuant to this provision, Landlord shall, credit such overpayment to Tenant's account. If Tenant has underpaid the amount of Operating Expenses owing pursuant to this provision, Tenant shall pay the total amount of such deficiency to Landlord as Additional Rent with the next payment of Base Rent due under this Lease following delivery of written notice of said deficiency from Landlord to Tenant.

(iii) Landlord shall keep its books of account and records concerning Operating Expenses in compliance with generally accepted accounting principles and retain the same for five (5) years after the calendar year for which they were prepared. Tenant shall have the right, at such time and place as Landlord may reasonably designate, not more than once in any twelve (12) month period, to inspect and audit Landlord's books and records related to the operation and maintenance of the Project, for the purpose of verifying Operating Expenses payable by Tenant. Tenant may employ an independent public accounting firm or other consulting company to conduct the audit. The costs of the audit shall be paid by Tenant unless the audit shows that Landlord's adjusted statement over-charged Tenant its share of Operating Expenses by more than three percent (3%), in which case Landlord shall pay all Tenant's costs of the audit; provided, however, in the event Landlord disputes the results of Tenant's audit, Landlord may, upon written notice to Tenant, submit the issue to binding arbitration pursuant to the rules of the American Arbitration Association, which arbitration shall take place in Seattle, Washington. Unless Tenant objects in writing regarding specific discrepancies in the Operating Expense calculations for any calendar year within twelve (12) months after receipt of Landlord's final calculations for such calendar year, Tenant shall be deemed to have approved the same and to have waived the right to object to such calculations. Notwithstanding anything in this Section 6.01 to the contrary, commencing with the second calendar year of the Lease Term, Tenant's Share

of controllable Common Area costs (defined as the cost of landscaping, parking sweeping and snow removal, janitorial and other controllable expenses associated with the physical upkeep of the Common Areas) shall not increase by more than five percent (5%) per calendar year on a cumulative basis.

(b) Defined Terms.

(i) Operating Expenses Inclusions. For purposes of this Lease, "Operating Expenses" means, except as provided below, an amount equivalent to the total of all expenses and costs incurred in connection with the ownership, operation, management, maintenance, repair and replacement of the Property, the Building and the Common Areas, including, but in no way limited to, the following:

A. The costs of operating, maintaining, repairing and replacing the Property, the Building and the Common Areas, including but not limited to: gardening and landscaping; painting; lighting; sanitary control; personal property taxes; public liability insurance and property damage insurance; utilities for the Common Areas; licenses and fees for the Common Area facilities; sweeping; removal of snow and ice, trash, rubbish, garbage and other refuse; repairing, restriping and resurfacing of parking area; and maintenance of and property taxes on personal property, machinery and equipment used in Common Area maintenance.

B. The Building's pro rata share of the costs of operating, maintaining, repairing and replacing the Common Areas, and other reasonable Project costs that are equitably allocated among the benefited properties.

C. All Real Property Taxes (as defined below) assessed against the Property, including land, Building and improvements thereon or thereto.

D. All premiums for fire, extended coverage and other insurance the Landlord reasonably deems necessary and keeps in force on or with respect to the Property and the Building of which the Premises are a part and/or the Common Areas, as the case may be, and commercially reasonable deductibles payable in connection therewith.

E. The cost of operating, maintaining, repairing and replacing any electrical, mechanical, automatic fire sprinkler and other utilities systems serving the Property, the Building and/or the Premises.

F. The cost of maintenance, repair and replacement of the structural and non-structural portions of the roof, roof membrane, exterior walls, foundation, and other exterior portions of the Building.

G. Property management charges in an amount equal to 3% of Base Rent and Operating Expenses payable hereunder (provided that during any free rent period the 3% shall be based on the Base Rent and Operating Expenses next payable after the applicable free rent period), together with the reasonable allocation of costs incurred in the operation of a management office, including without limitation the equitably allocated cost of rent and utilities.

H. Costs of replacements and improvements which are necessary to adequately maintain or protect the Property, the Building and/or the Common Areas, as the case may be, and/or which are required by law or governmental regulation enacted after the Commencement Date of this Lease, which are of a capital nature (as determined by GAAP accounting) to the extent amortization over the useful life thereof is applicable to the periods during the Lease Term.

I. Any other costs levied, assessed or imposed by or at the direction of, or resulting from statutes or regulations or interpretations thereof promulgated by any federal or governmental authority in connection with the use or occupancy of the Building.

J. Assessments made on or with respect to the Property made pursuant to any CC&Rs, Public Utility District conditions, Local Improvement District conditions and/or owner's associations affecting the Property, or any portion thereof, to the extent not recovered pursuant to Section B above.

K. Compensation (including wages and employer paid benefits and taxes) of employees and contractors proportionately to the extent engaged in the operation and maintenance of the Project, Property and/or Building.

(ii) Operating Expense Exclusions. Notwithstanding the foregoing, Operating Expenses to be reimbursed by Tenant shall not include:

A. Expenses which are separately metered or calculated for the Premises or other leased area of the Project or the Building, as the case may be, which expenses shall be billed separately to Tenant or such other tenant(s), as applicable.

B. Costs incurred in connection with the initial construction or design of the Tenant Improvements or to correct defects in the original construction or design of the Building.

C. Depreciation or amortization of expenses, except as expressly permitted above.

D. Costs, fines, interest or penalties incurred due to violation by Landlord of any applicable law.

E. Expenses incurred by Landlord in respect of individual tenants and/or the improvement or renovation of tenants' leasehold improvements, including leasing commissions, attorneys' fees arising from lease disputes and other specific costs incurred for the account of, separately billed to and paid by specific tenants.

warranties.

F. Repairs or replacements to the extent that the cost of the same is recoverable by the Landlord pursuant to original construction

G. Interest on debt or capital retirement of debt, and costs of capital improvements except as expressly provided above.

H. Legal fees and disbursements relating to legal matters other than such fees and costs directly relating to Operating Expense issues in connection with the Project, the Property, the Building, the Premises and/or the Common Areas.

I. Latent defects in the initial construction of the Building and Premises.

J. The failure of the Building, as initially constructed, to comply with laws, regulations and ordinances in effect as of the date of permit vesting.

K. Except to the extent included in the costs described in subsections (i)(G) and/or (i)(K) above, costs associated with the operation of the business of the ownership or entity which constitutes "Landlord", as distinguished from the costs of building operations, including, but not limited to, partnership accounting, consulting and legal matters not specifically benefiting the Property or occupants thereof, costs of defending any lawsuits with any mortgagee (except as the actions of any tenant may be in issue), costs of selling, syndicating, financing, mortgaging or hypothecating any of Landlord's interest in the Building, costs of any disputes between Landlord and its employees (if any) not engaged in Building operations, disputes of Landlord with Building management, or outside fees paid in connection with disputes with other tenants;

L. Costs of alterations or improvements to the Premises or the premises of other tenants;

M. Expenses directly resulting from the negligence and/or willful misconduct of Landlord, its agents, servants or employees;

N. Costs for which Landlord is reimbursed by its insurance carrier or any tenant's insurance carrier (excluding deductibles);

O. Any bad debt loss, rent loss, or reserves for bad debts or rent loss;

P. Wages and salaries of management or supervising employees offsite above the level of asset manager; and the wages of any employee who does not devote substantially all of his or her time to the Building (such as senior asset manager) except to the extent equitably apportioned among all projects for which such employee performed services based upon the time such employee spent on each project relative to the total time devoted by such employee to all projects;

Q. Amounts paid as ground rental by Landlord;

R. Any recalculation of or additional Operating Expenses actually incurred more than three (3) years prior to the year in which Landlord proposes that such costs be included, except to the extent Landlord did not have notice and was unaware of such additional costs at the expiration of such three (3) year period;

S. Costs incurred by Landlord with respect to goods and services (including utilities sold and supplied to tenants and occupants of the Building) to the extent that Landlord is entitled to and actually receives reimbursement for such costs directly from such tenant(s);

T. Costs incurred by Landlord for alterations which are considered capital improvements under generally accepted accounting principles, consistently applied, except as set forth in subsection (i)H above;

U. Any costs paid to Landlord or to subsidiaries or affiliates of Landlord for services in the Building to the extent the same exceeds the costs of such services rendered by unaffiliated third parties on a competitive basis;

V. Rentals and other related expenses incurred in leasing air conditioning systems, elevators or other equipment ordinarily considered to be of a capital nature, except equipment not affixed to the Building which is used in providing janitorial or similar services and except for temporary rentals that are necessitated by an emergency;

W. Any costs to repair or restore any portion of the Project following a condemnation or a casualty (except to the extent of a commercially reasonable deductible amount);

X. Any costs incurred by Landlord to correct any violation of any laws, ordinances, rules, regulations, permits or licenses in effect as of the date of permit vesting for the Building;

Y. Costs incurred to remove, encapsulate or remediate asbestos or any Hazardous Materials (as defined in Section 10.02).

Z. Costs associated with the development, leasing, landscaping, taxes, maintenance or sale of or any other costs attributable to pad sites, development sites or any other non Building areas within the Project which are not common areas which benefit the Building.

It is understood that Operating Expenses shall be reduced by all cash discounts, trade discounts, or quantity discounts received by Landlord or Landlord's managing agent in the purchase of any goods, utilities, or services in connection with the operation of the Building. In the calculation of any expenses hereunder, it is understood that no expense shall be charged in duplicate. Landlord shall use commercially reasonable efforts to effect an equitable proration of

bills for services rendered to the Building and to any other property owned by Landlord. Landlord agrees to keep books and records showing the Operating Expenses in accordance with a system of generally accepted accounting practices consistently maintained on a year-to-year basis.

Additional Rent payable by Tenant which would not otherwise be due until after the date of the expiration or earlier termination of the Lease shall, if the exact amount is uncertain at the time this Lease expires or terminates, be paid by Tenant to Landlord upon such expiration or termination in an amount to be determined by Landlord, with an adjustment to be made once the exact amount is known.

(iii) Tenant's Share. For purposes of this Lease, "Tenant's Share" means the percentage, as set forth in Section 1.01(o) or Section 1.01(p), as appropriate, and obtained by dividing the Rentable Area of the Premises by the aggregate Rentable Area of all premises available for lease, whether leased or not, in the Building or Project, as applicable, subject to adjustment in the event of changes in Rentable Area of the Project, the Building and/or the Premises. Notwithstanding the above, Landlord shall have the right, but not the obligation, to equitably adjust Tenant's Share of any specific Operating Expense so as to render such expense payable proportionately by those parties benefited by the same or otherwise in order to appropriately allocate such Operating Expense over the area covered by such Operating Expense.

(iv) Real Property Taxes. For purposes of this Lease, "Real Property Taxes" shall consist of all transit charges, housing fund assessments, real estate taxes and all other taxes relating to the Building, the Property, and the Common Areas located on the Property, all other taxes which may be levied in lieu of real estate taxes, all assessments, local improvement districts, assessment bonds, levies, fees and other governmental charges, including, but not limited to, charges for traffic facilities and improvements, water service studies, and improvements or amounts necessary to be expended because of governmental orders, whether general or special, ordinary or extraordinary, unforeseen as well as foreseen, of any kind and nature for public improvements, services, benefits, or any other purpose, which are assessed, levied, confirmed, imposed or become a lien upon the Building or any portion of the Property, or become payable during the Term (or which become payable after the expiration or earlier termination hereof and are attributable in whole or in part to any period during the Term hereof), together with all costs and expenses incurred by Landlord in successfully contesting, resisting or appealing any such taxes, rates, duties, levies or assessments. "Real Property Taxes" shall exclude any franchise, estate, inheritance or succession transfer tax of Landlord, or any federal or state income, profits or revenue tax or charge upon the net income of Landlord from all sources; provided, however, that if at any time during the Term there is levied or assessed against Landlord a federal, state or local tax or excise tax on rent, or any other tax however described on account of rent or gross receipts or any portion thereof, Tenant shall pay one hundred percent (100%) of the Tenant's Share of any said tax or excise applicable to Tenant's Rent as Additional Rent.

During any period in which Tenant leases 100% of the Rentable Area of the Property, if the ad valorem tax assessment of the Property and Building for any calendar year increases by more than five percent (5%) from the prior year's assessment, Tenant shall have the right, by

written notice to Landlord, to cause Landlord to contest or protest, through appropriate legal proceedings, such increased assessment. The cost of any such challenge shall be borne by Tenant but, if Landlord is successful in obtaining a reduced assessment or tax refund, Tenant shall be entitled to recoup its reasonable out-of-pocket expenses from the refund before the refund is applied against Operating Expenses. Tenant may only require Landlord to contest the amount or validity of any real estate taxes by appropriate proceedings and only if the Property or any part thereof would not by reason of such postponement or deferment be in danger of being forfeited or lost. Landlord shall not be subjected to any liability for the payment of any costs or expenses in connection with any such proceedings or any increased assessment of the Project which results from such proceeding.

6.02 Tenant's Personal Property Taxes. Tenant shall pay or cause to be paid, prior to delinquency, any and all taxes and assessments levied upon any trade fixtures, inventories and other real or personal property placed or installed in and/or upon the Premises by Tenant. If any such taxes on Tenant's personal property or trade fixtures are levied against Landlord or Landlord's property or if the assessed value of the Building is increased by the inclusion therein of a value placed upon such real or personal property or trade fixtures of Tenant, and if Landlord pays the taxes based upon such increased assessment, Tenant shall, upon not less than 30-days prior demand, repay to Landlord the taxes so levied or the portion of such taxes resulting from such increase in the assessment.

ARTICLE VII: INSURANCE

7.01 Landlord's Insurance. During the Term, Landlord shall procure and maintain in full force and effect with respect to the Building a an "all-risk" policy or policies of property insurance (including, to the extent required, sprinkler leakage, vandalism and malicious mischief coverage, and any other endorsements required by the holder of any fee or leasehold mortgage and earthquake and flood insurance if Landlord so requires) in 100% replacement value of the Building and Premises (excluding foundations). Landlord shall have the right, at its option, to keep and maintain in full force and effect during the Term such other insurance in such amounts and on such terms as Landlord and/or any first mortgagees or the beneficiary of any first trust deed against the Building, or the portion of the Property and/or the Project in which the Building is located, may reasonably require from time to time in form, in amounts and for insurance risks against which a prudent Landlord of similarly situated first class office buildings in the Issaquah, Washington area would protect itself, including but not limited to rental abatement, rental interruption, general commercial liability and earthquake and flood insurance.

7.02 Liability Insurance. Tenant shall, at its own cost and expense, keep and maintain in full force during the Term and any other period of occupancy of the Premises by Tenant, a policy or policies of commercial liability insurance, written by a reputable insurance company authorized to do business in the State of Washington in form and content acceptable to Landlord insuring Landlord's and Tenant's activities with respect to the Premises, the Common Areas and the Building for loss, damage or liability for personal injury or death of any person or loss or damage to property occurring in, upon or about the Building in an amount of not less than Three Million Dollars (\$3,000,000) combined single limit (with a \$5,000,000 of umbrella coverage). The policy shall insure the hazards of the Premises and Tenant's operations therein, shall include

independent contractor and contractual liability coverage (covering the indemnity contained in Section 7.08 hereof) and shall name both Landlord and Tenant as insureds as their interests appear and shall contain a provision that the insurance provided hereunder shall be primary and non-contributing with any other insurance available to the other party.

7.03 Tenant's Property and Other Insurance. Tenant shall, at its own cost and expense, keep and maintain in full force during the Term and any other period of occupancy of the Premises, a policy or policies of standard form property insurance insuring against the perils of fire, extended coverage, vandalism, malicious mischief, special extended coverage and sprinkler leakage. This insurance policy shall be upon all property owned by Tenant, for which Tenant is legally liable or that was installed at Tenant's expense, and which is located in the Premises, including without limitation, furniture, fittings, installations, fixtures (other than the improvements installed by Landlord), and any other personal property, in the amount of not less than one hundred percent (100%) of the full replacement costs thereof.

7.04 Form of Insurance/Certificates. All policies shall be written in a form satisfactory to Landlord and shall be taken out with insurance companies licensed in the state in which the Building is located and holding a General Policy Holder's Rating of "A" and a financial rating of "VII" or better, as set forth in the most current issues of Best's Insurance Guide. Tenant shall furnish to Landlord, prior to Tenant's entry into the Premises and thereafter within ten (10) days prior to the expiration of each such policy, a copy of the certificate of insurance (or renewal thereof) issued by the insurance carrier of each policy of insurance carried by Tenant pursuant hereto. Said certificates shall expressly provide that such policies shall not be cancelable or subject to reduction of coverage below the minimum amounts required by this Lease or required by any lender having an interest in the Building or otherwise be subject to modification except after thirty (30) days prior written notice to the parties named as insured in this Section 7.04. Any policies to be maintained by Tenant hereunder shall name Landlord and, if requested, Landlord's mortgagee, as additional named insureds.

7.05 Failure to Maintain Insurance. If either party fails to maintain any insurance required in the Lease, the failing party shall be liable for any loss or cost resulting from said failure, and the non defaulting party shall have the right, by not less than five (5) days written notice to the other party and failure of the defaulting party to correct such failure within said five (5) days period, to obtain such insurance on the other party's behalf and at their sole expense. This Section 7.05 shall not be deemed to be a waiver of any of their rights and remedies under any other section of this Lease. If Landlord or Tenant obtains any insurance which is the responsibility of the other to obtain under this Article VII, the failing party shall deliver to the other a written statement setting forth the cost of any such insurance and showing in reasonable detail the manner in which it has been computed and the failing party shall promptly remit said amount to the party who has paid the applicable costs.

7.06 Waiver of Subrogation. Any all risk policy or policies of fire, extended coverage or similar casualty insurance which either party obtains in connection with the Property, the Building, the Premises or Tenant's personal property therein shall include a clause or endorsement denying the insurer any rights of subrogation against the other party to the extent rights have been waived by the insured prior to the occurrence of injury or loss. Landlord and

Tenant waive any rights of recovery against the other for injury or loss due to hazards covered by insurance containing such a waiver of subrogation clause or endorsement to the extent of the injury or loss covered thereby.

7.07 Tenant's Properties and Fixtures. Tenant assumes the risk of damage to any furniture, equipment, machinery, goods, supplies or fixtures which are or remain the property of Tenant or as to which Tenant retains the right of removal from the Premises, except to the extent due to the negligent act or omission of Landlord and except as set forth herein. In no event shall Tenant carry on any activities which would invalidate any insurance coverage maintained by Landlord. Tenant shall promptly comply with all reasonable requirements of the insurance underwriters and/or any governmental authority having jurisdiction thereover, necessary for the maintenance of reasonable fire and extended insurance for the Building and/or the Project.

7.08 Indemnification.

(a) (i) Tenant, as a material part of the consideration to be rendered to Landlord, and subject to subsection (b) below, hereby indemnifies and agrees to defend and hold Landlord, its agents, employees, and lenders, harmless from and against (i) any and all liability, penalties, losses, damages, costs and expenses, demands, causes of action, claims, judgments and appeals arising from any injury to any person or persons or any damage to any property as a result of Tenant's or Tenants' officers, employees, agents, assignees, subtenants, concessionaires, licensees, contractors or invitees' use, maintenance, occupation, operation or control of the Premises during the Term, or resulting from any breach or default in the performance of any obligation to be performed by Tenant hereunder or for which Tenant is responsible under the terms of the Lease or pursuant to any governmental or insurance requirement, or arising from any act, neglect, fault or omission of Tenant or any of Tenant's officers, employees, agents, servants, subtenants, concessionaires, licensees, contractors or invitees, and (ii) from and against all reasonable legal costs and charges, including reasonable attorneys' and other reasonable professional fees, incurred in and about any of such matters and the defense of any action arising out of the same or in discharging the Project, the Property and/or Premises or any part thereof from any and all liens, charges or judgments which may accrue or be placed thereon by reason of any act or omission of the Tenant, except and to the extent as may arise out of the negligence or willful misconduct of Landlord and/or its agents or employees.

(ii) Landlord, as a material part of the consideration to be rendered to Tenant, and subject to subsection (b) below, hereby indemnifies and agrees to defend and hold Tenant harmless from and against (i) any and all liability, penalties, losses, damages, costs and expenses, demands, causes of action, claims, judgments and appeals arising from any injury to any person or persons or any damage to any property as a result of Landlord's or Landlord's' officers, employees, agents, assignees, subtenants, concessionaires, licensees, contractors or invitees' use, maintenance, occupation, operation or control of the Building, Common Areas or Project during the Term, or resulting from any breach or default in the performance of any obligation to be performed by Landlord hereunder or for which Landlord is responsible under the terms of the Lease or pursuant to any governmental or insurance requirement, or arising from any act, neglect, fault or omission of Landlord or any of Landlord's officers, employees, agents, servants, subtenants, concessionaires, licensees, contractors or invitees, and (ii) from and against

all reasonable legal costs and charges, including reasonable attorneys' and other reasonable professional fees, incurred in and about any of such matters and the defense of any action arising out of the same or in discharging Tenant and/or Premises or any part thereof from any and all liens, charges or judgments which may accrue or be placed thereon by reason of any act or omission of the Landlord, except and to the extent as may arise out of the negligence or willful misconduct of Tenant and/or its agents or employees.

(b) In the event of the concurrent negligence of Tenant, its sublessees, assignees, invitees, agents, employees, contractors, or licensees on the one hand and the negligence of Landlord, its agents, employees or contractors on the other hand, which concurrent negligence results in injury or damage to persons or property of any nature and howsoever caused, and relates to the construction, alteration, repair, addition to, subtraction from, improvement to or maintenance of the Common Areas or Premises such that RCW 4.24.115 is applicable, then (i) Tenant's obligation to indemnify Landlord as set forth in this Section 7.08 shall be limited to the extent of Tenant's negligence and that of Tenant's officers, sublessees, assignees, invitees, agents, employees, contractors or licensees, including Tenant's proportional share of costs, reasonable attorneys' fees and expenses incurred in connection with any claim, action or proceeding brought with respect to such injury or damage; and (ii) Landlord's obligation to indemnify Tenant as set forth in this Section 7.08 shall be limited to the extent of Landlord's negligence and that of Landlord's officers, agents, employees, contractors or licensees, including Tenant's proportional share of costs, reasonable attorneys' fees and expenses incurred in connection with any claim, action or proceeding brought with respect to such injury or damage.

(c) LANDLORD AND TENANT HEREBY WAIVE AND AGREE THAT IT WILL NOT ASSERT ITS INDUSTRIAL INSURANCE IMMUNITY UNDER TITLE 51 RCW IF SUCH ASSERTION WOULD BE INCONSISTENT WITH THE RIGHT OF THE OTHER PARTY TO INDEMNIFICATION PURSUANT TO THIS ARTICLE 7. THE PARTIES AGREE THAT THIS PROVISION WAS MUTUALLY NEGOTIATED AND RELATES ONLY TO A WAIVER OF IMMUNITY WITH RESPECT TO THE OTHER PARTY AND NO THIRD PARTY, INCLUDING BUT NOT LIMITED TO, ANY INJURED EMPLOYEE OF EITHER PARTY, SHALL BE A THIRD PARTY BENEFICIARY OF THIS PROVISION.

(d) In no event shall Landlord, its agents, employees and/or contractors be liable for any personal injury or death or property damage caused by other lessees or persons in or about the Premises, the Property, the Project and/or the Building, as the case may be, or caused by public or quasi-public work, or for consequential damages arising out of any loss of the use of the Premises or any equipment or facilities therein by Tenant or any person claiming through or under Tenant, except to the extent any such injury or damage is due to the negligent act or omission of Landlord.

7.09 Damage to Tenant's Property. Notwithstanding the provisions of Section 7.08 to the contrary, except to the extent due to the negligent act or omission of Landlord or except as may be covered by any insurance maintained by or in favor of Landlord, Landlord, its agents, employees and contractors shall not be liable for (i) any damage to property entrusted to

employees or security officers of the Project, (ii) loss or damage to any property by theft or otherwise, or (iii) any injury or damage to persons or property resulting from fire, explosion, falling substances or materials, steam, gas, electricity, water or rain which may leak from any part of the Building, the Common Areas, or the Property or from the pipes, appliances or plumbing work therein or from the roof, street, or subsurface or from any other place or resulting from dampness or any other cause. Neither Landlord nor its agents shall be liable for interference with light or other incorporeal hereditaments. Tenant shall give prompt notice to Landlord in case Tenant is or becomes aware of fire or accidents in the Building, the Common Areas or any other portion of the Project.

ARTICLE VIII: REPAIRS AND MAINTENANCE

8.01 Landlord Repairs and Maintenance. Subject to Landlord's right to reimbursement from Tenant pursuant to Section 6.01 hereof, to the extent applicable, Landlord shall at its expense maintain in good condition, repair and replace (as necessary) the structural portions of the Building including without limitation the foundation, roof and membrane and shall maintain in good condition the exterior of the Building, utilities to their point of connection to the Premises and the Common Areas of the Property, and any aspect of the Premises not expressly to be maintained by Tenant in Section 8.03 below, all in a manner consistent with other first class office buildings in the area. Tenant shall give Landlord prompt notice of any repairs required of Landlord and Landlord shall not be liable to Tenant for any failure to make any repairs or perform any maintenance unless such failure shall persist for an unreasonable time after written notice of the need for such repair or maintenance is given to Landlord. Except as otherwise provided in this Article 8, there shall be no abatement of Rent and, except for the negligence or willful misconduct of Landlord or its employees, no liability of Landlord by reason of any injury to or interference with Tenant's business arising from the making of any repairs, alterations or improvement in or to any portion of the Premises or in or to fixtures, appurtenances and equipment therein; provided, that Landlord, its employees, agents and contractors use reasonable efforts not to unreasonably interfere with Tenant's business in exercise of Landlord's rights or obligations hereunder.

8.02 Utilities and Services. Subject to reimbursement pursuant to Section 6.01 above, Landlord shall furnish or cause to be furnished to the Premises lines for water, electricity, sewage, telephone and any other utilities necessary for the use and occupancy of the Premises (but not including natural gas and cable television). Tenant shall pay before delinquency, at its sole cost and expense, all charges for water, heat, electricity, power, telephone service, sewer service charges and other utilities or services charged or attributable to the Premises; provided, however, that if any such services or utilities shall be billed to Landlord and are not separately billed to the Premises, Tenant shall pay to Landlord as Additional Rent, an amount equal to that proportion of the total charges therefor which the Rentable Area of the Premises bears to the rentable area of leased area covered by such charges.

8.03 Tenant Repairs and Maintenance. Except as otherwise set forth in Sections 8.01 and 8.02 above, Tenant shall, at Tenant's sole cost and expense, keep, maintain and, to the extent reasonably required, replace the interior, nonstructural components of the Premises, including but not by way of limitation, all interior walls, doors, ceiling, fixtures, furnishings, drapes,

specialty lamps, light bulbs, starters and ballasts, power generator, carpets and floor coverings within the Premises. In addition, Tenant, at Tenant's sole cost and expense, shall provide or obtain regular janitorial services, elevator and HVAC maintenance and any other services associated with the regularly scheduled maintenance of the Building systems (as specified by applicable maintenance schedules) and all security services. Landlord shall have the right to approve Tenant's contractors and vendors and to ensure that the same are properly licensed and bonded. Upon expiration or earlier termination of the Term, Tenant shall surrender the Premises to Landlord in the same condition as when leased, reasonable wear and tear and damage by fire or other casualty not required to be repaired by Tenant pursuant to this Lease excepted and except as permitted by Article IX below.

8.04 Non-liability of Landlord. Notwithstanding anything to the contrary contained in Sections 8.01 or 8.02 above or elsewhere in this Lease, Landlord shall not be in default hereunder or be liable for any damages directly or indirectly resulting from, nor shall the Rent herein reserved be abated or rebated by reason of (a) the interruption or curtailment of the use of the Premises as a result of the installation of any equipment in connection with the Building or Project; or (b) any failure to furnish or delay in furnishing any services required to be provided by Landlord, unless and to the extent such failure or delay is caused by accident or any condition created by Landlord's active negligence or by Landlord's failure to respond within a reasonable period of time to any written request for service or repair for which Landlord is obligated under this Lease; or (c) the limitation, curtailment, rationing or restriction of the use of water or electricity, or any other form of energy or any other service or utility whatsoever serving the Premises.

8.05 Inspection of Premises. Upon advance reasonable notice by Landlord to Tenant, Landlord may enter the Premises to maintain, repair and replace, to inspect the performance by Tenant of the terms and conditions hereof, show the Premises to prospective purchasers, tenants (but tenants only during the last twelve (12) months of the Lease Term and/or after exercise of Tenant of its Option to Terminate pursuant to Subsection 4.04 and except for any space deleted from the Premises pursuant to Subsection 2.03 above, which Landlord shall be entitled to show to prospective tenants at any time after exercise by Tenant of such contraction right) and lenders and for any other purpose required for Landlord to fulfill its obligations hereunder; provided, that Landlord (and its agents, contractors or employees) shall at all times be accompanied by a representative of Tenant and Landlord shall use reasonable efforts not to interfere with Tenant's business in exercise of Landlord's rights hereunder which shall include the scheduling of any work, which would disrupt Tenant's normal business operations, to after normal business hours. Landlord shall not be liable for any interference with Tenant's business or loss of occupancy or quiet enjoyment arising from Landlord's exercise of its rights under this Subsection.

8.06 Interruption of Services. In the event Tenant cannot reasonably use all or any material portion of the Premises for Tenant's intended business operations by reason of any interruption in the services to be provided by Landlord pursuant to this Lease or Landlord's failure to properly maintain the Premises and Building as required hereunder, and such condition (a) results from causes within Landlord's reasonable control, and (b) exists in excess of five (5) consecutive business days after Landlord has been allowed access to the Building as necessary to make the required repairs or improvements, then Tenant's Base Rent and Tenant's Share of

Operating Expenses shall be equitably abated thereafter for that portion of the Premises that Tenant is unable to use for Tenant's intended business operations until such service is restored to the Premises or such repair or maintenance is completed by Landlord. At the time of the loss or interruption of service or failure by Landlord to maintain or repair the Premises or the Building, Tenant must give written notice promptly to Landlord of such fact(s) and its claim for abatement and Tenant only shall be entitled to abatement of Base Rent and Tenant's Share of Operating Expenses in proportion to the area rendered unusable and only after expiration of the cure periods set forth above. Landlord may prevent or stop abatement by providing substantially the same service in similar quality and quantity by temporary or alternative means until the cause of the loss of service can be corrected. If any such interruption in services or failure by Landlord to maintain or repair the Premises or the Building, renders all or substantially all of the Premises unusable for one hundred twenty (120) or more days then such interruption of service shall constitute a casualty under Section 11.03 and Landlord and Tenant shall have all rights set forth in Section 11.03 at any time prior to the restoration of such services by Landlord (including the pertinent time frames set forth in said Subsection 11.03). Tenant shall not be entitled to the rent abatement and termination rights set forth above if the service interruption is caused by the act of omission of Tenant, its agents or employees.

ARTICLE IX: FIXTURES, PERSONAL PROPERTY AND ALTERATIONS

9.01 Fixtures and Personal Property. Tenant, at Tenant's expense, may install trade fixtures, equipment and furniture in the Premises, provided that such items are installed and are removable without damage to the structure of the Building. Landlord reserves the right to approve or disapprove of any interior improvements which are visible from outside the Premises or which violate the CCRs in effect as of the date of this Lease. Such improvements must be submitted for Landlord's written approval prior to installation, which approval shall not be unreasonably withheld. Said trade fixtures, equipment and furniture shall remain Tenant's property and shall be maintained in good condition while on the Premises and shall be removed by Tenant upon the expiration or earlier termination of the Lease. As a covenant which shall survive the expiration or earlier termination of the Lease, Tenant shall repair, at Tenant's sole expense, all damage caused by the removal of said trade fixtures, equipment, furniture or temporary improvements. If Tenant fails to remove the foregoing items on or before the expiration or earlier termination of this Lease, Landlord, at its option and without liability to Tenant for loss thereof, may keep and use them or remove any or all of them and cause them to be stored or sold in accordance with applicable law, and Tenant shall, upon demand of Landlord, pay to Landlord as Additional Rent hereunder all reasonable costs and expenses incurred by Landlord in so storing and/or selling said items. In the event any such fixtures, equipment, and/or furniture of Tenant are sold by Landlord, the proceeds of such sale shall be applied, first, to all expenses of Landlord incurred in connection with storage and sale; second, to any amounts owed by Tenant to Landlord under this Lease or otherwise, and, third, the remainder, if any, shall be paid to Tenant.

9.02 Alterations. Tenant shall not make or allow to be made any material alterations, additions or improvements to the Premises (defined as alterations, additions or improvements costing in excess of \$25,000.00 individually or in the aggregate with respect to separate items relating to the same improvement or alteration) (collectively "Alterations"), or Alterations,

which affect the structural components or mechanical systems of the Building, during the Term, without obtaining the prior written consent of Landlord which consent shall not be unreasonably withheld. Tenant shall deliver to Landlord the contractor's name, references and state license number and a certificate of insurance for said contractor, as well as full and complete plans and specifications of all such Alterations, and any subsequent modifications or additions to such plans and specifications, and no proposed work shall be commenced or continued by Tenant until Landlord has received and given its written approval of each of the foregoing. Landlord shall either approve or disapprove any proposed alteration, addition or improvement on or before the date twenty (20) days following receipt of all of the foregoing items. Landlord does not expressly or implicitly covenant or warrant that any plans or specifications submitted by Tenant are accurate, safe or sufficient or that the same comply with any applicable laws, ordinances, building codes, or the like. Further, Tenant shall indemnify and hold Landlord and the Building harmless from any loss, cost or expense, including attorneys' fees and costs, incurred by Landlord as a result of any defects in design, materials or workmanship resulting from Tenant's Alterations to the Premises. All Alterations, telephone or telecommunications lines, cables, conduits and equipment and all other additions or improvements to the Premises made by Tenant shall remain the property of Tenant. Landlord may, as a condition to approval of any such Alterations, require Tenant to remove all or any portion of such Alterations installed by Tenant during the Term, and Tenant shall repair all damage resulting from such removal or, at Landlord's option, shall pay to Landlord all costs arising from such removal. All repairs, alterations, additions and restorations by Tenant hereinafter required or permitted shall be done in a good and workmanlike manner and in compliance with all applicable laws and ordinances, building codes, by-laws, regulations and orders of any federal, state, county, municipal or other public authority and of the insurers of the Premises. If required by Landlord, Tenant shall secure at Tenant's cost a completion and lien indemnity bond or other adequate security in form and substance reasonably acceptable to Landlord. Tenant shall reimburse Landlord for Landlord's reasonable charges (including any professional fees incurred by Landlord and a reasonable administrative fee to compensate Landlord for burdened labor expenses incurred) for reviewing and approving or disapproving plans and specifications for any proposed Alterations.

9.03 Liens. Tenant shall promptly file and/or record, as applicable, all notices of completion provided for by law, and shall pay and discharge all claims for work or labor done, supplies furnished or services rendered at the request of Tenant or at the request of Landlord on behalf of Tenant, and shall keep the Premises, the Property and the Project free and clear of all mechanics' and materialmen's liens in connection therewith. Landlord shall have the right, and shall be given ten (10) business days written notice by Tenant prior to commencement of the work, to post or keep posted on the Premises, or in the immediate vicinity thereof, any notices of non-responsibility for any construction, alteration, or repair of the Premises by Tenant. If any such lien is filed, Tenant shall cause same to be discharged of record within ten (10) business days following written notice thereof, or if Tenant disputes the correctness or validity of any claim of lien, Landlord may, in its reasonable discretion, permit Tenant to post or provide security in a form and amount acceptable to Landlord to insure that title to the Property remains free from the lien claimed. If said lien is not timely discharged Landlord may, but shall not be required to, take such action or pay such amount as may be necessary to remove such lien and Tenant shall pay to Landlord as Additional Rent any such amounts expended by Landlord, together with interest thereon at the Default Rate, within five (5) days after notice is received from Landlord of the amount expended by Landlord.

ARTICLE X: USE AND COMPLIANCE WITH LAWS

10.01 General Use and Compliance with Laws. Tenant shall only use the Premises for the uses described in Section 1.01(e) above, and uses customarily incidental thereto and for no other use without the prior written the consent of Landlord. Tenant shall, at Tenant's sole cost and expense, comply with all requirements of municipal, county, state, federal and other applicable governmental authorities now or hereafter in force pertaining to Tenant's business operations, alterations and/or specific use of the Premises, and shall secure any necessary permits therefore and shall faithfully observe in the use of the Premises and the Project, all municipal, county, state, federal and other applicable governmental entities' requirements which are now or which may hereafter be in force. Tenant, in Tenant's use and occupancy of the Premises, shall not subject or permit the Premises to be used in any manner which would tend to damage any portion thereof. Tenant shall not do or permit anything to be done in or about the Premises, the Common Areas and/or the Property which will in any way obstruct or interfere with the rights of other tenants or occupants of the Common Areas and/or the Project or use or allow the Premises or any portion of the Project to be used for any improper, immoral, unlawful or objectionable purpose, nor shall Tenant cause, maintain or permit a nuisance in, on or about the Premises or the Common Areas. Landlord hereby acknowledges that Tenant, Tenant's employees and/or employees of subsidiaries of Tenant may occupy portions of the Premises from time to time under this Lease.

10.02 Hazardous Materials. Tenant shall not cause or permit any Hazardous Materials (as defined hereinbelow) to be brought upon, kept or used in or about the Building, the Property, the Common Areas and/or the Project by Tenant, its agents, employees, contractors, or licensees, except such Hazardous Materials that are typical in Tenant's business and that are at all times, used, kept and stored in the manner that complies with all laws, rules, regulations and ordinances now or hereafter regulating any such Hazardous Materials. If Tenant breaches the covenants and obligations set forth herein or, if the presence of Hazardous Materials on, in or about the Building, the Premises, the Project, the Property and/or the Common Areas, as the case may be, caused by Tenant, its agents, employees, contractors, licensees or invitees results in contamination of all or any portion of the Project or any other property, whether or not adjacent thereto, then Tenant shall indemnify, defend and hold Landlord free and harmless from and against any and all claims, judgments, damages, penalties, fines, costs, liabilities and losses (including, without limitation, sums paid in settlement of claims, attorneys' fees, consultant fees and expert fees) which arise during or after the Term as a result of such contamination. This indemnification by Tenant of Landlord shall include, without limitation, any and all costs incurred with any investigation of site conditions and any cleanup, remedial, removal or restoration work required by any federal, state or local governmental agency or political subdivision because of the presence of such Hazardous Materials caused by Tenant, its agents, employees, contractor, licensees and/or invitees in, on or about the Building, the Common Areas or the soil or ground water on or under the Property. The provisions of this Section 10.02 shall survive the expiration or earlier termination of this Lease. For purposes of the Lease, the term "Hazardous Materials" shall mean the following: (a) those substances included within the definitions of "hazardous substances,"

“pollutant,” or “contaminant” in the Comprehensive Environmental Response, Compensation and Liability Act of 1980, 42 U.S.C. Sections 9601 et. seq. as heretofore or hereafter amended, the regulations promulgated pursuant to such Act and state laws and regulations similar to or promulgated pursuant to such Act; (b) any material, waste or substance which is (i) petroleum, (ii) asbestos, (iii) flammable explosive, or (iv) radioactive; and (c) such other substances, materials and wastes which are or become regulated as hazardous or toxic under federal, state or local law. Without limiting the foregoing, Tenant shall be responsible for any leaks or spills associated with Tenant’s use of the back-up generator (which is being installed at Tenant’s request). Likewise, Landlord covenants that Landlord shall not cause or permit any Hazardous Materials to be brought upon, kept or used in or about the Building or Project by Landlord, its agents, employees, contractors or licensees in violation of any applicable laws or regulations. Further, Landlord shall indemnify, defend and hold Tenant free and harmless from and against any and all claims, judgments, damages, penalties, fines, costs, liabilities and losses (including without limitation, sums paid in settlement of claims, attorneys’ fees, consultant fees and expert fees) which arise during or after the Lease Term as a result of either a breach by Landlord of the foregoing covenant or otherwise due to the presence of Hazardous Materials existing upon commencement of the Lease Term by no fault of Tenant.

10.03 Signs.

(a) The Tenant shall not paint, display, inscribe, place or affix any sign, picture, advertisement, notice, lettering, or direction on any part of the outside of the Building or the Project or visible from the outside of the Premises, the Building or the Project, except as first approved by Landlord (except as otherwise expressly allowed by this Lease) and the City of Issaquah.

(b) During the Term of this Lease and provided that Tenant remains the sole tenant of the Building, Tenant shall have the exclusive right (i.e. neither Landlord nor any other tenant shall have signs on the Building exterior or on the parking facility except any reasonably sized address signs at street level identifying the name, address or location of the Building) to install and maintain, at its sole cost and expense, exterior signage on two (2) of the four (4) sides near the top of the Building (the “Building Signs”) subject to the following terms and conditions:

(i) The location, design, construction, size and other aspects of such Building Signs and all modifications, replacements or alterations thereto shall be subject to Landlord’s prior written consent, which consent shall not be unreasonably withheld or delayed.

(ii) The expense of installing, constructing, maintaining and removing the Building Signs (and repair of the Building exterior upon such removal) shall be the sole cost and expense of Tenant and shall be paid directly by Tenant.

(c) For such period as Tenant is the sole tenant of the Building, Tenant shall have the exclusive right at its sole cost and expense, to install and maintain its name on the monument signage adjacent to the Building to be constructed by Landlord (the "Monument Signage"), subject to the following terms and conditions:

(i) Landlord, at its sole cost and expense, shall install a monument sign adjacent to the main entrance of the Building. The design, construction, size, Tenant's identification and other aspects of such monument signage shall be generally as described on Exhibit C-2. Otherwise, all other aspects of Tenant's Signage including, without limitation, all modifications, replacements or alterations shall be subject to Landlord's prior written consent, which consent shall not be unreasonably withheld or delayed.

(ii) The expense of installing, constructing, maintaining and removing Tenant's Signage shall be the sole cost and expense of Tenant and shall be paid directly to Landlord by Tenant. Tenant shall be responsible for all costs and expenses associated with Tenant's Signage (i.e., Tenant's name on the monument sign).

ARTICLE XI: DAMAGE AND DESTRUCTION

11.01 Reconstruction. If the Building is damaged or destroyed during the Term, Landlord shall, except as hereinafter provided, diligently repair or rebuild it to substantially the condition in which it existed immediately prior to such damage or destruction. If Landlord is obligated or elects to repair or restore as herein provided, Landlord shall be obligated to make repair or restoration of only those portions of the Premises which were initially provided at Landlord's expense or as part of the original installation by Landlord for Tenant and the repair and/or restoration of other items within the Premises (i.e., Tenant's furniture, fixtures, equipment and any Alterations) shall be the obligation of the Tenant.

11.02 Rent Abatement. Rent due and payable hereunder shall be equitably abated during any period in which, by reason of any such damage or destruction, there is interference with the operation of Tenant's business in the Premises, unless Landlord is able to relocate Tenant (or affected portion of Tenant's operations) to substitute premises reasonably acceptable to Tenant. Such abatement shall continue for the period commencing with such damage or destruction and ending with a substantial completion by Landlord of the work of repair or reconstruction which Landlord is obligated or undertakes, plus a thirty (30) day fixturing period. Tenant shall not be entitled to any claim, compensation or damages for loss in the use in the whole or any part of the Premises (including loss of business) and/or any inconvenience or annoyance occasioned by such damage, repair, reconstruction or restoration.

11.03 Excessive Damage or Destruction. If the Building or the Premises is damaged or destroyed to the extent that it cannot with reasonable diligence, be fully repaired or restored by Landlord (as certified by Landlord's architect) within three hundred sixty (360) days after the date of the damage or destruction, either Landlord or Tenant may terminate this Lease by written notice to the other within thirty (30) days of the date of the damage or destruction. If neither party terminates this Lease, this Lease shall remain in full force and effect and Landlord shall diligently repair and restore the damage as soon as reasonably possible; provided, however, if neither party elects to terminate this Lease, then if such repair and restoration takes more than four hundred fifty (450) days from the date of casualty, for any reason other than Tenant's fault or delay, Tenant again shall have the right to terminate this Lease.

11.04 Uninsured Casualty. Notwithstanding anything contained herein to the contrary, in the event of damage to or destruction of all or any portion of the Building, which damage or destruction is not fully covered by the insurance proceeds received by Landlord under the insurance policies required under Article 7.01 hereinabove, Landlord may terminate this Lease by written notice to Tenant given within sixty (60) days after the date of notice to Landlord that said damage or destruction is not so covered. If Landlord does not elect to terminate this Lease, the Lease shall remain in full force and effect and the Building shall be repaired and rebuilt in accordance with the provisions for repair set forth in Section 11.01 hereinabove.

11.05 Waiver. With respect to any damage or destruction which Landlord is obligated to repair or may elect to repair under the terms of this Article 11, and to the extent permitted by law, Tenant hereby waives any rights to terminate this Lease pursuant to rights otherwise accorded by law to tenants, except as expressly otherwise provided herein.

11.06 Mortgagee's Right. Notwithstanding anything herein to the contrary, if the holder of any indebtedness secured by a mortgage or deed of trust covering the Property, the Building and/or the Project requires that the insurance proceeds be applied to such indebtedness, then Landlord shall have the right to terminate this Lease by delivering written notice of termination to Tenant within fifteen (15) days after such requirement is made. Upon any termination of this Lease under the provisions hereof, the parties shall be released without further obligation to the other from date possession of the Premises is surrendered to Landlord, except for items which are theretofore accrued and are then unpaid.

11.07 Damage Near End of Term. Notwithstanding anything to the contrary contained in this Article XI, in the event the Premises or the Building are subject to excessive damage (as defined in Section 11.03) during the last twenty-four (24) months of the Term or any applicable extension periods, either Landlord or Tenant may elect to terminate this Lease by written notice to the other within thirty (30) days after the date of such damage; provided however, Tenant shall have the right to exercise its Option to Extend (if and to the extent available pursuant to Subsection 4.03 and provided that Tenant has not exercised its right to contract the area of the Premises pursuant to Subsection 2.03 above) by written notice to Landlord within thirty (30) days after the date of casualty in which case neither party shall have the right to terminate this Lease solely on the basis of the timing of the casualty during the last 24 months of the Term.

ARTICLE XII: EMINENT DOMAIN

12.01 Eminent Domain. In the event the whole of the Premises, Building, Project and/or Common Areas, as the case may be, and/or such part thereof as shall unreasonably interfere with Tenant's use and occupation thereof, including without limiting the foregoing, the taking of more than ten percent (10%) of the parking stalls allocated to Tenant pursuant to Subsection 1.01(q) above in the parking areas serving the Building as required by Subsection 18.16, shall be taken for any public or quasi-public purpose by any lawful power or authority by exercise of the right of appropriation, condemnation or eminent domain, or is sold in lieu of or to prevent such taking, then Tenant shall have the right to terminate this Lease effective as of the date possession is required to be surrendered to said authority. In the event the whole of the

Premises, Building, Project, Common Areas and/or Property, as the case may be, or such part thereof as shall substantially interfere with Landlord's use and occupation thereof, or if any access points to adjoining streets, shall be taken for any public or quasi-public purpose by any lawful power or authority by exercise of the right of appropriation, condemnation or eminent domain, or is sold in lieu of or to prevent such taking, then Landlord shall have the right to terminate this Lease effective as of the date possession is required to be surrendered to said authority. Except as provided below, Tenant shall not assert any claim against Landlord or the taking authority for any compensation because of such taking, and Landlord shall be entitled to receive the entire amount of any award without deduction for any estate or interest of Tenant in the Premises. Nothing contained in this Section 12.01 shall be deemed to give Landlord any interest in any separate award made to Tenant for the value of any Alterations made by Tenant, the taking of personal property and fixtures belonging to Tenant and for Tenant's moving expenses to the extent such claim is available as a separate claim by Tenant pursuant to applicable law. In the event the amount of property or the type of estate taken shall not substantially interfere with the conduct of Tenant's business, Landlord shall be entitled to the entire amount of the award without deduction for any estate or interest of Tenant, Landlord shall promptly proceed to restore the Building to substantially their same condition prior to such partial taking less the portion thereof lost in such condemnation, and the Base Rent shall be proportionately reduced by the time during which, and the portion of the Premises which, Tenant shall have been deprived of possession on account of said taking and restoration.

ARTICLE XIII: DEFAULT

13.01 Events of Default. The occurrence of any of the following events shall constitute an "Event of Default" on the part of the Tenant with or without notice from Landlord:

(a) Tenant shall fail to pay on or before five (5) business days after written notice from Landlord to Tenant that Tenant has failed to pay on or before the due date any installment of Rent or other payment required pursuant to this Lease; or

(b) Tenant shall fail to comply with any term, provision, or covenant of this Lease, other than the payment of Rent or other sums of money due hereunder, and such failure is not cured within twenty (20) days after written notice thereof to Tenant (said notice being in lieu of, and not in addition to, any notice required as a prerequisite to an unlawful detainer or similar action for possession of the Premises); provided that if the nature of such cure is such that a longer cure period is necessary, Tenant shall only be in default if Tenant shall have failed to commence such cure within said 20-day period and thereafter to have diligently prosecuted such cure to completion.

(c) Tenant shall file a petition or be adjudged a debtor or bankrupt or insolvent under the United States Bankruptcy Code, as amended, or any similar law or statute of the United States or any State; or a receiver or trustee shall be appointed for all or substantially all of the assets of Tenant and such appointment or petition, if involuntary, is not dismissed within sixty (60) days of filing.

(d) Tenant shall make an assignment for the benefit of creditors; or

(e) There shall be an "Event of Default" by Tenant under the Lease of even date hereof, between Landlord and Tenant with respect to Tenant's lease of Building A of the Project.

13.02 Remedies.

(a) Upon the occurrence of any Event of Default set forth in this Lease, in addition to any other remedies available to Landlord at law or in equity, Landlord shall have the immediate option to terminate this Lease and all rights of Tenant hereunder. In the event that Landlord shall elect to so terminate this Lease, then Landlord may recover from Tenant: (i) any unpaid rent which as been earned at the time of such termination plus interest at the rates contemplated by this Lease; plus (ii) the worth at the time of award of the amount by which the unpaid rent for the balance of the Term after the date of termination exceeds the amount of such rental loss that Tenant proves could be reasonably avoided; plus (iii) any other amount necessary to compensate Landlord for all the damage proximately caused by Tenant's failure to perform Tenant's obligation under this Lease or which in the ordinary course of things would be likely to result therefrom, including, but not limited to, costs to reimprove the Premises, or portions thereof, for a new tenant, leasing commissions and incentives. As used in Subsections 13.02(a) (iii) above, the "worth at the time of award" is computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent (1%). Landlord hereby agrees to use commercially reasonable efforts to relet the Premises and otherwise mitigate its damages under this Lease.

(b) In the event of any such default by Tenant, Landlord shall also have the right with or without terminating this Lease, to re-enter the Premises in compliance with applicable laws and remove all persons and property from the Premises; such property may be removed and stored in a public warehouse or elsewhere at the cost of and for the account of the Tenant. No re-entry or taking possession of the Premises by Landlord pursuant to this Section 13.02(b) shall be construed as an acceptance of a surrender of the Premises or an election to terminate this Lease unless a written notice of such intention is given to Tenant or unless the termination thereof is decreed by a court of competent jurisdiction.

(c) In the event that Landlord shall elect to re-enter as provided above or shall take possession of the Premises pursuant to legal proceedings or pursuant to any notice provided by law, then if Landlord does not elect to terminate this Lease as provided above, Landlord may from time to time, without terminating this Lease, either recover all Rent as it becomes due or relet the Premises or any part thereof for the Term of this Lease on terms and conditions as Landlord at its reasonable discretion may deem advisable with the right to make alterations and repairs to the Premises.

(d) In the event that Landlord shall relet the Premises, the rents received by Landlord from such reletting shall be applied: first to the payment of any indebtedness other than Rent due hereunder from Tenant to Landlord; second to the payment of any costs of such reletting; third, to the payment of the cost of any alterations and repairs to the Premises; fourth,

to the payment of Rent due and unpaid hereunder; and the residual, if any, shall be held by Landlord and applied to payment of future Rent as the same shall become due and payable hereunder. Should that portion of such rents received from such reletting during the month which is applied to the payment of Rent be less than the Rent payable during that month by Tenant hereunder, then Tenant shall pay any such deficiency to Landlord immediately upon demand therefor by Landlord. Such deficiency shall be calculated and paid monthly. Tenant shall also pay to Landlord, as soon as is certain, any of the reasonable costs and expenses incurred by Landlord in such reletting or in making such alterations and repairs not covered by the rents received from such reletting.

(e) All rights, options and remedies of Landlord contained in this Lease shall be construed and held to be cumulative, and no one of them shall be exclusive of the other, and Landlord shall have the right to pursue any one or all of such remedies or any other remedy or relief which may be provided by law, whether or not stated in this Lease. No waiver of any default of Tenant hereunder shall be implied from any acceptance by Landlord of any Rent or other payments due hereunder or any omission by Landlord to take any action on account of such default if such default persists or is repeated, and no express waiver shall affect defaults other than as specified in said waiver. The consent or approval of Landlord to or of any act by Tenant requiring Landlord's consent or approval shall not be deemed to waive or render unnecessary Landlord's consent or approval to or of any subsequent similar acts by Tenant.

13.03 Landlord Default and Tenant Remedies. If Landlord fails to pay any amounts due to Tenant under this Lease and shall not cure such failure within twenty (20) days following Tenant's notice to Landlord (and to the holder of any mortgage) or if Landlord fails to keep or perform any of its obligations under this Lease and shall not cure such failure within thirty (30) days following Tenant's notice to Landlord (and to the holder of any mortgage), Landlord shall be in default under this Lease; provided, however, if the failure is of a nature that it cannot be cured within thirty (30) days, Landlord shall not be in default so long as Landlord commences the cure within such thirty (30) day period and diligently and continuously pursues the cure to completion as soon as reasonably possible. In the event of a default by Landlord hereunder, Tenant shall be entitled to pursue any remedies available to Tenant at law or in equity; provided that, in no event shall Tenant have the right to terminate this Lease except upon order of a court of applicable jurisdiction ordering such termination. In the event of any default by Landlord in any of its non-monetary obligations under this Lease after the expiration of the notice and cure period described above, Tenant may pursue any action reasonably necessary to cure Landlord's default if Tenant's use of the Premises for normal business operations has been adversely effected and provided that no such action shall affect the structural or mechanical functions of the Property or the rights of other occupants. If Tenant does in fact undertake curative actions for and on behalf of Landlord then Landlord shall reimburse Tenant for the reasonable cost of such actions within ten (10) days after receipt of invoice and substantiation thereof from Tenant.

13.04 Consequential and Incidental Damages. Except as otherwise expressly allowed by this Lease, neither Landlord nor Tenant shall be liable to the other for consequential or incidental damages.

14.01 Tenant's Bankruptcy.

Landlord and Tenant (as either debtor or debtor-in-possession) agree that if a petition ("Petition") is filed by or against tenant under any chapter of Title 11 of the United States Code (the "Bankruptcy Code"), the following provisions shall apply:

(a) Adequate protection for Tenant's obligations accruing after filing of the Petition and before this Lease is rejected or assumed shall be provided within 15 days after filing in the form of a security deposit equal to three months' Base Rent and Additional Rent and other Lease charges, to be held by the court or an escrow agent approved by Landlord and the court.

(b) The sum of all amounts payable by Tenant to Landlord under this Lease constitutes reasonable compensation for the occupancy of the Premises by Tenant.

(c) Tenant or Trustee shall give Landlord at least 30 days written notice of any abandonment of the Premises or any proceeding relating to administrative claims. If Tenant abandons without notice, Tenant or Trustee shall stipulate to entry of an order for relief from stay to permit Landlord to reenter and relet the Premises.

(d) If Tenant failed to timely and fully perform any of its obligations under this Lease before the filing of the Petition, whether or not Landlord has given Tenant written notice of that failure and whether or not any time period for cure expired before the filing of the Petition, Tenant shall be deemed to have been in default on the date the Petition was filed for all purposes under the Bankruptcy Code.

(e) For the purposes of Section 365(b)(1) of the Bankruptcy Code, prompt cure of defaults shall mean cure within 30 days after assumption.

(f) For the purposes of Section 365(b)(1) and 365(f)(2) of the Bankruptcy Code, adequate assurance of future performance of this Lease by Tenant, Trustee or any proposed assignee will require that Tenant, Trustee or the proposed assignee deposit three months of Base Rent and Additional Rent into an escrow fund (to be held by the court or an escrow agent approved by Landlord and the court) as security for such future performance. In addition, if this Lease is to be assigned, adequate assurance of future performance by the proposed assignee shall require that: (i) the assignee have a tangible net worth not less than the net worth of Tenant as of the Commencement Date or that such assignee's performance be unconditionally guaranteed by a person or entity that has a tangible net worth not less than the net worth of Tenant as of the Commencement Date; (ii) the assignee demonstrate that it possesses a history of success in operating a business of similar size and complexity in a similar market as Tenant's business; and (iii) assignee assume in writing all of Tenant's obligations relating to the Premises or this Lease.

(g) If Tenant or Trustee intends to assume and/or assign this Lease, Tenant or Trustee shall provide Landlord with 30 days written notice of the proposed action, separate from

and in addition to any notice provided to all creditors. Notice of a proposed assumption shall state the assurance of prompt cure, compensation for loss and assurance of future performance to be provided to Landlord. Notice of a proposed assignment shall state: (i) the name, address, and federal tax identification and registration numbers of the proposed assignee; (ii) all of the terms and conditions of the proposed assignment, and (iii) the assignee's proposed adequate assurance of future performance to be provided to Landlord.

(h) If Tenant is in default under this Lease when the Petition is filed, Landlord shall not be required to provide Tenant or Trustee with services or supplies under this Lease or otherwise before Tenant assumes this Lease, unless Tenant compensates Landlord for such services and supplies in advance.

ARTICLE XV: ASSIGNMENT AND SUBLETTING

15.01 Prohibition. Except as expressly set forth below, Tenant shall not assign, mortgage, pledge or otherwise transfer or encumber this Lease, in whole or in part, nor sublet, assign, or permit occupancy by any party other than Tenant of all or any part of the Premises, without the prior written consent of Landlord in each instance which consent shall not be unreasonably withheld or delayed. Tenant shall at the time the Tenant requests the consent of Landlord, deliver to Landlord the following information regarding the proposed assignee or subtenant: the name, address, nature of business, ownership, financial responsibility and standing of such proposed assignee or subtenant. Landlord shall have not less than ten (10) business days after receipt of all required information to elect one of the following: (a) consent to such proposed assignment, encumbrance or sublease, (b) refuse such consent, or (c) elect to terminate this Lease, in the case of a proposed assignment, or elect to terminate the Lease with respect to the portion of the Premises proposed to be subleased, as applicable; provided that Landlord may not exercise its right to terminate the Lease (or lease of the applicable portion of the Premises) pursuant to Subsection 15.01(c) above in the case of a requested sublease of the Premises except in the event the cumulative total area of the Premises subleased exceeds 50% of the total area of the Premises. In addition, as a condition to Landlord's consent to any assignment, sublease or encumbrance of this Lease shall be the delivery to Landlord of a true copy of the fully executed instrument of assignment, transfer or encumbrance and an agreement executed by the assignee, sublessee or other transferee in form and substance satisfactory to Landlord and expressly enforceable by Landlord, whereby the assignee assumes and agrees to be bound by the terms and provisions of this Lease and perform all the obligations of Tenant hereunder with respect to the assigned or subleased portion of the Premises. No assignment or subletting by Tenant shall relieve Tenant of any obligation under this Lease, including Tenant's obligation to pay Base Rent and Additional Rent hereunder. Except as expressly set forth below, any purported assignment or subletting contrary to the provisions hereof without consent shall be void. The consent by Landlord to any assignment or subletting shall not constitute a waiver of the necessity for such consent to any subsequent assignment or subletting. Tenant shall pay Landlord's reasonable actual third party costs and attorneys' fees incurred in reviewing any proposed assignment or sublease (not to exceed \$1,000 per assignment or sublease).

15.02 Excess Rental. If pursuant to any assignment or sublease, Tenant receives rent, either initially or over the term of the assignment or sublease, in excess of the Rent called for

hereunder, or in the case of this sublease of a portion of the Premises in excess of such Rent equitably allocable to such portion, after appropriate adjustments to assure that all other payments called for hereunder are appropriately taken into account, Tenant shall pay to Landlord, as Additional Rent hereunder, fifty percent (50%) of the excess of each such payment of rent received by Tenant after its receipt.

15.03 Scope. The prohibition against assigning or subletting contained in this Article XIV shall be construed to include a prohibition against any assignment or subletting by operation of law, except as set forth above. If this Lease be assigned, or if the underlying beneficial interest of Tenant is transferred, or if the Premises or any part thereof be sublet or occupied by anybody other than Tenant, Landlord may collect rent from the assignee, subtenant or occupant and apply the net amount collected to the Rent herein reserved and apportion any excess rent so collected in accordance with the terms of the immediately preceding paragraph, but no such assignment, subletting, occupancy or collection shall be deemed a waiver of this covenant, or the acceptance of the assignee, subtenant or occupant as tenant, or a release of Tenant from the further performance by Tenant of covenants on the part of Tenant herein contained. No assignment or subletting shall affect the continuing primary liability of Tenant (which, following assignment, shall be joint and several with the assignee), and Tenant shall not be released from performing any of the terms, covenants and conditions of this Lease.

15.04 Waiver. Notwithstanding any assignment or sublease, or any indulgences, waivers or extensions of time granted by Landlord to any assignee or sublessee or failure of Landlord to take action against any assignee or sublease, Tenant hereby agrees that Landlord may, at its option, and upon not less than ten (10) days' notice to Tenant, proceed against Tenant without having taken action against or joined such assignee or sublessee, except that Tenant shall have the benefit of any indulgences, waivers and extensions of time granted to any such assignee or sublessee.

15.05 Change in Control/Permitted Transfers. Except as expressly allowed below, if Tenant is a partnership, a withdrawal of or change in partners, in one or more transfers, owning more than a fifty percent (50%) interest in the partnership, shall constitute a voluntary assignment and shall be subject to the provisions of this Article XV. If the Tenant is a corporation, a transfer of fifty percent (50%) or more of the corporation's stock or assets in one or more transfers to a single party and/or its affiliates, or a change in the control of such company pursuant to a merger, consolidation, sale of assets or otherwise, shall be deemed for the purposes hereof to be an assignment of this Lease, and shall be subject to the provisions of this Article XV. Notwithstanding any provision to the contrary, Tenant may assign this Lease or sublet the Premises without Landlord's consent (i) to any corporation or other entity that controls, is controlled by or is under common control with Tenant; (ii) to any corporation or other entity resulting from a merger, acquisition, consolidation or reorganization of or with Tenant; (iii) in connection with the sale of all or substantially all of the assets of Tenant (all such transfers, assignments and subleases collectively hereinafter referred to as "Permitted Transfers" and all such transferees, assignees and sublessees are collectively hereinafter referred to as "Permitted Transferees"); provided that (a) Tenant provides evidence to Landlord in writing that such assignment or sublease complies with the criteria set forth in (i), (ii) or (iii) above, (b) such assignee, subtenant or successor-in-interest expressly assumes Tenants' obligations and liabilities

hereunder; and (c) the combined tangible net worth and debt to equity ratios of said assignee and Tenant after the transfer is equal to or better than that of Tenant as set forth in Tenant's 2001 10K financial statements. No such assignment, sublease or transfer shall release Tenant from any covenant, liability or obligation under this Lease.

ARTICLE XVI: ESTOPPEL CERTIFICATE, ATTORNMENT AND SUBORDINATION

16.01 Estoppel Certificates. Within ten (10) business days after receipt by Tenant of a request therefor by Landlord, or if on any sale, assignment or hypothecation by Landlord of Landlord's interest in the Property, the Project and/or the Premises, or any part thereof, an estoppel certificate shall be required from Tenant, Tenant shall deliver, in recordable form, a certificate in the form attached hereto as Exhibit F, or in such other form as reasonably requested by Landlord (the form of which is acceptable to Tenant), to any proposed mortgagee or purchaser, and to Landlord, certifying (if such be the case) that this Lease is in full force and effect, the date of Tenant's most recent payment of Rent, and that Tenant has no defenses or offsets outstanding, or stating those claimed by Tenant, and any other information contained in such Exhibit F or reasonably requested by Landlord or such proposed mortgagee or purchaser. Tenant's failure to deliver said statement within said period shall, at Landlord's option be an Event of Default hereunder and shall in any event be conclusive upon Tenant that: (i) this Lease is in full force and effect, without modification except as may be represented by Landlord; (ii) there are no uncured defaults in Landlord's performance and Tenant has no right to offset, counterclaim or deduction against Rent hereunder; and (iii) no more than one period's Base Rent has been paid in advance.

16.02 Attornment. Subject to the condition below, Tenant shall, in the event any proceedings are brought for the foreclosure of, or in the event of exercise of the power of sale under, any mortgage or deed of trust made by Landlord, its successors or assigns, encumbering the Building, or any part thereof or in the event of termination of a ground lease, if any, and if so requested, attorn to the purchaser upon such foreclosure or sale or upon any grant of a deed in lieu of foreclosure and recognize such purchaser as Landlord under this Lease; provided, that such purchaser recognizes Tenant's rights under this Lease and agrees not to disturb Tenant's quiet possession of the Premises for so long as Tenant is not in default hereunder past any applicable notice and cure periods.

16.03 Subordination. The rights of Tenant hereunder are and shall be, at the election of any mortgagee or the beneficiary of a deed of trust encumbering the Property (or the portion thereof on which the Building is located) and/or Building, subject and subordinate to the lien of such mortgage or deed of trust, or the lien resulting from any other method of financing or refinancing, now or hereafter in force against the Property (or the portion thereof on which the Building is located) and/or the Building, and to all advances made or hereafter to be made upon the security thereof; provided, however, that notwithstanding such subordination, so long as Tenant is not in default under any of the terms, covenants and conditions of the Lease past any applicable notice and cure periods, neither the Lease nor any of the rights of Tenant hereunder shall be terminated or subject to termination by any trustee's sale, any action to enforce the security, or by any proceeding or action in foreclosure. If requested, Tenant agrees to execute and deliver to Landlord or its mortgagee within ten (10) days after written notice, a subordination, nondisturbance and attornment agreement as may be required by Landlord or its mortgagee to further effect the provisions of this Article.

16.04 Recording. Tenant covenants and agrees with Landlord that Tenant shall not record this Lease but Landlord and Tenant shall execute and record a memorandum thereof in the form attached hereto as Exhibit H. Notwithstanding the provisions of Section 16.03, in the event that Landlord or its lender requires this Lease or a memorandum thereof to be recorded in priority to any mortgage, deed of trust or other encumbrance which may now or at any time hereafter affect in whole or in part the Building, the Property (or the portion thereof on which the Building is located) or the Project, and whether or not any such mortgage, deed of trust or other encumbrance shall affect only the Building, the Property (or the portion thereof on which the Building is located) or the Project, or shall be a blanket mortgage, deed of trust or encumbrance affecting other premises as well, the Tenant covenants and agrees with Landlord that the Tenant shall execute promptly upon request from Landlord any certificate, priority agreement or other instrument which may from time to time be requested to give effect thereto so long as Tenant reasonably approves the form thereof.

ARTICLE XVII: LANDLORD'S AGREEMENTS

17.01 Landlord hereby represents, warrants and covenants with Tenant as follows:

(a) Landlord is not aware of any Hazardous Materials with respect to the Property except as disclosed in that certain Phase I Environmental Audit prepared by URS Corporation, dated February 15, 2001 (the "Report") and has not received written notice of any violation of any environmental laws.

(b) The Property and Building is subject to the exceptions and encumbrances as shown in the Title Commitment issued by Chicago Title Insurance Company under Order No. 1006034, dated July 10, 2001 (the "Title Commitment") and that, to the best of Landlord's knowledge, the Property is not subject to any other matter of record which might affect this Lease or the terms and conditions hereof.

ARTICLE XVIII: MISCELLANEOUS

18.01 Notices. All notices required to be given hereunder shall be in writing and mailed postage prepaid by certified or registered mail, return receipt requested, or by personal delivery or nationally recognized courier service, to the appropriate address indicated in Section 1.01(b) or Section 1.01(d), as appropriate, at such street address or street addresses (but not more than three such addresses) as either Landlord or Tenant may, from time to time, respectively, designate in a written notice given to the other. Notices shall be deemed sufficiently served upon the earlier of actual receipt or the expiration of three (3) days after the date of mailing thereof sent by certified mail, return receipt requested.

18.02 Successors Bound. This Lease and each of its covenants and conditions shall be binding upon and shall inure to the benefit of the parties hereto and their respective assignees, subject to the provisions hereof. Whenever in this Lease a reference is made to Landlord, such

reference shall be deemed to refer to the person in whom the interest of Landlord shall be vested, and Landlord shall have no obligation hereunder as to any claim arising after the transfer of its interest in the Building but Landlord shall not be released from any duties, obligations or liabilities accruing prior to the date of transfer or arising out of events that occur prior to the date of transfer, unless such duties, obligations, or liabilities are expressly assumed by Landlord's transferee. Any successor or assignee of the Tenant who accepts an assignment of the benefit of this Lease and enters into possession or enjoyment hereunder shall thereby assume and agree to perform and be bound by the covenants and conditions thereof. Nothing herein contained shall be deemed in any manner to give a right of assignment without the prior written consent of Landlord pursuant to, or otherwise as provided in, Article XV hereof.

18.03 Waiver. No waiver of any default or breach of any covenant by either party hereunder shall be implied from any omission by either party to take action on account of such default if such default persists or is repeated, and no express waiver shall affect any default other than the default specified in the waiver and said waiver shall be operative only for the time and to the extent therein stated. Waivers of any covenant, term or condition contained herein by either party shall not be construed as a waiver of any subsequent breach of the same covenant, term or condition. The consent or approval by either party to or of any act by either party requiring further consent or approval shall not be deemed to waive or render unnecessary their consent or approval to or of any subsequent similar acts.

18.04 Subdivision and Easements. Landlord reserves the right to: (a) subdivide the Project (but not the Property); and (b) grant easements on the Project and Property and dedicate portions of the Project (but not the Property) for public use; provided, however, that no such grant or dedication shall materially interfere with Tenant's use of the Premises. Tenant hereby consents to such subdivision and/or grant or dedication of easements and agrees from time to time, at Landlord's request, to execute, acknowledge and deliver to Landlord, in accordance with Landlord's instructions, any and all documents, instruments, maps or plats necessary to effectuate Tenant's consent thereto.

18.05 Common Areas. Landlord reserves the right from time to time, provided that Tenant's use and enjoyment of the Premises is not materially and adversely affected thereby, to: (a) install, use, maintain, repair and replace pipes, ducts, conduits, wires and appurtenant meters and equipment for service to other parts of the Building above the ceiling surfaces, below the floor surfaces, within the walls and in the central core areas, and to relocate any pipes, ducts, conduit, wires and appurtenant meters in the Building which are so located or located elsewhere outside the Building; (b) make changes to the Common Areas and/or the parking facilities located thereon, including, without limitation, changes in the location, size, shape and number of driveways, entrances, parking spaces, parking areas, loading and unloading areas, ingress, egress, direction of traffic, landscaped areas and walkways; (c) close temporarily all or any portion of the Common Areas and/or the Building in order to perform any of the foregoing or any of Landlord's obligations under this Lease, so long as reasonable access to the Building remains available during normal business hours; and (d) alter, relocate or expand, and/or to add additional structures and improvements to, or remove same from, all or any portion of the Common Areas or other portions of the Project; provided, that Landlord shall repair any damage to the Premises resulting from the exercise by Landlord of its rights hereunder and provided, further that no such changes shall materially affect the usability of the Premises by Tenant, the visibility of or access to the Premises or reduce available parking provided to the Premises pursuant to Section 1.01(q).

18.06 Accord and Satisfaction. No payment by Tenant or receipt by Landlord of a lesser amount than the Rent herein stipulated shall be deemed to be other than on account of the Rent, nor shall any endorsement or statement on any check or any letter accompanying any check or payment as Rent be deemed an accord and satisfaction, and Landlord may accept such check or payment without prejudice to Landlord's right to recover the balance of such Rent or pursue any other remedy provided in this Lease.

18.07 Limitation of Landlord's Liability. The obligations of Landlord under this Lease do not constitute personal obligations of the individual partners, directors, officers, members, employees or shareholders of Landlord or its partners, and Tenant shall look solely to the Property, and the rents, issues, proceeds (including insurance proceeds) and profits therefrom, for satisfaction of any liability in respect of this Lease and will not seek recourse against the individual partners, directors, officers, members, employees or shareholders of Landlord or its partners or any of their personal assets for such satisfaction.

18.08. Intentionally Deleted.

18.09 Attorneys' Fees. In the event either party requires the services of an attorney in connection with enforcing the terms of this Lease or in the event suit is brought for the recovery of any Rent due under this Lease or the breach of any covenant or condition of this Lease, or for the restitution of the Premises to Landlord and/or eviction of Tenant during the Term of this Lease, or after the expiration thereof, the substantially prevailing party will be entitled to a reasonable sum for attorneys' fees, witness fees and other court costs, both at trial and on appeal.

18.10 Captions and Article Numbers. The captions, article, paragraph and section numbers and table of contents appearing in this Lease are inserted only as a matter of convenience and in no way define, limit, construe or describe the scope or intent or such sections or articles of this Lease nor in any way affect this Lease.

18.11 Severability. If any term, covenant, condition or provision of this Lease, or the application thereof to any person or circumstance, shall to any extent be held by a court of competent jurisdiction to be invalid, void or unenforceable, the remainder of the terms, covenants, conditions or provisions of this Lease, or the application thereof to any person or circumstance, shall remain in full force and effect and shall in no way be affected, impaired or invalidated.

18.12 Applicable Law. This Lease, and the rights and obligations of the parties hereto, shall be construed and enforced in accordance with the laws of the state in which the Building is located.

18.13 Submission of Lease. The submission of this document for examination and negotiation does not constitute an offer to lease, or a reservation of or option for leasing the Premises. This document shall become effective and binding only upon execution and delivery hereof by Landlord and Tenant. No act or omission of any officer, employee or agent of Landlord or Tenant shall alter, change or modify any of the provisions hereof.

18.14 Holding Over. Should Tenant, or any of its successors in interest, hold over the Premises or any part thereof after the expiration or earlier termination of this Lease without Landlord's prior written consent, such holding over shall constitute and be construed as tenancy at sufferance only, at a monthly rent equal to one hundred fifty percent (150%) of the Base Rent owed during the final month of the Term of this Lease and otherwise upon the terms and conditions in the Lease, so far as applicable. The acceptance by Landlord of Rent after such expiration or early termination shall not result in a renewal or extension of this Lease. The foregoing provisions of this Section 18.14 are in addition to and do not affect Landlord's right of re-entry or any other rights of Landlord hereunder or as otherwise provided by law. Tenant shall indemnify and hold Landlord harmless from and against all loss or liability, including without limitation, any claim made by any succeeding tenant resulting from such failure to surrender by Tenant and any attorneys' fees and costs incurred by Landlord with respect to any such claim.

18.15 Rules and Regulations. At all times during the Term, Tenant shall comply with Rules and Regulations for the Building and the Project, as set forth in Exhibit G attached hereto, together with such amendments thereto as Landlord may from time to time reasonably adopt and enforce in a non-discriminatory fashion, which amendments shall not affect Tenant's rights hereunder.

18.16 Parking. During the Term of this Lease, Tenant shall have the non-exclusive use of the number of vehicle parking spaces designated in Subsection 1.01(q) above for Tenant, its employees, visitors and customers, without fee or charge. Notwithstanding the non-exclusive nature of such parking rights, Tenant shall, at all times during the term of this Lease, have the ability to park vehicles in the minimum number of stalls provided in Subsection 1.01(q) above (as may be adjusted based upon contraction or recapture of any portion of the Premises). Landlord represents and warrants that the parking facility serving the Building shall contain at least the number of stalls required by Subsection 1.01(q) above (subject to reduction due to an action of governmental authority which action shall be controlled by the provisions of Subsection 12.01 above). Tenant shall have the right to designate parking spaces in the first row immediately adjacent to the Premises as reserved spaces for certain employees, for designated visitors or for other purposes.

18.17 No Nuisance. Tenant shall conduct its business and control its agents, employees, invitees and visitors in such a manner as not to create any nuisance, or interfere with, annoy or disrupt any other tenant or Landlord in its operation of the Project.

18.18 Broker; Agency Disclosure.

(a) Each of Tenant and Landlord warrant that it has had no discussions, negotiations and/or other dealings with any appraiser or agent in connection with the negotiation of this Lease other than the Broker(s) identified in Section 1.01(r) ("Brokers"), and that it knows of no other appraiser or agent who is or may be entitled to any commission or finder's fee in connection with this Lease. Landlord shall pay Brokers a commission pursuant to separate

agreements. Brokers shall be obligated to pay any co-brokers a portion of the commission received by such Broker. Each Tenant and Landlord agrees to indemnify the other and hold the other harmless from and against any and all claims, demands, losses, liabilities, lawsuits, judgments, costs and expenses (including without limitation, attorneys' fees and costs) with respect to any leasing commission or equivalent compensation alleged to be owing on account of such party's discussions, negotiations and/or dealings with any appraiser or agent. This Section 18.18 is not intended to benefit any third parties and shall not be deemed to give any rights to brokers or finders. No commission(s) or finders fee(s) shall be paid to Tenant, employee(s) of Tenant or any unlicensed representative of Tenant.

(b) At the signing of this Lease Tenant's Broker represented Tenant.

18.19 Landlord's Right to Perform. Upon Tenant's failure to perform any obligation of Tenant hereunder after notice from Landlord pursuant to Section 13.01 above, including without limitation, payment of Tenant's insurance premiums, charges of contractors who have supplied materials or labor to the Premises, etc., Landlord shall have the right to perform such obligation of Tenant on behalf of Tenant and/or to make payment on behalf of Tenant to such parties. Tenant shall reimburse Landlord the reasonable cost of Landlord's performing such obligation on Tenant's behalf, including reimbursement of any amounts that may be expended by Landlord, plus interest at the Default Rate, as Additional Rent.

18.20 Assignment by Landlord. In the event of a sale, conveyance, or other transfer by Landlord of the Building, the Property, or portion thereof on which the Building is located, or the Project or in the event of an assignment of this Lease by Landlord, the same shall operate to release Landlord from any further liability upon any of the covenants or conditions, express or implied, herein contained on the part of Landlord, and from any and all further liability, obligations, costs and expenses, demands, causes of action, claims or judgments arising out of this Lease from and after the effective date of said release. In such event, Tenant agrees to look solely to the successor in interest of transferor so long as such successor has expressly assumed the obligations of Landlord hereunder. Landlord shall transfer such Security Deposit to any purchaser and thereupon Landlord shall be discharged from any further liability in reference thereto.

18.21 Entire Agreement. This Lease sets forth all covenants, promises, agreements, conditions and understandings between Landlord and Tenant concerning the Building and the Project, and there are no covenants, promises, agreements, conditions or understandings, either oral or written, between Landlord and Tenant other than as are herein set forth. No subsequent alteration, amendment, change or addition to the Lease shall be binding upon Landlord or Tenant unless reduced to writing and signed by Landlord and Tenant.

18.22 Financial Covenants. Landlord acknowledges and agrees that Tenant, or Tenant's parent and/or the Guarantor, is/are a publicly traded corporation and as such, Landlord has access to all public information regarding Tenant. If at any time such information regarding Tenant or an assignee or successor of Tenant is not readily available to Landlord, then at Landlord's request, Tenant shall provide Landlord with current annual audited financial statements and quarterly unaudited financial statements setting forth Tenant's financial position (all such statements shall be prepared in compliance with GAAP standards), but only to the extent the providing of such financial information is not prohibited by applicable security laws or regulations.

18.23 Consents. Whenever the approval or consent of Landlord or Tenant is required under the terms of this Lease, such consent shall not be unreasonably withheld or delayed unless a different standard of approval is specifically set forth in the particular Section containing that particular consent requirement.

18.24 Intentionally Deleted.

18.25 Exhibits. Exhibits A through J are attached to this Lease after the signatures and by this reference incorporated herein.

18.26 Submission of Lease. Submission of this instrument for examination or signature by Tenant does not constitute a reservation of or option for lease, and it is not effective as a lease or otherwise until execution and delivery to both Landlord and Tenant.

18.27 Time. Time is of the essence with respect to the performance of every provision of this Lease in which time of performance is a factor.

18.28 Prior Agreement or Amendment. This Lease contains all of the agreements of the parties hereto with respect to any matter covered or mentioned in the Lease, and no prior agreement or understanding pertaining to any such matter shall be effective for any purpose. No provisions of this Lease may be amended or added to except by an agreement in writing signed by the parties hereto or their respective successors-in-interest.

18.29 Independently Provided Services.

(a) This Lease is entirely separate and distinct from and independent of any and all agreements that Tenant may at any time enter into with any third party for the provision of services, which include, but are not limited to, telecommunications, office automation, repair, maintenance services, computer, and photocopying ("Independent Services"). Tenant acknowledges that Landlord has no obligation of any type concerning the provision of Independent Services, and agrees that any cessation or interruption of Independent Services or any other act or neglect by the third party providing the Independent Services shall not constitute a default or constructive eviction by Landlord.

(b) Tenant agrees, except to the extent of the negligence of Landlord, its partners, employees, agents and/or assigns, to hold harmless and defend Landlord, its partners, employees, agents and assigns from any claim Tenant may have arising in any way out of the provision (or lack thereof) of the Independent Services which Tenant has contracted to receive from the third parties.

(c) In no event shall Landlord be liable to Tenant for incidental, consequential, indirect or special damages (including lost profits) which may arise in any way out of a claim concerning Independent Services.

18.30 Authority to Bind Landlord. Landlord has the right, power and authority to enter into this Lease and the individuals signing this Lease on behalf of Landlord hereby represent and warrant that they are empowered and duly authorized to bind Landlord to this Lease.

18.31 Authority to Bind Tenant. The individuals signing this Lease on behalf of Tenant hereby represent and warrant that they are empowered and duly authorized to bind Tenant to this Lease. If Tenant is a corporation, limited liability company or limited or general partnership, each individual executing this Lease on behalf of Tenant represents and warrants that he or she is duly authorized to execute and deliver this Lease on behalf of Tenant, in accordance with a duly adopted resolution or consents of all appropriate persons or entities required therefor and in accordance with the formation documents of tenant, and that this Lease is binding upon Tenant in accordance with its terms. At Landlord's request, tenant shall, prior to Landlord's execution of this Lease, deliver to Landlord a copy of the appropriate resolution or consent, certified by an appropriate officer, partner or manager of Tenant, authorizing or ratifying the execution of this Lease.

18.32 No Usury. No interest charged, or chargeable by Landlord under this Lease (including but not limited to the interest chargeable under Section 5(a) and/or any late charge, fee or other sum charged or withheld by Landlord and which is deemed to be interest) shall exceed the maximum amount of interest permitted by any applicable law. If any such interest, fee or charge would exceed such maximum, then such interest, fee or charge shall be automatically reduced to the maximum amount allowed by law and any sums already collected in excess of such maximum amount shall be refunded by Landlord in cash or by granting Tenant a credit in the applicable amount which credit shall be applied against the next Base Rent coming due.

18.33 Interpretation. The parties hereto specifically acknowledge and agree that the terms of this Lease have been mutually negotiated and the parties hereby specifically waive the rule or principle of contract construction which provides that any ambiguity in any term or provision of a contract will be interpreted or resolved against the party which drafted such term or provision.

18.34 Excused Delays. Except as otherwise set forth in this Section 18.34, neither party shall have liability to the other on account of the following acts (each of which is an "Excused Delay" and jointly all of which are "Excused Delays") which shall include: (a) the inability to fulfill, or delay in fulfilling, any obligations under this Lease by reason of strike, lockout, other labor trouble, dispute or disturbance; (b) governmental regulation, moratorium, action, preemption or priorities or other controls; (c) shortages of fuel, supplies or labor; (d) any failure or defect in the supply, quantity or character of electricity or water furnished to the Premises by reason of any requirement, act or omission of the public utility or others furnishing the Building with electricity or water; or (e) for any other reason, whether similar or dissimilar to the above, or for act of God beyond a party's reasonable control. If this Lease specifies a time period for performance of an obligation of a party, that time period shall be extended by the period of any

delay in the party's performance caused by any of the events of Excused Delay described herein; provided, that notwithstanding anything to the contrary above, no payment of money (whether as Base Rent, Tenant's Percentage of Taxes or Operating Costs, or any other payment due under this Lease) shall be postponed, delayed or forgiven by reason of any of the foregoing events of Excused Delay.

18.35 Antennae Equipment. During the Term of this Lease, Tenant shall have the exclusive right to install, maintain and operate, free of charge, satellite dishes and related equipment (the "Equipment") on the roof of the Building subject to the following terms and conditions:

- (a) The location of all Equipment shall be approved by Landlord prior to Tenant's installation of the Equipment, together with appropriate screening.
- (b) Tenant shall operate the Equipment in compliance with all applicable laws, rules, regulations and ordinances.
- (c) Tenant shall have the right, subject to the reasonable supervision of the Building engineer, to use the Building risers to install cabling to connect the Equipment to the Premises.
- (d) Tenant shall remove any such Equipment and repair any damage resulting from the same, upon expiration or earlier termination of this Lease.

18.36. Letter of Credit.

(a) Concurrently with the execution of this Lease, Tenant shall deliver to Landlord an unconditional, irrevocable standby letter of credit ("Letter of Credit") which conforms in form and substance to the form attached as Exhibit "I" (or is otherwise acceptable to Landlord) and which:

- (i) is issued by a United States federal or state chartered bank ("Issuer") that is a member of the New York Clearing House Association or is a commercial bank or trust company, all as reasonably acceptable to Landlord;
- (ii) names Landlord as beneficiary thereunder;
- (iii) has a term ending not less than one year after the date of issuance;
- (iv) automatically renews for one-year periods unless Issuer notifies beneficiary in writing, at least 60 days prior to the expiration date, that Issuer elects not to renew the Letter of Credit;
- (v) provides for payment to beneficiary of immediately available funds (denominated in United States dollars) in the amount of Two Million Five Hundred Thousand Dollars (\$2,500,000.00) upon presentation of the Sight Draft substantially conforming to the form attached as Schedule "A" to the Letter of Credit and the certification required under the Letter of Credit;

(vi) provides that draws may be presented, and are payable at the Issuer's letterhead office or other office designated by the Issuer in writing (as reasonably acceptable to Landlord);

(vii) is payable in sight drafts which only require the beneficiary to state that the draw is payable to the order of beneficiary;

(viii) permits partial and multiple draws;

(ix) permits multiple transfers by beneficiary;

(x) waives any rights Issuer may have, at law or otherwise, to subrogate to any claims beneficiary may have against applicant or applicant may have against beneficiary; and

(xi) is governed by the International Standby Practices 1998, published by the International Chamber of Commerce.

Except as expressly provided in Subsections 18.36(f) and (k) below, the Letter of Credit (as transferred, extended, renewed or replaced) must be maintained during the entire Lease Term, as extended or renewed, and for a period of 45 days thereafter.

(b) Transfer; Fees. Landlord may freely transfer the Letter of Credit in connection with an assignment of this Lease without (i) Tenant's consent, (ii) restriction on the number of transfers, or (iii) any condition, other than presentment to Issuer of the original Letter of Credit and a duly executed transfer document conforming to the form attached as Schedule "B" to the Letter of Credit. Tenant is solely responsible for any bank fees or charges imposed by Issuer in connection with the issuance of the Letter of Credit or any transfer, renewal, extension or replacement thereof. If Tenant fails to timely pay such transfer fee, Landlord may, at its option and without notice to Tenant, elect to pay any transfer fees to Issuer when due, and upon payment, such amount will become immediately due and payable from Tenant to Landlord as Additional Rent under this Lease.

(c) Definition of Draw Event. "Draw Event" means the occurrence of any of the following events:

(i) Tenant fails to pay fully any item of Rent as and when due, and such failure continues for a period of five (5) days after written notice from Landlord to Tenant;

(ii) Tenant (i) breaches or fails to timely perform any of its other obligations under this Lease, (ii) the breach or failure continues for a period of thirty (30) days without regard to any cure period granted under this Lease and without regard to whether such breach or failure is determined (upon occurrence or at any later time) to be an Event of Default and (iii) Tenant has either failed to commence cure of the breach or failure or, if cure has been commenced, is not diligently pursuing such cure;

(iii) There is an Event of Default under this Lease, pursuant to Subsection 13.01 above;

(iv) Subject to Subsection 18.36(k) below, Tenant fails to timely cause the Letter of Credit to be renewed or replaced as required in Subsection 18.36(f) below; or

(v) an Issuer Quality Event as described in Subsection (g) below.

(d) Draw and Use of Draw Proceeds. Immediately upon the occurrence of any one or more Draw Events, and at any time thereafter, Landlord may draw on the Letter of Credit, in whole or in part (if partial draw is made, Landlord may make multiple draws), as Landlord may determine in Landlord's sole and absolute discretion (subject to application as contemplated in Subsection 18.36(d) below). The term "Draw Proceeds" means the cash proceeds of any draw or draws made by Landlord under the Letter of Credit. Any delays by Landlord in drawing on the Letter of Credit or using the Draw Proceeds will not constitute a waiver by Landlord of any of its rights hereunder with respect to the Letter of Credit or the Draw Proceeds. Landlord will hold the Draw Proceeds in its own name and may co-mingle the Draw Proceeds with other accounts of Landlord or invest them as Landlord may determine in its sole and absolute discretion.

(e) Application of Draw Proceeds. In addition to any other rights and remedies Landlord may have, Landlord may in its sole and absolute discretion and at any time, use and apply all or any portion of the Draw Proceeds to pay Landlord for any one or more of the following:

(i) Rent or any other sum which is past due, due or becomes due, or to which Landlord is otherwise entitled under the terms of this Lease, whether due to the passage of time, the existence of a default or otherwise (including, without limitation, late payment fees or charges and any amounts which Landlord is or would be allowed to collect under this Lease, and without deducting therefrom any offset for proceeds of any potential reletting or other potential mitigation which has not in fact occurred at the time of the draw);

(ii) any and all amounts incurred or expended by Landlord in connection with the exercise and pursuit of any one or more of Landlord's rights or remedies under this Lease, including, without limitation, reasonable attorneys' fees and costs;

(iii) any and all amounts incurred or expended by Landlord in obtaining the Draw Proceeds, including, without limitation, reasonable attorneys' fees and costs; or

(iv) any and all other damage, injury, expense or liability caused to or incurred by Landlord as a result of any Event of Default, Draw Event or other breach, failure or default by Tenant under this Lease.

To the extent that Draw Proceeds exceed the amounts so applied, such excess Draw Proceeds will be deemed paid to Landlord to establish a credit on Landlord's books in the amount of such excess, which credit may be applied by Landlord thereafter (in Landlord's sole and absolute discretion), to any of Tenant's obligations to Landlord under this Lease as and when they become due. Following any use or application of the Draw Proceeds, Tenant, if requested by Landlord in writing, must, within 10 days after receipt of Landlord's request, cause a replacement Letter of Credit complying with Subsection 18.36(a) above to be issued and delivered to Landlord; provided, however, that the amount of the replacement Letter of Credit will be an amount equal to the original amount of the Letter of Credit (as set forth in Section (e) above) less any unapplied Draw Proceeds on the date the replacement Letter of Credit is issued. Upon Landlord's receipt of the replacement Letter of Credit, Landlord will deliver the prior original Letter of Credit to Issuer for cancellation (if not theretofore fully drawn) and any unapplied Draw Proceeds will be applied in accordance with the above provisions.

If it is determined or adjudicated by a court of competent jurisdiction that Landlord was not entitled to draw on the Letter of Credit, Tenant may, as its sole and exclusive remedy, cause Landlord to (i) deliver the prior original Letter of Credit to Issuer for cancellation (if not theretofore fully drawn), (ii) return to Issuer the amount of the Draw Proceeds which the court determines Landlord was not entitled to draw and (iii) reimburse Tenant for all out-of-pocket fees, costs and interest expenses actually incurred by Tenant as a direct result of Landlord's draw on the Letter of Credit; provided, however, Tenant may exercise its exclusive remedy only after Tenant has (y) cured all defaults under this Lease and (z) caused a replacement Letter of Credit complying with Subsection 18.36(a) above to be issued and delivered to Landlord. Landlord will not be liable for any other actual damages or any indirect, consequential, special or punitive damages incurred by Tenant in connection with either a draw by Landlord on the Letter of Credit or the use or application by Landlord of the Draw Proceeds. Nothing in this Lease or in the Letter of Credit will confer upon Tenant any property right or interest in any Draw Proceeds.

(f) Renewal and Replacement. The Letter of Credit must provide that it will be automatically renewed unless Issuer provides written notice of nonrenewal to Landlord at least 60 days prior to the expiration date of the Letter of Credit. If written notice of nonrenewal is received from Issuer, Tenant must renew the Letter of Credit or replace it with a new Letter of Credit, at least 30 days prior to the stated expiration date of the then-current Letter of Credit. Any renewal or replacement Letter of Credit must meet the criteria set forth in Subsection 18.36(a) above, and must have a term commencing at least one day prior to the stated the expiration date of the immediately prior Letter of Credit. Failure to provide a renewal or replacement Letter of Credit as provided above will, at Landlord's election, be an Event of Default under this Lease.

(g) Issuer Quality Event. If an Issuer Quality Event occurs, Tenant, upon 30 days advance written notice from Landlord, must, at its own cost and expense, provide Landlord with a replacement Letter of Credit meeting all of the requirements of Section 18.36(a) above. The term "Issuer Quality Event" means the financial strength and/or quality of reputation materially decreases from that at the time of original issuance of the Letter of Credit by Issuer, as reasonably determined by Landlord. An Issuer Quality Event will, at Landlord's election, be an Event of Default under this Lease.

(h) Additional Agreements of Tenant. Tenant expressly acknowledges and agrees that:

- (i) the Letter of Credit constitutes a separate and independent contract between Landlord and Issuer, and Tenant has no right to submit a draw to Issuer under the Letter of Credit;
- (ii) Tenant is not a third-party beneficiary of such contract, and Landlord's ability to either draw under the Letter of Credit for the full or any partial amount thereof or to apply Draw Proceeds may not, in any way, be conditioned, restricted, limited, altered, impaired or discharged by virtue of any Laws to the contrary, including, but not limited to, any Laws that restrict, limit, alter, impair, discharge or otherwise affect any liability that Tenant may have under this Lease or any claim that Landlord has or may have against Tenant;
- (iii) neither the Letter of Credit nor any Draw Proceeds will be or become the property of Tenant, and Tenant does not and will not have any property right or interest therein;
- (iv) Tenant is not entitled to any interest on any Draw Proceeds;
- (v) neither the Letter of Credit nor any Draw Proceeds constitute an advance payment of Rent, security deposit or rental deposit;
- (vi) neither the Letter of Credit nor any Draw Proceeds constitute a measure of Landlord's damages resulting from any Draw Event, Event of Default or other breach, failure or default (past, present or future) under this Lease; and
- (vii) Tenant will cooperate with Landlord, at Tenant's own expense, in promptly executing and delivering to Landlord all modifications, amendments, renewals, extensions and replacements of the Letter of Credit, as Landlord may reasonably request to carry out the terms and conditions of this Subsection.

(i) Restrictions on Tenant Actions. Tenant hereby irrevocably waives any and all rights and claims that it may otherwise have at law or in equity, to contest, enjoin, interfere with, restrict or limit, in any way whatsoever, any requests or demands by Landlord to Issuer for a draw or payment to Landlord under the Letter of Credit provided that such requested or demanded draw and/or payment are made in accordance with this Subsection 18.36 and the Letter of Credit.

(j) Cancellation After End of Term. Provided that no Draw Event, Event of Default, or other breach or default under this Lease then exists, Landlord will deliver the Letter of Credit to the Issuer for cancellation within 45 days after the expiration or termination of this Lease and surrender of the Premises by Tenant to Landlord.

(k) Tenant shall, on or before the date thirty (30) days after the closing of the acquisition of Tenant by Instrumentarium Corporation, a Finnish corporation, provide Landlord with a Guaranty from Instrumentarium Corporation, in the form attached to this Lease as Exhibit J, (and with evidence of due execution and authorization of the Guaranty by Guarantor acceptable to Landlord in its reasonable discretion). In the event such Guaranty and the evidence of due execution and authorization is so provided, Landlord shall cause the Letter of Credit to be returned to Issuer for cancellation within thirty (30) days after receipt by Landlord of such Guaranty. Notwithstanding the above, in the event (A) the acquisition of Tenant by Instrumentarium Corporation does not occur by the date twelve (12) months after the date of mutual execution of this Lease, and/or (B) the financial strength of Instrumentarium Corporation at the time of the proposed substitution of the Guaranty is materially less than the financial strength of such corporation as shown on its fiscal year 2001 audited financial statement, Landlord shall have no obligation to allow substitution of the Guaranty for the Letter of Credit and may require the Letter of Credit to be maintained pursuant to this Subsection 18.36 for the entire Lease Term and any Extended Terms.

IN WITNESS WHEREOF, the parties have executed this Lease as of the date first above written.

“Landlord”

“Tenant”

S/I SAMMAMISH II, LLC

SPACELABS MEDICAL, INC.

By: _____

By: _____

Its: _____

Its: _____

SUBSIDIARIES OF THE COMPANY

Advance Research & Applications Corp.	Sunnyvale, California
Advanced Micro Electronics AS	Horten, Norway
Ancore Corporation	Santa Clara, California
Centro Vision, Inc.	Newbury Park, California
Corrigan Canada, Ltd.	Ontario, Canada
CXR Limited	Surrey, United Kingdom
Dolphin Medical, Inc.	Hawthorne, California
Dolphin Pvt Ltd.	Singapore
Ferson Technologies, Inc.	Ocean Springs, Mississippi
Metorex Security Products, Inc.	Ewing, New Jersey
Metorex Security Products, Oy	Espoo, Finland
Opto Sensors (Malaysia) Sdn. Bhd.	Johor Bahru, Malaysia
Opto Sensors (Singapore) Pte. Ltd.	Singapore
OSI Defense Systems, L.L.C.	Orlando, Florida
OSI Electronics, Inc.	Camarillo, California
OSI Fibercomm, Inc.	Hawthorne, California
OSI Medical (Singapore) Pte. Ltd.	Singapore
OSI Systems Germany GmbH	Dusseldorf, Germany
OSI Systems Pvt. Ltd.	Secunderabad, India
Osteometer MediTech USA, Inc.	Hawthorne, California
Rapiscan Asia Pte. Ltd.	Singapore
Rapiscan Consortium (M) Sdn. Bhd.	Johor Bahru, Malaysia
Rapiscan Hong Kong, Ltd.	Hong Kong
Rapiscan Security Products (U.S.A), Inc.	Hawthorne, California
Rapiscan Security Products, Ltd.	Crawley, United Kingdom
RapiTec, Inc.	Upland, California
Spacelabs Medical (Canada) Inc.	Ontario, Canada
Spacelabs Medical Austria GmbH	Vienna, Austria
Spacelabs Medical Finland Oy	Espoo, Finland
Spacelabs Medical SAS	Creteil, France
Spacelabs Medical UK Limited	Crawley, United Kingdom
Spacelabs Medical, Inc.	Issaquah, Washington
Spacelabs (Singapore) Pte. Ltd.	Singapore
UDT Sensors, Inc.	Hawthorne, California

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement No. 333-106176 of OSI Systems, Inc. and subsidiaries on Form S-8 and in Registration Statements Nos. 333-75228, 333-73618, 333-100791 and 333-101716 of OSI Systems, Inc. and subsidiaries on Form S-3 of our report dated September 13, 2004 (which report expresses an unqualified opinion and includes an explanatory paragraph relating to the adoption of SFAS No. 142, "Goodwill and Other Intangible Assets") appearing in the Annual Report on Form 10-K of OSI Systems, Inc. and subsidiaries for the year ended June 30, 2004.

/s/ DELOITTE & TOUCHE LLP

Los Angeles, California
September 13, 2004

Certification required by Rule 13a-14(a) or Rule 15d-14(a) Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Deepak Chopra, certify that:

1. I have reviewed this Annual Report on Form 10-K of OSI Systems, Inc.;
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(s) 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)) 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) 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
 - (c) 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(s) 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: September 13, 2004

/s/ DEEPAK CHOPRA

Deepak Chopra
Chief Executive Officer

Certification required by Rule 13a-14(a) or Rule 15d-14(a) Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Anuj Wadhawan, certify that:

1. I have reviewed this Annual Report on Form 10-K of OSI Systems, Inc.;
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(s) 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)) 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) 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
 - (c) 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(s) 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: September 13, 2004

/s/ ANUJ WADHAWAN

Anuj Wadhawan
Chief Financial Officer

CERTIFICATION

Certification of Chief Executive Officer
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350

In connection with the Annual Report of OSI Systems, Inc. (the "Company") on Form 10-K for the year ended June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Deepak Chopra, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and

The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company at the dates and for the periods presented in this Report.

Date: September 13, 2004

/s/ DEEPAK CHOPRA

Deepak Chopra
Chief Executive Officer

CERTIFICATION

Certification of Chief Financial Officer
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350

In connection with the Annual Report of OSI Systems, Inc. (the "Company") on Form 10-K for the year ended June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Anuj Wadhawan, Chief Financial Officer of the Company, certify, pursuant to 18, U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and

The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company at the dates and for the periods presented in this Report.

Date: September 13, 2004

/s/ ANUJ WADHAWAN

Anuj Wadhawan
Chief Financial Officer