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

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2003

COMMISSION FILE NUMBER 0-23599

MERCURY COMPUTER SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

MASSACHUSETTS
(State or other jurisdiction of
incorporation or organization)

04-2741391
(I.R.S. Employer
Identification No.)

199 RIVERNECK ROAD
CHELMSFORD, MA
(Address of principal executive offices)

01824
(Zip Code)

978-256-1300
(Registrant's telephone number, including area code)

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

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

Number of shares outstanding of the issuer's classes of common stock as of January 30, 2004:

<u>Class</u>	<u>Number of Shares Outstanding</u>
Common Stock, par value \$.01 per share	21,180,856

MERCURY COMPUTER SYSTEMS, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MERCURY COMPUTER SYSTEMS, INC.

CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	December 31, 2003	June 30, 2003
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 40,650	\$ 27,158
Marketable securities	42,846	40,892
Accounts receivable, net of allowances of \$500 at December 31, 2003 and June 30, 2003	18,875	22,975
Inventory	8,438	10,735
Deferred tax assets, net	4,778	4,778
Prepaid expenses and other current assets	4,052	3,513
	<hr/>	<hr/>
Total current assets	119,639	110,051
Marketable securities	43,678	45,211
Property and equipment, net	24,977	26,349
Goodwill	4,225	4,225
Acquired intangible assets, net	1,745	2,339
Deferred tax assets, net	1,321	1,321
Other assets	5,205	1,059
	<hr/>	<hr/>
Total assets	\$ 200,790	\$ 190,555
	<hr/>	<hr/>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 5,015	\$ 5,235
Accrued expenses	5,903	4,354
Accrued compensation	8,554	10,053
Notes payable	744	718
Income taxes payable	1,724	2,440
Deferred revenues and customer advances	4,481	2,741
	<hr/>	<hr/>
Total current liabilities	26,421	25,541
Notes payable	11,220	11,599
Deferred compensation	1,032	759
	<hr/>	<hr/>
Total liabilities	38,673	37,899
Commitments and contingencies (Note J)		
Stockholders' equity:		
Common stock, \$.01 par value; 65,000,000 shares authorized; 22,357,552 shares issued at December 31, 2003 and June 30, 2003; 21,145,682 and 20,990,461 shares outstanding at December 31, 2003 and June 30, 2003, respectively	223	223
Additional paid-in capital	52,604	52,174
Treasury stock, at cost, 1,211,870 and 1,367,091 shares at December 31, 2003 and June 30, 2003, respectively	(35,617)	(40,197)
Retained earnings	144,376	140,142
Accumulated other comprehensive income	531	314
	<hr/>	<hr/>
Total stockholders' equity	162,117	152,656
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 200,790	\$ 190,555
	<hr/>	<hr/>

The accompanying notes are an integral part of the consolidated financial statements.

MERCURY COMPUTER SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED AND IN THOUSANDS, EXCEPT PER SHARE DATA)

	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
Net revenues	\$40,557	\$47,665	\$81,078	\$87,072
Cost of revenues	13,686	16,573	28,225	30,319
Gross profit	26,871	31,092	52,853	56,753
Operating expenses:				
Selling, general and administrative	12,746	13,905	25,542	26,466
Research and development	8,877	9,726	17,611	18,850
Total operating expenses	21,623	23,631	43,153	45,316
Income from operations	5,248	7,461	9,700	11,437
Interest income	450	502	879	983
Interest expense	(224)	(233)	(447)	(469)
Gain on sale of division	—	1,600	—	3,200
Other income (expense), net	(78)	26	38	164
Income before income taxes	5,396	9,356	10,170	15,315
Income tax provision	1,672	2,901	3,152	4,748
Net income	\$ 3,724	\$ 6,455	\$ 7,018	\$10,567
Net income per share:				
Basic	\$ 0.18	\$ 0.30	\$ 0.33	\$ 0.50
Diluted	\$ 0.17	\$ 0.29	\$ 0.32	\$ 0.48
Weighted average shares outstanding:				
Basic	21,065	21,174	21,034	21,154
Diluted	21,725	22,131	21,652	21,979

The accompanying notes are an integral part of the consolidated financial statements.

MERCURY COMPUTER SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED AND IN THOUSANDS)

	Six Months Ended December 31,	
	2003	2002
Cash flows from operating activities:		
Net income	\$ 7,018	\$ 10,567
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,771	4,021
Gain on sale of division	—	(3,200)
Impairment of intangible asset	185	—
Tax benefit from stock options	254	447
Stock-based compensation	176	252
Changes in operating assets and liabilities:		
Accounts receivable	4,202	15,427
Inventory	2,361	1,869
Prepaid expenses and other current assets	(526)	223
Other assets	(300)	(52)
Accounts payable and accrued expenses	(55)	859
Deferred revenues and customer advances	1,740	1,904
Income taxes payable	(983)	4,326
Net cash provided by operating activities	17,843	36,643
Cash flows from investing activities:		
Purchases of marketable securities	(17,876)	(50,847)
Sales and maturities of marketable securities	17,919	47,849
Purchases of property and equipment	(1,962)	(2,717)
Purchased intangible assets	(3,845)	—
Proceeds from sale of division	—	3,200
Net cash used in investing activities	(5,764)	(2,515)
Cash flows from financing activities:		
Proceeds from employee stock purchase plans	1,795	1,422
Purchases of treasury stock	—	(1,553)
Payments of principal under notes payable and capital lease obligations	(353)	(420)
Net cash provided by (used in) financing activities	1,442	(551)
Effect of exchange rate changes on cash and cash equivalents	(29)	(40)
Net increase in cash and cash equivalents	13,492	33,537
Cash and cash equivalents at beginning of period	27,158	17,513
Cash and cash equivalents at end of period	\$ 40,650	\$ 51,050
Cash paid during the period for:		
Interest	\$ 521	\$ 469
Income taxes, net	3,614	743

The accompanying notes are an integral part of the consolidated financial statements.

MERCURY COMPUTER SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

A. Nature of the Business

Mercury Computer Systems, Inc. (the "Company" or "Mercury") designs, manufactures and markets high-performance, real-time digital signal and image processing computer systems that transform sensor-generated data into information that can be displayed as images for human interpretation or subjected to additional computer analysis. These multicomputer systems are heterogeneous and scalable, allowing them to accommodate several different microprocessor types and to scale from a few to hundreds of microprocessors within a single system. The primary markets for the Company's products are Defense Electronics, Medical Imaging, and other Original Equipment Manufacturers ("OEM") solutions. These markets have computing needs that benefit from the unique system architecture developed by the Company.

B. Basis of Presentation

The accompanying financial data as of December 31, 2003 and for the three months and six months ended December 31, 2003 and December 31, 2002 has been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2003.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present a fair statement of financial position as of December 31, 2003, results of operations for the three and six-month periods ended December 31, 2003 and 2002, and cash flows for the six-month periods ended December 31, 2003 and 2002 have been made. The results of operations for the three and six months ended December 31, 2003 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

C. Accounting for Stock-Based Compensation

The Company has several stock-based employee compensation plans. The Company accounts for stock-based awards to employees using the intrinsic value method as prescribed by Accounting Principles Board ("APB") Opinion No. 25 "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no compensation expense is recorded for options issued to employees in fixed amounts with fixed exercise prices at least equal to the fair market value of the Company's common stock at the date of grant. The Company has adopted the provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," through disclosure only. All stock-based awards to non-employees are accounted for at their fair value in accordance with SFAS No. 123.

MERCURY COMPUTER SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee awards.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2003	2002	2003	2002
Net income as reported	\$ 3,724	\$ 6,455	\$ 7,018	\$ 10,567
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	—	—	—	—
Deduct: Total stock-based employee compensation determined under fair value based method for all awards, net of related tax effects	3,538	4,243	7,670	8,282
Pro forma net income (loss)	\$ 186	\$ 2,212	\$ (652)	\$ 2,285
Earnings (loss) per share:				
Basic – as reported	\$ 0.18	\$ 0.30	\$ 0.33	\$ 0.50
Basic – pro forma	\$ 0.01	\$ 0.10	\$ (0.03)	\$ 0.11
Diluted – as reported	\$ 0.17	\$ 0.29	\$ 0.32	\$ 0.48
Diluted – pro forma	\$ 0.01	\$ 0.10	\$ (0.03)	\$ 0.10

The weighted average grant-date fair values for options granted during the three and six months ended December 31, 2003 were \$17.54 and \$14.86, respectively, per option. The weighted average grant-date fair values for options granted during the three and six months ended December 31, 2002 were \$19.10 and \$13.71, respectively, per option. The fair value of options at date of grant was estimated using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2003	2002	2003	2002
Option life	6 years	6 years	6 years	6 years
Risk-free interest rate	3.42%	3.07%	3.47%	4.64%
Stock volatility	76%	80%	77%	81%
Dividend rate	0%	0%	0%	0%

The weighted-average fair value of stock purchase rights granted as part of the Employee Stock Purchase Plan (“ESPP”) during the three months ended December 31, 2003 and 2002 was \$6.56 and \$7.36 respectively. The weighted-average fair value of stock purchase rights granted as part of the ESPP during the six months ended December 31, 2003 and 2002 was \$6.63 and \$7.71, respectively. The fair value of the employees’ stock purchase rights was estimated using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2003	2002	2003	2002
Option life	6 months	6 months	6 months	6 months
Risk-free interest rate	1.02%	1.13%	1.00%	1.27%
Stock volatility	75%	79%	68%	79%
Dividend rate	0%	0%	0%	0%

MERCURY COMPUTER SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

D. Inventory

	December 31, 2003	June 30, 2003
Raw materials	\$ 2,182	\$ 3,642
Work in process	1,994	3,149
Finished goods	4,262	3,944
Total	\$ 8,438	\$ 10,735

E. Net Income per Share

The following table sets forth the computation of basic and diluted net income per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2003	2002	2003	2002
Net income	\$ 3,724	\$ 6,455	\$ 7,018	\$ 10,567
Shares used in computation of net income per share—basic	21,065	21,174	21,034	21,154
Potential dilutive common shares:				
Stock options	660	957	618	825
Shares used in computation of net income per share—diluted	21,725	22,131	21,652	21,979
Net income per share—basic	\$ 0.18	\$ 0.30	\$ 0.33	\$ 0.50
Net income per share—diluted	\$ 0.17	\$ 0.29	\$ 0.32	\$ 0.48

Options to purchase 2,202,143 and 1,710,170 shares of common stock were not included in the calculation of diluted net income per share for the three months ended December 31, 2003 and 2002, respectively, because the option exercise prices were greater than the average market price of the Company's common stock during those periods. Options to purchase 2,318,114 and 2,089,642 shares of common stock were not included in the calculation of diluted net income per share for the six months ended December 31, 2003 and 2002, respectively, because the option exercise prices were greater than the average market price of the Company's common stock during those periods.

F. Recent Accounting Pronouncements

In April 2003, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards 149 ("SFAS 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS 149 amends and clarifies accounting and reporting of derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities under SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." This statement is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company's adoption of SFAS 149 did not have any impact on its financial position or results of operations.

In May 2003, FASB issued Statement of Financial Accounting Standards 150 ("SFAS 150"), "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability. For all financial instruments entered into or modified after May 31, 2003, SFAS 150 is effective immediately.

MERCURY COMPUTER SYSTEMS, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

For all other instruments, SFAS 150 goes into effect at the beginning of the first interim period beginning after June 15, 2003. The Company's adoption of SFAS 150 did not have any impact on its financial position or results of operations.

In November 2002, FASB issued Emerging Issues Task Force 00-21 ("EITF 00-21"), "Revenue Arrangements with Multiple Deliverables." EITF 00-21 requires revenue arrangements with multiple deliverables to be divided into separate units of accounting. If the deliverables in the arrangement meet certain criteria, arrangement consideration should be allocated among the separate units of accounting based on their relative fair values. Applicable revenue recognition criteria are to be considered separately for separate units of accounting. The guidance in EITF 00-21 was effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company's adoption of EITF 00-21 did not have a material impact on its financial position or results of operations.

In January 2003, the FASB issued Interpretation ("FIN") No. 46, "Consolidation of Variable Interest Entities" ("FIN 46") and, in December 2003, issued a revision to that interpretation ("FIN 46R"). FIN 46R replaces FIN 46 and addresses consolidation by business enterprises of variable interest entities that possess certain characteristics. A variable interest entity ("VIE") is defined as (a) an ownership, contractual or monetary interest in an entity where the ability to influence financial decisions is not proportional to the investment interest, or (b) an entity lacking the invested capital sufficient to fund future activities without the support of a third party. FIN 46R establishes standards for determining under what circumstances VIEs should be consolidated with their primary beneficiary, including those to which the usual condition for consolidation does not apply. The Company adopted the provisions of FIN 46R during the three months ended December 31, 2003. The Company's adoption of FIN 46R did not have a material effect on its financial position or results of operations.

On December 17, 2003, the Staff of the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 104 (SAB 104), "Revenue Recognition", which supersedes SAB 101, "Revenue Recognition in Financial Statements." SAB 104's primary purpose is to rescind the accounting guidance contained in SAB 101 related to multiple-element revenue arrangements that was superseded as a result of the issuance of EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." Additionally, SAB 104 rescinds the SEC's related "Revenue Recognition in Financial Statements Frequently Asked Questions and Answers" issued with SAB 101 that had been codified in SEC Topic 13, "Revenue Recognition." While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104, which was effective upon issuance. The Company's adoption of SAB 104 did not have a material effect on its financial position or results of operations.

G. Comprehensive Income

The Company's total comprehensive income was as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2003	2002	2003	2002
Net income	\$ 3,724	\$ 6,455	\$ 7,018	\$ 10,567
Other comprehensive income (loss):				
Foreign currency translation adjustments	(12)	73	(16)	79
Change in unrealized gain (loss) on marketable securities	173	(22)	234	(211)
Other comprehensive income (loss)	161	51	218	(132)
Total comprehensive income	\$ 3,885	\$ 6,506	\$ 7,236	\$ 10,435

MERCURY COMPUTER SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

H. Operating Segment Information

The Company has three operating and reportable segments: Defense Electronics, Medical Imaging and OEM Solutions. These operating segments were determined based upon the nature of the products offered to customers, the market characteristics of each operating segment and the Company's management structure.

The accounting policies of the business segments are the same as those described in "Note B: Summary of Significant Accounting Policies" in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2003. Asset information by reportable segment is not reported because the Company does not produce such information internally. The following is a summary of the Company's operations by reportable segment:

	<u>Defense Electronics</u>	<u>Medical Imaging</u>	<u>OEM Solutions</u>	<u>Corporate and Other</u>	<u>Total</u>
THREE MONTHS ENDED DECEMBER 31, 2003:					
Sales to unaffiliated customers	\$ 27,722	\$ 7,397	\$ 5,438	—	\$ 40,557
Income (loss) from operations (1)	13,985	2,905	908	(12,550)	5,248
Depreciation and amortization expense	439	15	73	1,328	1,855
THREE MONTHS ENDED DECEMBER 31, 2002:					
Sales to unaffiliated customers	\$ 31,666	\$ 10,369	\$ 5,630	—	\$ 47,665
Income (loss) from operations (1)	16,535	4,813	1,428	(15,315)	7,461
Depreciation and amortization expense	427	19	58	1,535	2,039
SIX MONTHS ENDED DECEMBER 31, 2003:					
Sales to unaffiliated customers	\$ 56,504	\$ 14,556	\$ 10,018	—	\$ 81,078
Income (loss) from operations (1)	27,552	5,774	2,049	(25,675)	9,700
Depreciation and amortization expense	893	35	150	2,693	3,771
SIX MONTHS ENDED DECEMBER 31, 2002:					
Sales to unaffiliated customers	\$ 57,181	\$ 20,213	\$ 9,678	—	\$ 87,072
Income (loss) from operations (1)	26,683	9,731	2,311	(27,288)	11,437
Depreciation and amortization expense	800	38	111	3,072	4,021

- (1) Income (loss) from operations of each reporting segment excludes the effects of substantially all research and development expenses and other unallocated operating expenses that cannot be specifically identified with a reporting segment, all of which are reflected in the Corporate and Other category.

I. Goodwill and Acquired Intangible Assets

As of June 30, 2003 and December 31, 2003, goodwill of \$4,225 from an acquisition is allocated to the Defense Electronics reportable segment.

At December 31, 2003, acquired intangible assets consisted of the following:

	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Amount</u>	<u>Useful Life</u>
Completed technology	\$ 3,100	(\$ 1,355)	\$ 1,745	4 years

MERCURY COMPUTER SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

At June 30, 2003, acquired intangible assets consisted of the following:

	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Amount</u>	<u>Useful Life</u>
Completed technology	\$ 3,100	(\$ 968)	\$ 2,132	4 years
Licensing agreement	300	(93)	207	4 years
Total acquired intangible assets	\$ 3,400	(\$ 1,061)	\$ 2,339	

In September 2003, a \$185 asset impairment charge was recorded in selling, general and administrative expenses related to the Company's abandonment of the acquired licensing agreement. The impaired asset is in the Defense Electronics segment of the Company.

Amortization expense related to acquired intangible assets for the three months ended December 31, 2003 and 2002 was \$194 and \$212, respectively. Amortization expense related to acquired intangible assets for the six months ended December 31, 2003 and 2002 was \$388 and \$424, respectively. Estimated remaining amortization expense for each fiscal year is as follows:

<u>Year</u>	<u>Amount</u>
2004 (Remainder)	\$ 388
2005	775
2006	582
	\$1,745

J. Commitments and Contingencies

LEGAL PROCEEDINGS

The Company is subject to legal proceedings and claims that arise in the ordinary course of business. The Company does not believe these actions will have a material adverse effect on its financial position or results of operations.

GUARANTEES AND INDEMNIFICATION OBLIGATIONS

For "Guarantees and Indemnification Obligations" of the Company see Note I: "Commitments and Contingencies" in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on September 12, 2003. There were no material changes in the Company's guarantee and indemnification obligations from those set forth in our Annual Report for the year ended June 30, 2003, except that the Company has entered into indemnification agreements with its current directors.

K. Stock Repurchase

During fiscal 2003, the Board of Directors authorized the Company to purchase up to \$25,000 of the Company's common stock, of which \$14,861 was available under the plan for future purchases as of December 31, 2003. In October 2003, the Board of Directors extended the program through December 2004. The Company has made no stock purchases during fiscal 2004.

MERCURY COMPUTER SYSTEMS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

L. Product Warranty Liability

The Company's product sales include a one-year hardware warranty. At time of product shipment, the Company accrues for the estimated cost to repair or replace potentially defective products. Estimated warranty costs are based upon prior actual warranty costs for substantially similar transactions. The following table presents the changes in the Company's product warranty liability for the six months ended December 31, 2003 and 2002:

	<u>2003</u>	<u>2002</u>
Beginning balance at June 30	\$ 925	\$ 835
Accruals for warranties issued during the period	768	672
Settlements made during the period	(629)	(648)
	<u> </u>	<u> </u>
Ending balance at December 31	<u>\$ 1,064</u>	<u>\$ 859</u>

M. Workforce Reduction

In the fourth quarter of fiscal 2003, the Company recorded workforce reduction charges approximating \$1,388. The accrual for severance and benefits related to workforce reductions is reflected in accrued compensation in the consolidated balance sheet. All remaining severance and benefits payable to these employees as of December 31, 2003 are expected to be paid by the fourth quarter of fiscal 2004. A summary of the workforce reduction accrual is outlined as follows:

	<u>Severance and Benefits</u>
Fourth quarter fiscal 2003 provision	\$ 1,388
Cash payments	(298)
	<u> </u>
Balance at June 30, 2003	1,090
Cash payments	(1,015)
	<u> </u>
Balance at December 31, 2003	<u>\$ 75</u>

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

From time to time, information provided by Mercury, statements made by its employees or information included in its filings with the Securities and Exchange Commission may contain statements which are not historical facts but which are "forward-looking statements" which involve risks and uncertainties. The words "may," "will," "expect," "anticipate," "continue," "estimate," "plan," "project," "intend" and similar expressions are intended to identify forward-looking statements regarding events, conditions and financial trends that may affect Mercury's future plans of operations, business strategy, results of operations and financial position. These statements are based on Mercury's current expectations and estimates as to prospective events and circumstances about which there can be no firm assurances given. Further, any forward-looking statement speaks only as of the date on which such statement is made, and Mercury undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made. As it is not possible to predict every new factor that may emerge, forward-looking statements should not be relied upon as a prediction of actual future financial condition or results. Actual results, performances or achievements may differ materially from the anticipated future results, performances or achievements expressed or implied by these forward-looking statements. Important factors that may cause Mercury's actual results to differ from these forward-looking statements include, but are not limited to, those referenced in the section entitled "Factors that May Affect Future Results" in Part I - Item 2 of this Form 10-Q.

OVERVIEW

Mercury designs, manufactures and markets high-performance, real-time digital signal and image processing computer systems that transform sensor-generated data into information which can be displayed as images for human interpretation or be subjected to additional computer analysis. These multicomputer systems are heterogeneous and scalable, allowing them to accommodate several microprocessor types and to scale from a few to hundreds of microprocessors within a single system.

During the past several years, the majority of Mercury's revenue has been generated from sales of its products to the defense electronics market, generally for use in intelligence gathering electronic warfare systems. Mercury's activities in this area have focused on the proof of concept, development and deployment of advanced military applications in radar, sonar and airborne surveillance. Medical imaging is another primary market currently served by Mercury. Mercury's computer systems are embedded in magnetic resonance imaging ("MRI"), computed tomography ("CT"), positron emission tomography ("PET"), and digital cardiology imaging machines. Mercury's remaining revenues are derived from computer systems used in such commercial OEM solutions as semiconductor photomask generation, wafer inspection, baggage scanning, seismic analysis and development of new reticle inspection and wafer inspection systems.

During the first six months of the fiscal year 2004, revenues decreased by \$6.0 million compared to the same period in fiscal 2003 primarily as a result of the anticipated loss of CT revenues within the medical imaging group and the timing of defense electronics orders. Mercury expects total revenues to increase throughout the remainder of the fiscal year compared to the first six months of fiscal 2004. Operating expenses decreased for the six months ended December 31, 2003 as compared to the same period in fiscal 2003 primarily as a result of operating effectiveness initiatives which began in the fourth quarter of fiscal 2003. Mercury continues to monitor key operating metrics in order to maintain an appropriate operating expense cost structure relative to its revenue growth expectations. The overall decrease in earnings per share for the six months ended December 31, 2004 as compared to the same period last year was primarily due to the absence of significant non-operating income resulting from the sale of the Shared Storage Business Unit ("SSBU") and the previously mentioned decline in revenues.

Going forward, business and market uncertainties may affect future results. For a discussion of key factors that could impact the future and must be managed by the Company, please refer to the discussion below.

CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT JUDGMENTS AND ESTIMATES

Mercury has identified the policies discussed below as critical to understanding its business and its results of operations. The impact and any associated risks related to these policies on its business operations are discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect its reported and expected financial results.

The preparation of consolidated financial statements requires Mercury to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. On an on-going basis, Mercury evaluates its estimates and judgments, including those related to revenue recognition, allowances for bad debts, the valuation of inventory, long-lived assets and income tax assets, warranties, contingencies and litigation. Mercury bases its estimates on historical experience and on appropriate and customary assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Revenue Recognition and Accounts Receivable

Revenue from system sales is recognized upon shipment provided that title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sales price is fixed or determinable, collection of the related receivable is reasonably assured, and customer acceptance criteria, if any, have been successfully demonstrated.

Certain contracts with customers require Mercury to perform tests of its products prior to shipment to ensure their performance complies with Mercury's published product specifications and, on occasion, with additional customer-requested specifications. In these cases, Mercury conducts such tests and, if they are completed successfully, includes a written confirmation with each order shipped. As a result, at the time of each product shipment, Mercury believes that no further customer testing requirements exist and that there is no uncertainty of non-acceptance by its customer. In the rare instance that customer payment is conditioned upon final acceptance testing by the customer at its own facility, Mercury does not recognize any revenue until the final acceptance testing has been completed and written confirmation from the customer has been received.

Mercury does not provide its customers with rights of product return, other than those related to warranty provisions that permit repair or replacement of defective goods. Mercury accrues for anticipated warranty costs upon product shipment.

Installation of Mercury's products requires insignificant effort that does not alter the capabilities of Mercury's products and may be performed by its customers or other vendors. If an order includes installation or training services that are undelivered at the time of product shipment, Mercury defers revenue equal to the fair value of the installation or training obligations until such time as the services have been provided. Mercury determines these fair values based on the price typically charged to its customers who purchase these services separately.

In limited circumstances, Mercury engages in long-term contracts to design, develop, manufacture or modify complex equipment. For these contracts, Mercury recognizes revenue using the percentage-of-completion method of contract accounting, measuring progress towards completion based on contract cost incurred to date as compared with total estimated contract costs. The use of the percentage-of-completion method of accounting requires significant judgment relative to estimating total contract costs, including assumptions relative to the length of time to complete the contract, the nature and complexity of the work to be performed, anticipated increases in wages and prices for subcontractor services and materials, and the availability of subcontractor services and materials. Mercury's estimates are based upon the professional knowledge and experience of its

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engineers, program managers and other personnel who review each long-term contract monthly to assess the contract's schedule, performance, technical matters and estimated cost at completion. When adjustments in estimated contract costs are determined, such revisions may have the effect of adjusting in the current period the earnings applicable to performance in prior periods. Anticipated losses, if any, are recognized in the period in which determined.

For transactions involving the licensing of stand-alone software products and of software that is not incidental to the product, Mercury recognizes revenue when there is persuasive evidence of an arrangement, delivery of the software has occurred, the price is fixed or determinable and collection of the related receivable is reasonably assured. Mercury's stand-alone software products are not deemed essential to the functionality of any hardware system and do not require installation by Mercury or significant modification or customization of the software. The fair value of maintenance agreements related to stand-alone software products is recognized as revenue ratably over the term of each maintenance agreement.

At the time of product shipment, Mercury assesses collectibility of trade receivables based on a number of factors, including past transaction and collection history with a customer and the credit-worthiness of the customer. If Mercury determines that collectibility of a particular sale is not reasonably assured, revenue is deferred until such time as collection becomes reasonably assured, which generally occurs upon receipt of payment from the customer. After the time of sale, Mercury assesses its exposure to changes in its customers' abilities to pay outstanding receivables and records allowances for such potential bad debts.

Inventory

Inventory, which includes materials, labor and manufacturing overhead, is stated at the lower of cost (first-in, first-out basis) or net realizable value. On a quarterly basis, Mercury uses consistent methodologies to evaluate inventory for net-realizable value. Mercury records a provision for excess and obsolete inventory, consisting of on-hand and non-cancelable on-order inventory in excess of estimated usage. The excess and obsolete inventory evaluation is based upon assumptions about future demand, product mix and possible alternative uses. If actual demand, product mix or possible alternative uses are less favorable than those projected by management, additional inventory write-downs may be required.

Impairment of Long-Lived Assets

Mercury assesses the impairment of acquired intangible assets, property and equipment and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors Mercury considers important that could indicate impairment include significant underperformance relative to prior operating results projections, significant changes in the manner of Mercury's use of the asset or the strategy for Mercury's overall business and significant negative industry or economic trends. When Mercury determines that the carrying value of acquired intangible assets, property and equipment or goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, Mercury measures any impairment based on a projected discounted cash flow method using a discount rate determined by its management to be commensurate with the risk inherent in its current business model.

Income Tax Assets

Mercury evaluates the realizability of its deferred tax assets on a quarterly basis and assesses the need for a valuation allowance. Realization of Mercury's net deferred tax assets is dependent on its ability to generate sufficient future taxable income. Mercury believes that it is more likely than not that its net deferred tax assets will be realized based on forecasted income; however, there can be no assurance that Mercury will be able to meet its expectations of future income.

[Table of Contents](#)*Warranty Accrual*

The Company's product sales include a one-year hardware warranty. At time of product shipment, the Company accrues for the estimated cost to repair or replace potentially defective products. Estimated warranty costs are based upon prior actual warranty costs for substantially similar transactions.

RESULTS OF OPERATIONS:

The following tables set forth, for the periods indicated, certain financial data as a percentage of total revenues:

	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
Revenues	100%	100%	100%	100%
Cost of revenues	33.7	34.8	34.8	34.8
Gross profit	66.3	65.2	65.2	65.2
Operating expenses:				
Selling, general and administrative	31.4	29.1	31.5	30.4
Research and development	21.9	20.4	21.7	21.7
Total operating expenses	53.3	49.5	53.2	52.1
Income from operations	12.9	15.7	12.0	13.1
Other income, net	0.4	3.9	0.5	4.5
Income before income taxes	13.3	19.6	12.5	17.6
Provision for income taxes	4.1	6.1	3.8	5.5
Net income	9.2%	13.5%	8.7%	12.1%

REVENUES

The Company's total revenues decreased 15% or \$7.1 million to \$40.6 million for the three months ended December 31, 2003 compared to \$47.7 million during the same period in fiscal 2003. Revenues decreased 7% or \$6.0 million to \$81.1 million for the six months ended December 31, 2003 compared to \$87.1 million during the same period in fiscal 2003. Mercury's revenues by segment as a percentage of total revenues are as follows:

	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
Defense Electronics	68%	66%	70%	66%
Medical Imaging	18	22	18	23
OEM Solutions	14	12	12	11
Total revenues	100%	100%	100%	100%

Defense electronics revenues decreased 13% or \$4.0 million to \$27.7 million for the three months ended December 31, 2003 compared to \$31.7 million during the same period in fiscal 2003. Defense electronics revenues decreased 1% or \$0.7 million to \$56.5 million for the six months ended December 31, 2003 compared to \$57.2 million during the same period in fiscal 2003. The decrease for the second quarter of 2004 was primarily related to a decrease of approximately \$5.0 million for defense rated orders and shipments primarily within radar applications that were accelerated in the second quarter of fiscal 2003 to meet specific customer requirements,

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primarily offset by increased shipments of signals intelligence applications. The decrease for the six months ended December 31, 2003 compared to the same period in the prior year was related to decreased radar and emerging market applications business, offset by an increase in the shipments of signals intelligence applications. Mercury continues to experience limited visibility into the defense programs that utilize Mercury's products and as a result defense electronics revenues may fluctuate in future periods due to the timing of large orders.

Medical imaging revenues decreased 29% or \$3.0 million to \$7.4 million for the three months ended December 31, 2003 compared to \$10.4 million during the same period in fiscal 2003. Medical imaging revenues decreased 28% or \$5.6 million to \$14.6 million for the six months ended December 31, 2003 compared to \$20.2 million during the same period in fiscal 2003. The decreases in the medical imaging revenues were primarily related to a decrease in revenues of boards used in CT imaging systems of \$2.2 million and \$3.8 million for the three months and six months ended December 31, 2003, respectively. Mercury also experienced a decrease in both periods in its magnetic resonance imaging ("MRI") modality as a result of the timing of customer orders and softness in the overall MRI market.

OEM solutions revenues decreased 4% or \$0.2 million to \$5.4 million for the three months ended December 31, 2003 compared to \$5.6 million during the same period in fiscal 2003. OEM Solutions revenues increased 3% or \$0.3 million to \$10.0 million for the six months ended December 31, 2003 compared to \$9.7 million during the same period in fiscal 2003. The OEM solutions revenues were affected by a decrease in shipments of systems for inclusion in baggage scanning applications of \$0.8 million and \$1.2 million for the three and six months ended December 31, 2003, respectively. These decreases were offset by increased shipments of semiconductor imaging boards for developing and testing new semiconductor systems.

GROSS PROFIT

Gross profit was 66.3% for the three months ended December 31, 2003, an increase of 110 basis points from the 65.2% gross profit achieved in the same period of fiscal 2003. Gross profit was 65.2% for the first six months of fiscal 2004, unchanged from the first six months of fiscal 2003. The increase in gross profit for the three months ended December 31, 2003 as compared to the same period of last fiscal year is primarily a result of the increased mix of defense electronics revenues which carry higher margins, the product mix within the defense electronics revenues, and less margin contribution from long-term contracts which carry higher costs than do standard products due to the addition of third party products and direct labor. For the six months ended December 31, 2003 as compared to the same period last fiscal year, the gross profit percentage remained unchanged at 65.2%. This was due to the net effect of the increase in the defense electronics related business, which was offset by an increase in inventory provisions for excess and obsolescence reserves.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses decreased 9% or \$1.2 million to \$12.7 million for the three months ended December 31, 2003 compared to \$13.9 million during the same period in fiscal 2003. Selling, general and administrative expenses decreased 4% or \$1.0 million to \$25.5 million for the six months ended December 31, 2003 compared to \$26.5 million during the same period in fiscal 2003. The decreases in selling, general and administrative expenses were primarily the result of an arbitration award against the Company in a former employee matter of approximately \$0.8 million in the second quarter of fiscal 2003, as well as a decrease in compensation expense as a result of a decrease in headcount in the fourth quarter of fiscal 2003.

RESEARCH AND DEVELOPMENT

Research and development expenses decreased 9% or \$0.8 million to \$8.9 million for the three months ended December 31, 2003 compared to \$9.7 million during the same period in fiscal 2003. Research and development expenses decreased 7% or \$1.3 million to \$17.6 million for the six months ended December 31, 2003 compared to \$18.9 million during the same period in fiscal 2003. The decrease in research and development

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expenses for the three months ended December 31, 2003 was primarily the result of the increased utilization of research and development personnel temporarily engaged in cost of sales activities partially offset by an increase in prototype development expenses of approximately \$0.5 million. The decrease in research and development expenses for the six months ended December 31, 2003 is primarily related to the increased utilization of research and development personnel temporarily engaged in cost of sales activities partially offset by an increase in personnel related expenses.

INTEREST INCOME, NET

Interest income, net of interest expense decreased \$0.1 million to \$0.2 million for the three months ended December 31, 2003 compared to \$0.3 million during the same period in fiscal 2003. Interest income, net of interest expense decreased \$0.1 million to \$0.4 million for the six months ended December 31, 2003 compared to \$0.5 million during the same period in fiscal 2003. The decreases were primarily due to lower interest rates in fiscal 2004 than in fiscal 2003.

GAIN ON THE SALE OF DIVISION

For the three and six months ended December 31, 2002, Mercury received \$1.6 million and \$3.2 million, respectively, in payments related to the sale of the SSBU. Mercury received the final payment due from the sale in March 2003.

INCOME TAX PROVISION

Mercury recorded tax provisions during the three and six months ended December 31, 2003 and 2002 reflecting a 31% effective tax rate. The effective tax rate for all periods is less than the U.S. statutory tax rate of 35% primarily due to research and development credits, tax-exempt interest, and the extra territorial income ("ETI") benefit.

SEGMENT OPERATING RESULTS

Income from operations of each reporting segment excludes substantially all research and development expenses and other unallocated operating expenses that cannot be specifically identified with a reporting segment.

Income from operations of the defense electronics segment decreased \$2.5 million to \$14.0 million for the three months ended December 31, 2003 from \$16.5 million for the same period of fiscal 2003, and increased \$0.9 million to \$27.6 million for the six months ended December 31, 2003 from \$26.7 million for the same period of fiscal 2003. The decrease in income from operations of the defense electronics segment for the three months ended December 31, 2003 is primarily related to the decrease of revenues of \$4.0 million, slightly offset by an increase in gross profit as a result of product mix within the defense electronics business applications. The increase in income from operations of the defense electronics segment for the six months ended December 31, 2003 compared to the same period in the prior year was primarily related to an increase in gross profit relating to product mix, partially offset by a decrease in revenues.

Income from operations of the medical imaging segment decreased \$1.9 million to \$2.9 million for the three months ended December 31, 2003 from \$4.8 million for the same period of fiscal 2003, and decreased \$3.9 million to \$5.8 million for the six months ended December 31, 2003 from \$9.7 million for the same period of fiscal 2003. The decreases in income from operations of the medical imaging segment were primarily the result of a decrease of revenues of \$3.0 million and \$5.6 million for the three and six months ended December 31, 2003, respectively.

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Income from operations of the OEM solutions segment decreased \$0.5 million to \$0.9 million for the three months ended December 31, 2003 from \$1.4 million for the same period of fiscal 2003, and decreased \$0.3 million to \$2.0 million for the six months ended December 31, 2003 from \$2.3 million for the same period of fiscal 2003. The decreases in income from operations of the OEM solutions segment were primarily a result of a decrease in gross profit due to a change in the product mix.

See Note H to Mercury's financial statements included in this report for more information regarding its operating segments.

LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2003, Mercury had cash and marketable investments of approximately \$127.2 million. During the six months ended December 31, 2003, Mercury generated approximately \$17.8 million in cash from operations compared to \$36.6 million generated during the same period of fiscal 2003. The \$18.8 million decrease in cash from operating activities is primarily due to a \$11.2 million increase in accounts receivable, a \$5.3 million increase in income taxes payable, and a \$3.5 million decrease in net income. The operating cash flows generated in fiscal 2003 resulted from significant working capital improvements, particularly within accounts receivable that are not expected to be repeated to that extent in future periods.

During the six months ended December 31, 2003, Mercury's investing activities used cash of \$5.8 million, an increase in use of cash of \$3.3 million as compared to the same period last year. The increase in the use of cash for investing activities was due primarily to a \$3.8 million purchase of intangible assets in fiscal 2004 and the absence of \$3.2 million in proceeds as recorded in fiscal 2003 from the sale of the SSBU, offset by a decrease in fiscal 2004 capital expenditures of \$0.8 million and a decrease of net purchases of marketable securities of \$3.1 million.

During the six months ended December 31, 2003, Mercury's financing activities provided cash of \$1.4 million, an increase of \$2.0 million from the same period in fiscal 2003. The increase in cash from financing activities primarily consisted of \$0.4 million in increased proceeds from the employee stock plans and the absence of stock repurchases in fiscal 2004.

During fiscal 2003, the Board of Directors authorized the Company to purchase up to \$25 million of the Company's common stock, of which approximately \$14.9 million was available under the plan for future purchases as of December 31, 2003. In October 2003, the Board of Directors extended the program through December 2004. The Company has made no stock purchases during fiscal 2004.

The terms of Mercury's mortgage note agreements contain certain covenants, which, among other provisions, require Mercury to maintain a minimum net worth. The mortgage note agreements also include significant prepayment penalties. Mercury was in compliance with all covenants of the mortgage note agreements as of December 31, 2003.

The following is a schedule of Mercury's contractual obligations outstanding at December 31, 2003:

<u>(in thousands)</u>	<u>Total</u>	<u>Less than 1 Year</u>	<u>2-3 Years</u>	<u>4-5 Years</u>	<u>More than 5 Years</u>
Notes payable	\$ 11,964	\$ 744	\$ 1,662	\$ 1,922	\$ 7,636
Interest due on notes payable	5,356	844	1,515	1,253	1,744
Unconditional purchase obligations	8,871	8,871	—	—	—
Operating leases	2,454	876	1,268	310	—
Total	\$ 28,645	\$ 11,335	\$ 4,445	\$ 3,485	\$ 9,380

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Currently, Mercury's prime source of liquidity comes from cash, marketable securities and cash generated from operations. As of December 31, 2003, Mercury had \$12.0 million of outstanding debt and does not anticipate entering into any debt or credit agreements in the foreseeable future. Mercury's fixed commitments for cash expenditures consist primarily of payments under operating leases and inventory purchase commitments. Mercury does not currently have any material commitments for capital expenditures, or any other material commitments aside from operating leases for its facilities and inventory purchase commitments.

If cash generated from operations is insufficient to satisfy working capital requirements, Mercury may need to access funds through bank loans, sales of securities or other means. There can be no assurance that Mercury will be able to raise any such capital on terms acceptable to Mercury, on a timely basis or at all. If Mercury is unable to secure additional financing, Mercury may not be able to develop or enhance its products, take advantage of future opportunities, respond to competition or continue to effectively operate its business.

Based on Mercury's current plans and business conditions, Mercury believes that existing cash and marketable securities will be sufficient to satisfy its anticipated cash requirements for at least the next twelve months.

Additional Information on Stock Option Plans and Grants

Stock Option Program Description

The Company currently has one active plan under which it grants options: the 1997 Stock Option Plan. The Company has terminated the 1991, 1993, and 1998 plans. No new options can be granted from the terminated plans. All three of the terminated plans still have options outstanding as of December 31, 2003.

Stock option grants are designed to reward employees for their long-term contributions to the Company and provide incentives for them to remain with the Company. The Company considers its equity compensation program critical to its operation and productivity. Approximately 82% of the Company's employees participate in its equity compensation program.

At the Company's Special Meeting in lieu of the Annual Meeting of Stockholders held on November 17, 2003, the stockholders approved amendments to the 1997 Stock Option Plan by increasing the authorized shares available for grant by 1,000,000 and authorizing the issuance of up to 100,000 shares of common stock thereunder pursuant to restricted stock grants.

Employee and Executive Option Grants

Option grants for the period:

	Six months ended December 31, 2003	Year ended June 30,	
		2003	2002
Grants during the period as a percentage of outstanding shares at the end of such period	3.4%	4.5%	5.4%
Grants to Named Executive Officers* during the period as a percentage of total options granted during such period	19.0%	24.4%	19.6%
Grants to Named Executive Officers* during the period as a percentage of outstanding shares at the end of such period	0.6%	1.1%	1.1%
Cumulative options held by Named Executive Officers* as a percentage of total options outstanding at the end of such period	22.2%	22.0%	20.3%

* The term "Named Executive Officers" as used in these notes includes the Chief Executive Officer and the four other most highly compensated executive officers as of December 31, 2003.

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Summary of stock option activity

	Options Outstanding	
	Number of Shares	Weighted Average Exercise Price
June 30, 2002	3,663,639	\$ 25.46
Grants	950,000	19.69
Exercises	(156,192)	10.81
Cancellations	(234,681)	29.43
June 30, 2003	4,222,766	\$ 24.52
Grants	721,530	20.49
Exercises	(119,800)	10.75
Cancellations	(390,370)	29.24
December 31, 2003	4,434,126	\$ 23.83

As of December 31, 2003, there were 2,061,468 shares available for future option awards.

Summary of in-the-money and out-of-the-money option information

	As of December 31, 2003					
	Exercisable		Unexercisable		Total	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
In-the-money	1,214,950	\$ 13.48	1,360,386	\$ 19.04	2,575,336	\$ 16.42
Out-of-the-money (1)	994,899	\$ 34.06	863,891	\$ 33.91	1,858,790	\$ 33.99
Total options outstanding	2,209,849	\$ 22.76	2,224,277	\$ 24.81	4,434,126	\$ 23.79

(1) Out-of-the-money options are those options with an exercise price equal to or above the closing price of Mercury's common stock of \$24.90 as of December 31, 2003.

Options Granted to Named Executive Officers, during the six months ended December 31, 2003

	Individual Grants				Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term (2)	
	Number of Securities Underlying Options Per Grant	Percent of Total Options Granted to Employees Year to Date (1)	Weighted Average Exercise Price	Expiration Date	5%	10%
James R. Bertelli	75,000	10.85%	\$ 19.03	7/28/2013	\$ 897,590	\$ 2,274,669
Robert D. Becker	20,000	2.90%	\$ 19.03	7/28/2013	\$ 239,357	\$ 606,578
Douglas F. Flood	10,000	1.47%	\$ 19.03	7/28/2013	\$ 119,679	\$ 363,289
Barry S. Isenstein	16,000	2.31%	\$ 19.03	7/28/2013	\$ 191,486	\$ 485,263
Craig Lund	16,000	2.31%	\$ 19.03	7/28/2013	\$ 191,486	\$ 485,263

(1) Based on a year-to-date total of 691,530 shares subject to options granted to employees under Mercury's option plans.

(2) Amounts reported in these columns represent amounts that may be realized upon exercise of the options immediately prior to the expiration of their term assuming the specified compounded rates of appreciation (5% and 10%) of Mercury's common stock over the term of the options. These numbers are calculated based on rules promulgated by the Securities and Exchange Commission and do not reflect Mercury's estimate of future stock price increases. Actual gains, if any, on stock option exercises and common stock holdings are dependent on the timing of such exercise and the future performance of Mercury's common stock. There can be no assurance that the rates of appreciation assumed in this table can be achieved or that the amounts reflected will be received by the individuals.

Option Exercises and Remaining Holdings of Named Executive Officers

Name	During the six months ended December 31, 2003 Shares Acquired on Exercise	Value Realized	Number of Securities Underlying Unexercised Options as of December 31, 2003:		Values of Unexercised In-the-Money Options as of December 31, 2003: (1)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
James R. Bertelli	—	—	232,503	201,054	\$ 2,507,960	\$ 1,169,063
Robert D. Becker	—	—	37,184	78,666	\$ 55,955	\$ 285,265
Douglas F. Flood	—	—	66,154	50,156	\$ 586,358	\$ 482,994
Barry S. Isenstein	—	—	47,082	48,000	\$ 73,614	\$ 208,775
Craig Lund	—	—	76,980	41,500	\$ 551,180	\$ 182,270

(1) Option values based on the closing price of Mercury’s common stock of \$24.90 on December 31, 2003.

Equity Compensation Plans

The following table sets forth information as of December 31, 2003 with respect to compensation plans under which equity securities of the Company are authorized for issuance.

Plan category	(1)	(2)	(3)
	Number of securities to be issued upon exercise of outstanding options, warrants, and rights	Weighted-average exercise price of outstanding options, warrants, and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (1))
Equity compensation plans approved by shareholders(a)	4,434,126(b)	\$ 23.83	2,274,773(c)
Equity compensation plans not approved by shareholders	—	—	—
TOTAL	4,434,126	\$ 23.83	2,274,773

- (a) Consists of the 1991, 1993, 1997 and 1998 stock option plans and the Company’s 1997 Employee Stock Purchase Plan (“ESPP”).
- (b) Does not include purchase rights under the ESPP, as the purchase price and number of shares to be purchased is not determined until the end of the relevant purchase period.
- (c) Includes 217,055 shares available for future issuance under the ESPP. The Company is no longer permitted to grant options under its 1982, 1991, 1993 and 1998 plans.

RECENT ACCOUNTING PRONOUNCEMENTS

In April 2003, FASB issued Statement of Financial Accounting Standards 149 (“SFAS 149”), “Amendment of Statement 133 on Derivative Instruments and Hedging Activities.” SFAS 149 amends and clarifies accounting and reporting of derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities under SFAS 133, “Accounting for Derivative Instruments and Hedging Activities.” This statement is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company’s adoption of SFAS 149 did not have any impact on its financial position or results of operations.

In May 2003, FASB issued Statement of Financial Accounting Standards 150 (“SFAS 150”), “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity.” SFAS 150 establishes

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standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability. For all financial instruments entered into or modified after May 31, 2003, SFAS 150 is effective immediately. For all other instruments, SFAS 150 goes into effect at the beginning of the first interim period beginning after June 15, 2003. The Company's adoption of SFAS 150 did not have any impact on its financial position or results of operations.

In November 2002, FASB issued Emerging Issues Task Force 00-21 ("EITF 00-21"), "Revenue Arrangements with Multiple Deliverables." EITF 00-21 requires revenue arrangements with multiple deliverables to be divided into separate units of accounting. If the deliverables in the arrangement meet certain criteria, arrangement consideration should be allocated among the separate units of accounting based on their relative fair values. Applicable revenue recognition criteria are to be considered separately for separate units of accounting. The guidance in EITF 00-21 was effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company's adoption of EITF 00-21 did not have a material impact on its financial position or results of operations.

In January 2003, the FASB issued Interpretation ("FIN") No. 46, "Consolidation of Variable Interest Entities" ("FIN 46") and, in December 2003, issued a revision to that interpretation ("FIN 46R"). FIN 46R replaces FIN 46 and addresses consolidation by business enterprises of variable interest entities that possess certain characteristics. A variable interest entity ("VIE") is defined as (a) an ownership, contractual or monetary interest in an entity where the ability to influence financial decisions is not proportional to the investment interest, or (b) an entity lacking the invested capital sufficient to fund future activities without the support of a third party. FIN 46R establishes standards for determining under what circumstances VIEs should be consolidated with their primary beneficiary, including those to which the usual condition for consolidation does not apply. The Company adopted the provisions of FIN 46R during the three months ended December 31, 2003. The Company's adoption of FIN 46R did not have a material effect on its financial position or results of operations.

On December 17, 2003, the Staff of the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 104 (SAB 104), "Revenue Recognition", which supersedes SAB 101, "Revenue Recognition in Financial Statements." SAB 104's primary purpose is to rescind the accounting guidance contained in SAB 101 related to multiple-element revenue arrangements that was superseded as a result of the issuance of EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." Additionally, SAB 104 rescinds the SEC's related "Revenue Recognition in Financial Statements Frequently Asked Questions and Answers" issued with SAB 101 that had been codified in SEC Topic 13, "Revenue Recognition." While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104, which was effective upon issuance. The Company's adoption of SAB 104 did not have a material effect on its financial position or results of operations.

FACTORS THAT MAY AFFECT FUTURE RESULTS

Mercury depends heavily on defense electronics programs that incorporate Mercury's products, which may be only partially funded and subject to potential termination and reductions in government spending, which may have a material adverse effect on Mercury's business.

Sales of Mercury's computer systems, primarily as an indirect subcontractor or team member and in some cases directly, to the United States Government and its agencies as well as foreign governments and agencies, accounted for approximately 69%, 65% and 67% of revenues in fiscal 2003, 2002 and 2001, respectively, and approximately 70% of revenues for the six months ended December 31, 2003. Mercury's computer systems are included in many different domestic and international programs. Over its lifetime, the award of many different individual contracts and subcontracts may implement a program's requirements. The funding of U.S. Government programs is subject to congressional appropriations. Although multiple-year contracts may be

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planned in connection with major procurements, Congress generally appropriates funds on their fiscal year basis even though a program may continue for several years. Consequently, programs are often only partially funded initially, and additional funds are committed only as Congress makes further appropriations and prime contracts receive such funding. The U.S. Government could reduce or terminate a prime contract under which Mercury is a subcontractor or team member irrespective of the quality of Mercury's products or services. The reduction in funding or termination of a government program in which Mercury is involved would result in a loss of anticipated future revenues attributable to that program and contracts or orders received by Mercury. The termination of a program or the reduction in or failure to commit additional funds to a program in which Mercury is involved could increase Mercury's overall costs of doing business and have a material adverse effect on Mercury's financial condition and results of operations. In addition, changes in government administration, and changes in national and international priorities including developments in the geo-political environment such as the current "War on Terrorism," Operation Enduring Freedom, Operation Iraqi Freedom, and nuclear proliferation in North Korea, could have a significant impact on defense spending priorities and the efficient handling of routine contractual matters. These changes could have either a positive or negative impact on Mercury's business, financial condition or results of operations in the future.

Mercury faces the risks and uncertainties associated with defense related contracts.

Whether Mercury's contracts are directly with the U.S. Government and its agencies, or indirectly as a subcontractor or team member, or they are directly with foreign governments and agencies, or indirectly as a subcontractor or team member, Mercury's contracts and subcontracts are subject to special risks, including:

- delays in funding;
- reprioritizing of department of defense rated orders;
- reduction or modification in the event of changes in government priorities and policies, or as the result of budgetary constraints or political changes;
- increased or unexpected costs under fixed price contracts; and
- other factors that are not under Mercury's control.

In addition, Mercury's contracts with the United States and foreign governments and their prime and subcontractors are subject to termination either upon default by Mercury or at the convenience of the government or contractor if the program has been terminated itself. Termination for convenience provisions generally entitle Mercury to recover costs incurred, settlement expenses and profit on work completed prior to termination, but there can be no assurance in this regard.

Because Mercury contracts to supply goods and services to the United States and foreign governments and their prime and subcontractors, Mercury also is subject to other risks, including:

- contract suspensions;
- protests by disappointed bidders of contract awards that can result in the reopening of the bidding process;
- changes in governmental policies or regulations;
- other political factors.; and
- providing goods and services as a commercial off-the-shelf provider.

Finally, consolidation among defense industry contractors has resulted in fewer contractors with increased bargaining power relative to Mercury. Mercury cannot assure that this increased bargaining power of the contractors will not adversely affect its business, financial condition or results of operations in the future.

The loss of one or more of Mercury's largest customers could adversely affect Mercury's business, financial condition and results of operations.

Mercury is dependent on a small number of customers for a large portion of its revenues. A significant decrease in the sales to or loss of any of its major customers would have a material adverse effect on Mercury's business, financial condition and results of operations. Mercury has several customers who each account for greater than 10% of revenues. In fiscal 2003, Lockheed Martin, GE Medical, Northrop Grumman and Raytheon Company accounted for 12%, 12%, 11% and 10% of revenues, respectively. In fiscal 2002, GE Medical, Lockheed Martin and Raytheon Company accounted for 16%, 12% and 12% of revenues, respectively. In fiscal 2001, Raytheon Company, Lockheed Martin and GE Medical accounted for 18%, 14% and 13% of revenues, respectively. For the six months ended December 31, 2003, three customers collectively accounted for 40% of revenues. Customers in the defense electronics market generally purchase Mercury's products in connection with government programs that have a limited duration, leading to fluctuating sales to any particular customer in the defense electronics market from year to year. In addition, Mercury's revenues are largely dependent upon the ability of customers to develop and sell products that incorporate Mercury's products. No assurance can be given that Mercury's customers will not experience financial or other difficulties that could adversely affect their operations and, in turn, Mercury's results of operations.

Mercury's medical imaging revenues currently come from a small number of customers and modalities, and any significant decrease in revenue from one of these customers or modalities could adversely impact operating results.

Sales of computer systems to the medical imaging market accounted for approximately 20%, 28% and 24% of revenues in fiscal 2003, 2002 and 2001, respectively. For the six months ended December 31, 2003, sales of Mercury's computer systems to the medical imaging market accounted for approximately 18% of revenues. GE Medical Systems, Siemens Medical and Philips Medical Systems accounted for substantially all of Mercury's medical imaging revenues for each of the fiscal years ended June 30, 2003, 2002 and 2001, respectively. In addition, GE Medical accounted for 59%, 57% and 52% of aggregate sales to the medical imaging market in fiscal 2003, 2002 and 2001, respectively. For the six months ended December 31, 2003, GE Medical accounted for 66% of aggregate sales to the medical imaging market. If a major customer significantly reduces the amount of business it does with Mercury, there would be an adverse impact on operating results.

Although Mercury is seeking to broaden its commercial customer base, Mercury will continue to depend on sales to a relatively small number of major customers and modalities in the medical imaging market. Because it often takes significant time to replace lost business, it is likely that operating results would be adversely affected if one or more of Mercury's major customers were to cancel, delay or reduce significant orders in the future. Mercury's customer agreements typically permit the customer to discontinue future purchases after timely notice.

Competition from existing or new companies in the medical imaging business could cause Mercury to experience downward pressure on prices, fewer customer orders, reduced margins, the inability to take advantage of new business opportunities and the loss of market share.

Medical imaging is a highly competitive industry, and Mercury's medical imaging OEM customers generally extend the competitive pressures they face throughout their respective supply chains. Mercury is subject to competition based upon product design, performance, pricing, quality and services. Mercury's product performance, embedded systems engineering expertise, and product quality have been important factors in growth. While Mercury tries to maintain competitive pricing on those products which are directly comparable to products manufactured by others, in many instances Mercury's products will conform to more exacting specifications and carry a higher price than analogous products manufactured by others.

Many of Mercury's medical imaging OEM customers and potential medical imaging OEM customers have the capacity to design and manufacture the products Mercury manufactures internally. Mercury faces competition

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from research and product development groups and the manufacturing operations of current and potential customers, who continually evaluate the benefits of internal research and product development and manufacturing versus outsourcing.

Mercury's sales to the medical imaging market could be adversely affected by changes in technology, strength of the economy, and health care reforms.

Medical imaging OEM customers provide products to markets that are subject to both economic and technological cycles. Any change in the demand for medical imaging devices that renders any of Mercury's products unnecessary or obsolete, or any change in the technology in these devices, could result in a decrease in Mercury's revenues. In addition to Mercury's medical imaging OEM customers, the end users of their products and the health care industry generally are subject to extensive federal, state and local regulation in the United States as well as in other countries. Changes in applicable health care laws and regulations or new interpretations of existing laws and regulations could cause these customers or end users to demand fewer medical imaging products. Mercury cannot assure future health care regulations or budgetary legislation or other changes in the administration or interpretation of governmental health care programs both in the United States and abroad will not have a material adverse effect on business. The economic and technological conditions affecting Mercury's industry in general, or any major medical imaging OEM customers in particular, may adversely affect operating results.

If Mercury is unable to respond adequately to its competition, Mercury may lose existing customers and fail to win future business opportunities.

The markets for Mercury's products are highly competitive and are characterized by rapidly changing technology, frequent product performance improvements and evolving industry standards. Competitors may be able to offer more attractive pricing or develop products that could offer performance features that are superior to Mercury's products, thereby reducing demand for Mercury's products. Due to the rapidly changing nature of technology, Mercury may not become aware in advance of the emergence of new competitors into Mercury's markets. The emergence of new competitors into markets historically targeted by Mercury could result in the loss of existing customers and may have a negative impact on the ability to win future business opportunities. With continued microprocessor evolution, low-end systems could become adequate to meet the requirements of an increased number of the lesser-demanding applications within target markets. Mercury cannot assure that workstation manufacturers, other low-end single-board computer, and merchant board computer companies, or a new competitor, will not attempt to penetrate the high-performance market for defense electronics systems, which could have a material adverse effect on Mercury's business, financial condition and results of operations.

Mercury faces the continuing impact on its business from the slowdown in worldwide economies.

Mercury's business has been, and may continue to be, negatively impacted by the slowdown in the economies of the United States, Europe, Asia and elsewhere that began during fiscal 2001. The uncertainty regarding the growth rate of the worldwide economies has caused companies to reduce capital investment and may cause further reduction of these capital investments. These reductions have been particularly severe in the electronics and semiconductor industries, which Mercury serves. While Mercury's business may be performing better than some companies in periods of economic decline, the effects of the economic decline are being felt across all business segments and is a contributor to the slower than normal customer orders. Mercury cannot predict if or when the growth rate of worldwide economies will rebound, whether the growth rate of customer orders will rebound when the worldwide economies begin to grow, or if and when the growth rate of customer orders will return to historical numbers. All components of forecasting and budgeting processes are dependent upon estimates of growth in the markets Mercury serves. The prevailing economic uncertainty renders estimates of future income and expenditures even more difficult than usual. As a result, Mercury may make significant investments and expenditures, but never realize the anticipated benefits, which could adversely affect results of operations. The future direction of the overall domestic and global economies could have a significant impact on Mercury's overall performance.

Mercury cannot predict the consequences of future terrorist activities, but they may adversely affect the markets in which Mercury operates, Mercury's ability to insure against risks, and Mercury's operations or profitability.

The terrorist attacks in the United States on September 11, 2001, as well as the U.S.-led response, including Operation Enduring Freedom and Operation Iraqi Freedom, the potential for future terrorist activities, and the development of a Homeland Security organization have created economic and political uncertainties that could have a material adverse effect on business and the price of Mercury's common stock. These matters have caused uncertainty in the world's financial and insurance markets and may increase significantly the political, economic and social instability in the geographic areas in which Mercury operates. These developments may affect adversely business and profitability and the prices of Mercury's securities in ways that cannot be predicted at this time.

Implementation of Mercury's growth strategy may not be successful, which could affect the ability to increase revenues.

Mercury's growth strategy includes developing new products and entering new markets. Mercury's ability to compete in new markets will depend upon a number of factors including, without limitation:

- the ability to create demand for products in new markets;
- the ability to manage growth effectively;
- the quality of new products;
- the ability to successfully integrate acquisitions that are made;
- the ability to respond to changes in customers' businesses by updating existing products and introducing, in a timely fashion, new products which meet the needs of customers; and
- the ability to respond rapidly to technological change.

The failure to do any of the foregoing could have a material adverse effect on Mercury's business, financial condition and results of operations. In addition, Mercury may face competition in these new markets from various companies that may have substantially greater research and development resources, marketing and financial resources, manufacturing capability and customer support organizations.

Mercury may be unable to obtain critical components from suppliers, which could disrupt or delay the ability to deliver products to customers.

Several components used in Mercury's products are currently obtained from sole-source suppliers. Mercury is dependent on key vendors like LSI Logic, Atmel, Xilinx and Toshiba for custom-designed Application Specific Integrated Circuits ("ASICs") and Field Programmable Gate Arrays ("FPGAs"); Motorola and IBM for PowerPC microprocessors; IBM for a specific Static Random Access Memory ("SRAM"); as well as Arrow, JMR and Force Computers for chassis and chassis components ("Chassis"). Generally, suppliers may terminate their contract with Mercury without cause upon 30-days notice and may cease offering Mercury products upon 180-days notice. If any of Mercury's sole-source suppliers were to limit or reduce the sale of these components, or if these or other component suppliers, some of which are small companies, were to experience financial difficulties or other problems which prevented them from supplying Mercury with the necessary components, these events could result in a loss of revenues due to the inability to fulfill orders in a timely manner or at all. These sole-source and other suppliers are each subject to quality and performance issues, materials shortages, excess demand, reduction in capacity and other factors that may disrupt the flow of goods to Mercury or to Mercury's customers, thereby adversely affecting business and customer relationships. Mercury has no guaranteed supply arrangements with its suppliers and there can be no assurance that suppliers will continue to meet Mercury's requirements. If supply arrangements are interrupted, there can be no assurance that Mercury will find another

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supplier on a timely or satisfactory basis. Any shortage or interruption in the supply of any of the components used in Mercury's products, or the inability to procure these components from alternate sources on acceptable terms, could increase the cost or disrupt or delay the ability to deliver products to customers and thereby have a material adverse effect on Mercury's business, financial condition and results of operations. Mercury cannot assure that severe shortages of components will not occur in the future. Mercury could incur set-up costs and delays in manufacturing should it become necessary to replace any key vendors due to work stoppages, shipping delays, financial difficulties or other factors and, under certain circumstances, these costs and delays could materially and adversely affect operating results.

Mercury may not be able to efficiently manage relationships with contract manufacturers.

Mercury relies on contract manufacturers to build hardware sub-assemblies for products in accordance with its specifications. During the normal course of business, Mercury may provide demand forecasts to contract manufacturers up to five months prior to scheduled delivery of products to customers. If Mercury overestimates requirements, the contract manufacturers may assess cancellation penalties or Mercury may be left with excess inventory, which may negatively impact earnings. If Mercury underestimates requirements, the contract manufacturers may have inadequate inventory, which could interrupt manufacturing of Mercury's products and result in delays in shipment to customers and revenue recognition. Mercury may not be able to effectively manage the relationship with contract manufacturers, and the contract manufacturers may not meet future requirements for timely delivery. Contract manufacturers also build products for other companies, and they cannot assure Mercury that they will always have sufficient quantities of inventory available to fill orders or that they will allocate their internal resources to fill these orders on a timely basis. In addition, there have been a number of major acquisitions within the contract manufacturing industry in recent periods. While to date there has been no significant impact on Mercury's contract manufacturers, future acquisitions could potentially have an adverse effect on working relationships with contract manufacturers.

Performance and stock price may decline if Mercury is unable to retain and attract key personnel.

Mercury is largely dependent upon the skills and efforts of senior management including James R. Bertelli, Mercury's president and chief executive officer, as well as managerial, sales and technical employees. None of Mercury's senior management or other key employees is subject to any employment contract or non-competition agreement. The loss of services of any executive or other key personnel could have a material adverse effect on Mercury's business, financial condition and results of operations and stock price. In addition, Mercury's future success will depend to a significant extent on the ability to attract, train, motivate and retain highly skilled technical professionals, particularly project managers, engineers and other senior technical personnel. There can be no assurance that Mercury will be successful in retaining current or future employees.

Mercury is exposed to risks associated with international operations.

Mercury markets and sells products in international markets, and has established offices and subsidiaries in the United Kingdom, Japan, the Netherlands and France. There are risks inherent in transacting business internationally, including:

- changes in applicable laws and regulatory requirements;
- export and import restrictions;
- export controls relating to technology;
- tariffs and other trade barriers;
- less favorable intellectual property laws;
- difficulties in staffing and managing foreign operations;

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- longer payment cycles;
- problems in collecting accounts receivable;
- political instability;
- fluctuations in currency exchange rates;
- expatriation controls; and
- potential adverse tax consequences.

There can be no assurance that one or more of these factors will not have a material adverse effect on Mercury's future international activities and, consequently, on Mercury's business, financial condition or results of operations.

Mercury may be unable to successfully integrate acquisitions that are made.

Acquisitions may be costly and difficult to integrate, divert management resources or dilute shareholder value, and Mercury may in the future acquire or make investments in complementary companies, products or technologies.

Future potential acquisitions may pose risks to operations, including:

- problems and increased costs in connection with the integration of the personnel, operations, technologies or products of the acquired companies;
- unanticipated costs;
- diversion of management's attention from the core business;
- adverse effects on business relationships with suppliers and customers and those of the acquired company;
- acquired assets becoming impaired as a result of technical advancements or worse-than-expected performance by the acquired company;
- entering markets in which Mercury has no, or limited, prior experience; and
- potential loss of key employees, particularly those of the acquired organization.

In addition, in connection with any acquisitions or investments Mercury could:

- issue stock that would dilute existing shareholders' percentage ownership;
- incur debt and assume liabilities;
- obtain financing on unfavorable terms;
- incur amortization expenses related to acquired intangible assets or incur large and immediate write-offs;
- incur large expenditures related to office closures of the acquired companies, including costs relating to termination of employees and facility and leasehold improvement charges relating to vacating the acquired companies' premises; and
- reduce the cash that would otherwise be available to fund operations or to use for other purposes.

The failure to successfully integrate any acquisition or for acquisitions to yield expected results may negatively impact Mercury's financial condition and operating results.

If Mercury is unable to respond to technological developments and changing customer needs on a timely and cost-effective basis, its results of operations may be adversely affected.

Future success will depend in part on Mercury's ability to enhance current products and to develop new products on a timely and cost-effective basis in order to respond to technological developments and changing customer needs. Defense electronics customers, in particular, demand frequent technological improvements as a means of gaining military advantage. Military planners historically have funded significantly more design projects than actual deployments of new equipment, and those systems that are deployed tend to contain the components of the subcontractors selected to participate in the design process. In order to participate in the design of new defense electronics systems, Mercury must demonstrate the ability to deliver superior technological performance on a timely and cost-effective basis. There can be no assurance that Mercury will secure an adequate number of defense electronics design wins in the future, that the equipment in which Mercury's products are intended to function eventually will be deployed in the field, or that Mercury's products will be included in such equipment if it eventually is deployed.

Customers in the medical imaging and OEM solutions markets, including the semiconductor imaging market, also seek technological improvements through product enhancements and new generations of products. OEMs historically have selected certain suppliers whose products have been included in the OEMs' machines for a significant portion of the products' life cycle. There can be no assurance that Mercury will be selected to participate in the future design of any medical or semiconductor imaging equipment, or that, if selected, Mercury will generate any revenues for such design work.

The design-in process is typically lengthy and expensive, and there can be no assurance that Mercury will be able to continue to meet the product specifications of OEM customers in a timely and adequate manner. In addition, any failure to anticipate or respond adequately to changes in technology and customer preferences, or any significant delay in product developments or introductions, could negatively impact Mercury's financial condition and results of operations, including the risk of inventory obsolescence. Because of the complexity of Mercury's products, Mercury has experienced delays from time to time in completing products on a timely basis. If Mercury is unable to design, develop or introduce competitive new products on a timely basis, future operating results would be adversely affected. There can be no assurance that Mercury will be successful in developing new products or enhancing existing products on a timely or cost-effective basis, or that such new products or product enhancements will achieve market acceptance.

Mercury may be unsuccessful in protecting intellectual property rights.

Mercury's ability to compete effectively against other companies in Mercury's industry depends, in part, on the ability to protect current and future proprietary technology under current and future patent, copyright, trademark, trade secret and unfair competition laws. Mercury cannot assure that the means of protecting proprietary rights in the United States or abroad will be adequate, or that others will not develop technologies similar or superior to Mercury's technology or design around the proprietary rights owned by Mercury. In addition, management may be distracted and may incur substantial costs in attempting to protect proprietary rights.

If Mercury becomes subject to intellectual property infringement claims, Mercury could incur significant expenses and could be prevented from selling specific products.

Mercury may become subject to claims that Mercury infringes the intellectual property rights of others in the future. Mercury cannot assure that, if made, these claims will not be successful. Any claim of infringement could cause Mercury to incur substantial costs defending against the claim even if the claim is invalid, and could distract management from other business. Any judgment against Mercury could require substantial payment in damages and could also include an injunction or other court order that could prevent Mercury from offering certain products.

Mercury's need for continued investment in research and development may increase expenses and reduce profitability.

Mercury's industry is characterized by the need for continued investment in research and development. If Mercury fails to invest sufficiently in research and development, Mercury's products could become less attractive to potential customers and Mercury's business and financial condition could be materially adversely affected. As a result of the need to maintain or increase spending levels in this area and the difficulty in reducing costs associated with research and development, operating results could be materially harmed if research and development efforts fail to result in new products or if revenues fall below expectations. In addition, as a result of Mercury's commitment to invest in research and development, spending levels of research and development expenses as a percent of revenues may fluctuate in the future.

Mercury's results of operations are subject to fluctuation from period to period and may not be an accurate indication of future performance.

Mercury has experienced fluctuations in operating results in large part due to the sale of computer systems in relatively large dollar amounts to a relatively small number of customers. Mercury's quarterly results may be subject to fluctuations resulting from a number of other factors, including:

- the timing of significant orders;
- delays in completion of internal product development projects;
- delays in shipping computer systems and software programs;
- delays in acceptance testing by customers;
- a change in the mix of products sold to the defense electronics, medical imaging and other markets;
- production delays due to quality problems with outsourced components;
- shortages and costs of components;
- the timing of product line transitions; and
- declines in quarterly revenues from previous generations of products following announcement of replacement products containing more advanced technology.

Results of operations in any period should not be considered indicative of the results to be expected for any future period.

In addition, from time to time, Mercury has entered into contracts, referred to as development contracts, to engineer a specific solution based on modifications to standard products. Gross margins from development contract revenues are typically lower than gross margins from standard product revenues. Mercury intends to continue to enter into development contracts and anticipates that the gross margins associated with development contract revenues will continue to be lower than gross margins from standard product sales.

Another factor contributing to fluctuations in quarterly results is the fixed nature of expenditures on personnel, facilities and marketing programs. Expense levels for these programs are based, in significant part, on expectations of future revenues. If actual quarterly revenues are below management's expectations, results of operations likely will be adversely affected. As a result of the foregoing factors, operating results, from time to time, may be below the expectations of public market analysts and investors, which could have a material adverse effect on the market price of Mercury's common stock.

The trading price of Mercury's common stock may continue to be volatile which may adversely affect business, and investors in Mercury's common stock may experience substantial losses.

Mercury's stock price, like that of other technology companies, has been volatile. The stock market in general, and technology companies in particular, may continue to experience volatility in their stock prices. This

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volatility may or may not be related to operating performance. In addition, the continued threat of terrorism in the United States and abroad, the resulting military action and heightened security measures undertaken in response to that threat may cause continued volatility in securities markets. When the market price of a stock has been volatile, holders of that stock will sometimes institute securities class action litigation against the company that issued the stock. If any stockholders were to institute a lawsuit, Mercury could incur substantial costs defending the lawsuit. Also, the lawsuit could divert the time and attention of management.

Provisions in Mercury's organizational documents and Massachusetts law could make it more difficult for a third party to acquire Mercury.

Provisions of Mercury's charter and by-laws could have the effect of discouraging a third party from making a proposal to acquire Mercury and could prevent certain changes in control, even if some stockholders might consider the proposal to be in their best interests. These provisions include a classified board of directors, advance notice to Mercury's board of directors of stockholder proposals and director nominations, and limitations on the ability of stockholders to remove directors and to call stockholder meetings. In addition, Mercury may issue shares of any class or series of preferred stock in the future without stockholder approval upon such terms as the board of directors may determine. The rights of holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any such class or series of preferred stock that may be issued. Mercury is also subject to Chapter 110F of the Massachusetts General Laws which, subject to certain exceptions, prohibits a Massachusetts corporation from engaging in a broad range of business combinations with any "interested stockholder" for a period of three years following the date that such stockholder becomes an interested stockholder.

These provisions could discourage a third party from pursuing an acquisition of Mercury at a price considered attractive by many stockholders because such provisions could have the effect of delaying or deferring a potential acquirer from acquiring control of Mercury.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There were no material changes in the Company's exposure to market risk from June 30, 2003 to December 31, 2003.

ITEM 4. CONTROLS AND PROCEDURES

The Company conducted an evaluation under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Interim Chief Financial Officer (its Principal Executive Officer and Principal Financial Officer, respectively) regarding the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Interim Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to them by others within the Company and its consolidated subsidiaries. The Company continues to review its disclosure controls and procedures and may from time to time make changes aimed at enhancing its effectiveness and to ensure that its systems evolve with the Company's business.

There was no change in the Company's internal control over financial reporting that occurred during the quarter ended December 31, 2003 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Mercury is subject to legal proceedings and claims that arise in the ordinary course of business. Mercury does not believe these actions will have a material adverse effect on its financial position or results of its operations.

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

On November 17, 2003, the Company held a Special Meeting of Stockholders in lieu of the 2003 Annual Meeting of Stockholders (the "Meeting"). At the Meeting, James R. Bertelli and Russell K. Johnsen were re-elected as directors for terms ending in 2006. The voting results were as follows:

James R. Bertelli	For	18,608,276	Withheld	273,600
Russell K. Johnsen	For	18,478,860	Withheld	403,016

The terms of the following directors continued after the meeting: Dr. Gordon B. Baty, Dr. Albert P. Belle Isle, Sherman N. Mullin, Lee C. Steele and Dr. Richard P. Wishner.

At the Meeting, the stockholders approved an amendment to increase the number of shares of common stock authorized for issuance pursuant to the Company's 1997 Stock Option Plan from 6,650,000 shares to 7,650,000 shares. The voting results were as follows:

For	9,829,251	Against	4,149,963	Abstain	60,876	Broker Non-Votes	4,841,786 ⁽¹⁾
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At the Meeting, the stockholders approved an amendment to the Company's 1997 Stock Option Plan that authorizes grants of restricted stock up to 100,000 shares in the aggregate and makes corresponding changes to the 1997 Stock Option Plan as appropriate.

For	10,734,660	Against	3,239,068	Abstain	66,362	Broker Non-Votes	4,841,786 ⁽¹⁾
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⁽¹⁾ Shares held by a broker or nominee that do not have the authority, either express or discretionary, to vote on a particular matter are counted as present for the purposes of determining the existence of a quorum for the transaction of business.

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS.

ITEM NO.	DESCRIPTION OF EXHIBIT
3.1	Restated Articles of Organization, as amended. (Incorporated herein by reference to Exhibit 3.1 of the Company's Annual Report on Form 10-K for the year ended June 30, 2003).
3.2	By-laws, as amended. (Incorporated herein by reference to Exhibit 3.2 filed with the Company's Annual Report on Form 10-K for the year ended June 30, 2003).
4.1	Form of Stock Certificate. (Incorporated herein by reference to Exhibit 4.1 of the Company's Registration Statement on Form S-1 (File No. 333-41139)).
10.1	Form of Indemnification Agreement between the Company and each of its current directors.
10.2	1997 Stock Option Plan, as amended and restated
31.1	Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Company's Interim Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of the Company's Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of the Company's Interim Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* This certification shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, nor shall it be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

(b) Reports on Form 8-K.

On October 16, 2003, the Company furnished a Current Report on Form 8-K, dated the same date, regarding its earnings press release for the quarter ended September 30, 2003.

INDEMNIFICATION AGREEMENT

This Agreement is made as of the 17th day of November, 2003, by and between Mercury Computer Systems, Inc., a Massachusetts corporation (the "Corporation"), and _____ (the "Indemnitee"), a director of the Corporation.

WHEREAS, it is essential to the Corporation to retain and attract as directors the most capable persons available, and

WHEREAS, the substantial increase in corporate litigation subjects directors to expensive litigation risks at the same time that the availability of directors' and officers' liability insurance has been severely limited, and

WHEREAS, it is now and has always been the express policy of the Corporation to indemnify its directors, and

WHEREAS, the Indemnitee does not regard the protection available under the Corporation's Articles of Organization, By-Laws and insurance as adequate in the present circumstances, and may not be willing to serve or continue to serve as a director without adequate protection, and

WHEREAS, the Corporation desires the Indemnitee to serve, or continue to serve, as a director of the Corporation.

NOW, THEREFORE, the Corporation and the Indemnitee do hereby agree as follows:

1. Agreement to Serve.

The Indemnitee agrees to serve or continue to serve as a director of the Corporation for so long as the Indemnitee is duly elected or until such time as the Indemnitee tenders a resignation in writing.

2. Third Party Actions.

The Corporation shall indemnify the Indemnitee if the Indemnitee was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (each, a "Proceeding") (other than an action by or in the right of the Corporation), by reason of the fact that he is or was a director, officer, employee or agent of the Corporation, or is or was serving at the request of the Corporation as a director, officer, trustee, principal, partner, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the Indemnitee in connection with such Proceeding.

3. Derivative Actions.

The Corporation shall indemnify the Indemnitee if the Indemnitee was or is a party or is threatened to be made a party to any Proceeding by or in the right of the Corporation to procure a judgment in its favor by reason of the fact that the Indemnitee is or was a director, officer, employee or agent of the Corporation, or is or was serving at the request of the Corporation as a director, officer, trustee, principal, partner, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by the Indemnitee in connection with the defense or settlement of such Proceeding.

4. Expenses.

To the extent that the Indemnitee has been successful on the merits or otherwise in defense of any Proceeding referred to in Sections 2 and 3, or in defense of any claim, issue or matter therein, the Indemnitee shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by the Indemnitee in connection therewith.

5. Authorization and Request for Indemnification.

(a) Any indemnification requested by the Indemnitee under Section 2 hereof shall be made no later than ten (10) days after receipt of the written request of the Indemnitee, unless with respect to such matter it shall have been adjudicated in any proceeding that the Indemnitee did not act in good faith in the reasonable belief that his action was in the best interests of the Corporation, or to the extent that such matter relates to service with respect to an employee benefit plan, in the best interests of the participants or beneficiaries of such employee benefit plan, and with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful.

(b) Any indemnification requested by the Indemnitee under Section 3 hereof shall be made no later than ten (10) days after receipt of the written request of the Indemnitee, unless with respect to such matter it shall have been adjudicated in any proceeding that the Indemnitee did not act in good faith in the reasonable belief that his action was in the best interests of the Corporation, or to the extent that such matter relates to service with respect to an employee benefit plan, in the best interests of the participants or beneficiaries of such employee benefit plan, or unless the Indemnitee shall have been finally adjudged to be liable to the Company by a court of competent jurisdiction due to willful misconduct of a culpable nature in the performance of the Indemnitee's duty to the Corporation unless and only to the extent that any court in which such Proceeding was brought shall determine upon application that despite the adjudication of liability, but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses as such court shall deem proper.

6. Advance Payment of Expenses.

Subject to Section 5 above, the Corporation shall advance all expenses incurred by the Indemnitee in connection with the investigation, defense, settlement or appeal of any Proceeding to which the Indemnitee is a party or is threatened to be made a party by reason of the fact that

the Indemnitee is or was an agent of the Corporation. The Indemnitee hereby undertakes to repay such amounts advanced only if, and to the extent that, it shall ultimately be determined that the Indemnitee is not entitled to be indemnified by the Corporation. The advances to be made hereunder shall be paid by the Corporation to or on behalf of the Indemnitee within thirty (30) days following delivery of a written request therefor by the Indemnitee to the Corporation.

7. Remedies.

The right to indemnification or advancement of expenses as provided by this Agreement shall be enforceable by the Indemnitee in any court of competent jurisdiction. Unless otherwise required by law, the burden of proving that indemnification is not appropriate shall be on the Corporation. The Indemnitee's expenses reasonably incurred in connection with successfully establishing the Indemnitee's right to indemnification, in whole or in part, in any such Proceeding shall also be indemnified by the Corporation.

8. Partial Indemnification.

If the Indemnitee is entitled under any provision of this Agreement to indemnification by the Corporation for some or a portion of the expenses, judgments, fines, penalties or amounts paid in settlement actually and reasonably incurred by or on behalf of the Indemnitee in connection with any Proceeding but not, however, for the total amount thereof, the Corporation shall nevertheless indemnify the Indemnitee for the portion of such expenses, judgments, fines, penalties or amounts paid in settlement to which the Indemnitee is entitled.

9. Subrogation.

In the event of any payment under this Agreement, the Corporation shall be subrogated to the extent of such payment to all of the rights of recovery of the Indemnitee, who shall execute all papers required and take all action necessary to secure such rights, including execution of such documents as are necessary to enable the Corporation to bring suit to enforce such rights.

10. Term of Agreement.

This Agreement shall continue until and terminate upon the later of (a) six years after the date that the Indemnitee shall have ceased to serve as a director or officer of the Corporation or, at the request of the Corporation, as a director, officer, trustee, principal, partner, employee or agent of another corporation, partnership, joint venture, trust or other enterprise or (b) the final termination of all Proceedings pending on the date set forth in clause (a) in respect of which the Indemnitee is granted rights of indemnification or advancement of expenses hereunder and of any proceeding commenced by the Indemnitee pursuant to Paragraph 7 of this Agreement relating thereto.

11. Indemnification Hereunder Not Exclusive.

The indemnification and advancement of expenses provided by this Agreement shall not be deemed exclusive of any other rights to which the Indemnitee may be entitled under the Articles of Organization, the By-Laws, any other agreement, any vote of stockholders or

disinterested directors, Chapter 156B of the Massachusetts General Laws, any other law (common or statutory), or otherwise, both as to action in the Indemnitee's official capacity and as to action in another capacity while holding office for the Corporation. Nothing contained in this Agreement shall be deemed to prohibit the Corporation from purchasing and maintaining insurance, at its expense, to protect itself or the Indemnitee against any expense, liability or loss incurred by it or the Indemnitee in any such capacity, or arising out of the Indemnitee's status as such, whether or not the Indemnitee would be indemnified against such expense, liability or loss under this Agreement; provided that the Corporation shall not be liable under this Agreement to make any payment of amounts otherwise identifiable hereunder if and to the extent that the Indemnitee has otherwise actually received such payment under any insurance policy, contract, agreement or otherwise.

12. No Special Rights.

Nothing herein shall confer upon the Indemnitee any right to continue to serve as an officer or director of the Corporation for any period of time or at any particular rate of compensation.

13. Savings Clause.

If this Agreement or any portion thereof shall be invalidated on any ground by any court of competent jurisdiction, then the Corporation shall nevertheless indemnify the Indemnitee as to expenses, judgments, fines, penalties and amounts paid in settlement with respect to any Proceeding to the full extent permitted by any applicable portion of this Agreement that shall not have been invalidated and to the fullest extent permitted by applicable law.

14. Counterparts.

This Agreement may be executed in any number of counterparts, each of which shall constitute the original.

15. Successors and Assigns.

This Agreement shall be binding upon the Corporation and its successors and assigns and shall inure to the benefit of the estate, heirs, executors, administrators and personal representatives of the Indemnitee.

16. Headings.

The headings of the paragraphs of this Agreement are inserted for convenience only and shall not be deemed to constitute part of this Agreement or to affect the construction thereof.

17. Modification and Waiver.

This Agreement may be amended from time to time to reflect changes in Massachusetts law or for other reasons. No supplement, modification or amendment of this Agreement shall be binding unless executed in writing by both of the parties hereto. No waiver of any of the

provisions of this Agreement shall be deemed or shall constitute a waiver of any other provision hereof nor shall any such waiver constitute a continuing waiver.

18. Notices.

All notices, requests, demands and other communications hereunder shall be in writing and shall be deemed to have been given (i) when delivered by hand or (ii) if mailed by certified or registered mail with postage prepaid, on the third day after the date on which it is so mailed:

(a) if to the Indemnitee, to:

(b) if to the Corporation, to:

Mercury Computer Systems, Inc.
199 Riverneck Road
Chelmsford, MA 01824

or to such other address as may have been furnished to the Indemnitee by the Corporation or to the Corporation by the Indemnitee, as the case may be.

19. Applicable Law.

This Agreement shall be governed by, and construed and enforced in accordance with, the laws of the Commonwealth of Massachusetts. The Indemnitee may elect to have the right to indemnification or reimbursement or advancement of expenses interpreted on the basis of the applicable law in effect at the time of the occurrence of the event or events giving rise to the applicable Proceeding, to the extent permitted by law, or on the basis of the applicable law in effect at the time such indemnification or reimbursement or advancement of expenses is sought. Such election shall be made, by a notice in writing to the Corporation, at the time indemnification or reimbursement or advancement of expenses is sought; provided, however, that if no such notice is given, and Chapter 156B of the Massachusetts General Laws is amended, or other Massachusetts law is enacted, to permit further indemnification of the directors and officers, then the Indemnitee shall be indemnified to the fullest extent permitted under Chapter 156B of the Massachusetts General Laws, as so amended, or by such other Massachusetts law, as so enacted.

20. Enforcement.

The Corporation expressly confirms and agrees that it has entered into this Agreement in order to induce the Indemnitee to continue to serve as an officer or director of the Corporation, and acknowledges that the Indemnitee is relying upon this Agreement in continuing in such capacity.

21. Entire Agreement.

This Agreement sets forth the entire agreement of the parties hereto in respect of the subject matter contained herein and supercedes all prior agreements, whether oral or written, by any officer, employee or representative of any party hereto in respect of the subject matter contained herein; and any prior agreement of the parties hereto in respect of the subject matter contained herein is hereby terminated and cancelled. For avoidance of doubt, the parties confirm that the foregoing does not apply to or limit the Indemnitee's rights under Massachusetts law or the Corporation's Articles of Organization or By-Laws.

[Signature Page to Follow]

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed as of the day and year first above written.

MERCURY COMPUTER SYSTEMS, INC.

Attest: _____
By: _____
Name: _____

By: _____
Name: _____
Title: _____

INDEMNITEE:

MERCURY COMPUTER SYSTEMS, INC.
1997 STOCK OPTION PLAN

1. PURPOSE OF THE PLAN.

This stock option plan (the "Plan") is intended to encourage ownership of the stock of Mercury Computer Systems, Inc. (the "Company") by employees and advisors of the Company and its subsidiaries, to induce qualified personnel to enter and remain in the employ of the Company or its subsidiaries and otherwise to provide additional incentive for optionees to promote the success of its business.

2. STOCK SUBJECT TO THE PLAN.

(a) The maximum number of shares of common stock, par value \$0.01 per share, of the Company (the "Common Stock") for which options or shares of restricted stock may be granted under this Plan shall be seven million six hundred fifty thousand (7,650,000) shares, provided that not more than 100,000 shares shall be issued in the form of restricted stock. The maximum number of shares of Common Stock available for granting incentive stock options under this Plan shall be seven million six hundred fifty thousand (7,650,000) shares. These limitations and all other limitations on the number of shares referenced in this Plan shall be subject to adjustment as provided in Section 12 of the Plan. Shares issued under the Plan may be authorized but unissued shares of Common Stock, or shares of Common Stock held in treasury by the Company.

(b) If an option or restricted stock award granted hereunder is forfeited, canceled, reacquired by the Company, satisfied without the issuance of shares of Common Stock or otherwise terminated (other than by exercise), the shares of Common Stock subject thereto shall again be available for subsequent option or restricted stock award grants under the Plan.

(c) Stock issuable upon exercise of an option granted under the Plan or the grant of a restricted stock award may be subject to such restrictions on transfer, repurchase rights or other restrictions as shall be determined by the Committee.

3. ADMINISTRATION OF THE PLAN.

The Plan shall be administered by a committee (the "Committee") consisting of two or more members of the Company's Board of Directors. The selection of persons for participation in the Plan and all decisions concerning the timing, pricing and amount of any grant or award under the Plan shall be made solely by the Committee. The Board of Directors may from time to time appoint a member or members of the Committee in substitution for or in addition to the member or members then in office and may fill vacancies on the Committee however caused. The Committee shall choose one of its members as Chairman and shall hold meetings at such times and places as it shall deem advisable. A majority of the members of the Committee shall constitute a quorum and any action may be taken by a majority of those present and voting at any

meeting. Any action may also be taken without the necessity of a meeting by a written instrument signed by a majority of the Committee. The decision of the Committee as to all questions of interpretation and application of the Plan shall be final, binding and conclusive on all persons. The Committee shall have the authority to adopt, amend and rescind such rules and regulations as, in its opinion, may be advisable in the administration of the Plan. The Committee may correct any defect or supply any omission or reconcile any inconsistency in the Plan or in any option or restricted stock agreement granted hereunder in the manner and to the extent it shall deem expedient to carry the Plan into effect and shall be the sole and final judge of such expediency. No Committee member shall be liable for any action or determination made in good faith.

4. TYPE OF OPTIONS.

Options granted pursuant to the Plan shall be authorized by action of the Committee and may be designated as either incentive stock options meeting the requirements of Section 422 of the Internal Revenue Code of 1986, as amended (the "Code"), or non-qualified options which are not intended to meet the requirements of such Section 422 of the Code, the designation to be in the sole discretion of the Committee. The Plan shall be administered by the Committee in such manner as to permit options to qualify as incentive stock options under the Code.

5. ELIGIBILITY.

Options designated as incentive stock options shall be granted only to employees (including officers and directors who are also employees) of the Company and any of its subsidiaries. Options designated as non-qualified options may be granted to officers, directors, employees, consultants, and advisors of the Company or of any of its subsidiaries. "Subsidiary" or "subsidiaries" shall be as defined in Section 424 of the Code and the Treasury Regulations promulgated thereunder (the "Regulations") and shall include present and future subsidiaries.

The Committee shall, from time to time, at its sole discretion, select from such eligible individuals those to whom options shall be granted and shall determine the number of shares to be subject to each option. In determining the eligibility of an individual to be granted an option, as well as in determining the number of shares to be granted to any individual, the Committee in its sole discretion shall take into account the position and responsibilities of the individual being considered, the nature and value to the Company or its subsidiaries of his or her service and accomplishments, his or her present and potential contribution to the success of the Company or its subsidiaries, and such other factors as the Committee may deem relevant.

No option designated as an incentive stock option shall be granted to any employee of the Company or any subsidiary if such employee owns, immediately prior to the grant of an option, stock representing more than 10% of the combined voting power of all classes of stock of the Company or a parent or a subsidiary, unless the purchase price for the stock under such option shall be at least 110% of its fair market value at the time such option is granted and the option, by its terms, shall not be exercisable more than five years from the date it is granted. In determining the stock ownership under this paragraph, the provisions of Section 424(d) of the Code shall be controlling. In determining the fair market value under this paragraph, the provisions of Section 7 hereof shall apply.

The maximum number of shares of the Company's Common Stock with respect to which an option or options may be granted to any employee in any one taxable year of the Company shall not exceed 200,000 shares, taking into account shares granted during such taxable year under options that are terminated or repriced.

6. OPTION AGREEMENT.

(a) Each option shall be evidenced by an option agreement (the "Agreement") duly executed on behalf of the Company and by the optionee to whom such option is granted, which Agreement shall comply with and be subject to the terms and conditions of the Plan. The Agreement may contain such other terms, provisions and conditions which are not inconsistent with the Plan as may be determined by the Committee, provided that options designated as incentive stock options shall meet all of the conditions for incentive stock options as defined in Section 422 of the Code. The date of grant of an option shall be as determined by the Committee. More than one option may be granted to an individual.

(b) Unless the Agreement specifies otherwise, the Committee may cancel, rescind, suspend, withhold or otherwise limit or restrict any option (whether vested or unvested, exercised or unexercised) at any time if the optionee is not in compliance with all applicable provisions of the Agreement and the Plan, or if the optionee engages in any "Detrimental Activity." For purposes of this Section 6, "Detrimental Activity" shall include: (i) the rendering of services for any organization or engaging directly or indirectly in any business which is or becomes competitive with the Company, or which organization or business, or the rendering of services to such organization or business, is or becomes otherwise prejudicial to or in conflict with the interests of the Company; (ii) the disclosure to anyone outside the Company, or the use in other than the Company's business, without prior written authorization from the Company, of any confidential information or material, as defined in the Company's Employee Confidentiality Agreement or such other agreement regarding confidential information and intellectual property that the optionee and the Company may enter into (collectively, the "Confidentiality Agreement"), relating to the business of the Company, acquired by the optionee either during or after employment with the Company; (iii) the failure or refusal to disclose promptly and to assign to the Company, pursuant to the Confidentiality Agreement or otherwise, all right, title and interest in any invention or idea, patentable or not, made or conceived by the optionee during employment by the Company, relating in any manner to the actual or anticipated business, research or development work of the Company or the failure or refusal to do anything reasonably necessary to enable the Company to secure a patent where appropriate in the United States and in other countries; (iv) activity that results in termination of the optionee's employment for cause; (v) a material violation of any rules, policies, procedures or guidelines of the Company; (vi) any attempt directly or indirectly to induce any employee of the Company to be employed or perform services elsewhere or any attempt directly or indirectly to solicit the trade or business of any current or prospective customer, supplier or partner of the Company; or (vii) the optionee being convicted of, or entering a guilty plea with respect to, a crime, whether or not connected with the Company.

(c) Upon exercise, payment, or delivery pursuant to an option, the optionee shall certify in a manner acceptable to the Company that he or she is in compliance with the terms and conditions of the Plan. In the event an optionee engages in any Detrimental Activity

as set forth in paragraphs (b)(i)-(vii) of this Section 6 prior to, or during the six (6) months after, any exercise, payment, or delivery pursuant to an option, such exercise, payment, or delivery may be rescinded by the Company within two (2) years thereafter. In the event of any such rescission, the optionee shall pay to the Company the amount of any gain realized or payment received as a result of the rescinded exercise, payment, or delivery, in such manner and on such terms and conditions as may be required, and the Company shall also be entitled to set-off against the amount of any such gain any amount owed to the optionee by the Company, and to be reimbursed for any attorney's fees or other costs or expenses incurred in enforcing this Section 6 of the Plan.

7. OPTION PRICE.

The option price or prices of shares of the Company's Common Stock for options designated as non-qualified stock options shall be determined by the Committee, but in no event shall the option price of a non-qualified stock option be less than 100% of the fair market value of such Common Stock at the time the option is granted, as determined by the Committee. The option price or prices of shares of the Company's Common Stock for incentive stock options shall be not less than the fair market value of such Common Stock at the time the option is granted as determined by the Committee in accordance with the Regulations promulgated under Section 422 of the Code. If the shares of Common Stock are listed on any national securities exchange, or traded on the National Association of Securities Dealers Automated Quotation System ("Nasdaq") National Market System, the fair market value of a share of Common Stock on the date of grant of an option shall be the closing price, if any, on the largest such exchange, or if not traded on an exchange, the Nasdaq National Market System on such day, or if the date of grant is not a business day, the business day immediately preceding the date of the grant, or if there are no sales of shares of Common Stock on the date of grant or on the business day immediately preceding the date of grant, the fair market value of a share of Common Stock shall be determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the date of grant in accordance with Treasury Regulations Section 25.2512-2. If the shares are not then either listed on any such exchange or quoted in NASDAQ/NM, the fair market value shall be the mean between the average of the "Bid" and the average of the "Ask" prices, if any, as reported in the National Daily Quotation Service for the date of grant, or if the date of grant is not a business day the business day immediately preceding the date of the grant of the option, or, if none, shall be determined by taking a weighted average of the means between the highest and lowest sales prices on the nearest date before and the nearest date after the date of grant in accordance with Treasury Regulations Section 25.2512-2. If the fair market value cannot be determined under the preceding two sentences, it shall be determined in good faith by the Committee.

8. MANNER OF PAYMENT; MANNER OF EXERCISE.

(a) Options granted under the Plan may provide for the payment of the exercise price, as determined by the Committee and set forth in the Agreement, by delivery of (i) cash or a check payable to the order of the Company in an amount equal to the exercise price of such options, (ii) shares of Common Stock of the Company owned by the optionee having a fair market value equal in amount to the exercise price of the options being exercised, (iii) any combination of (i) and (ii), provided, however, that payment of the exercise price by delivery of

shares of Common Stock of the Company owned by such optionee may be made only if such payment does not result in a charge to earnings for financial accounting purposes as determined by the Committee, or (iv) payment may also be made by delivery of a properly executed exercise notice to the Company, together with a copy of irrevocable instruments to a broker to deliver promptly to the Company the amount of sale or loan proceeds to pay the exercise price. The fair market value of any shares of the Company's Common Stock which may be delivered upon exercise of an option shall be determined by the Committee in accordance with Section 7 hereof. To facilitate clause (iv) above, the Company may enter into agreements for coordinated procedures with one or more brokerage firms. The date of exercise shall be the date of delivery of such exercise notice.

(b) To the extent that the right to purchase shares under an option has accrued and is in effect, options may be exercised in full at one time or in part from time to time, by giving written notice, signed by the person or persons exercising the option, to the Company, stating the number of shares with respect to which the option is being exercised, accompanied by payment in full for such shares as provided in subparagraph (a) above. Upon such exercise, delivery of a certificate for paid-up non-assessable shares shall be made at the principal office of the Company to the person or persons exercising the option at such time, during ordinary business hours, after 9:00 a.m. but not more than thirty (30) days from the date of receipt of the notice by the Company, as shall be designated in such notice, or at such time, place and manner as may be agreed upon by the Company and the person or persons exercising the option. Upon exercise of the option and payment as provided above, the optionee shall become a stockholder of the Company as to the Shares acquired upon such exercise.

9. VESTING OF OPTIONS.

Except as otherwise provided in an optionee's Agreement, each option granted under the Plan shall, subject to Section 10 and Section 12 hereof, be exercisable with reference to the option's Vesting Reference Date (the date selected by the Committee) as follows: prior to the First Anniversary Date of the Vesting Reference Date—zero percent (0%); on the First Anniversary Date of the Vesting Reference Date—twenty five percent (25%); on the Second Anniversary Date of the Vesting Reference Date—fifty percent (50%); on the Third Anniversary Date of the Vesting Reference Date—seventy-five percent (75%); and on the Fourth Anniversary Date of the Vesting Reference Date—one hundred percent (100%). Notwithstanding any other provisions of this section, in the event of a Change of Control (as hereinafter defined) of the Company, fifty percent (50%) of the unvested shares of each Participant with a minimum of six months' service will automatically be fully Vested; in the event of a Change of Control of the Company not approved by the Board of Directors prior to such Change of Control, all of the Shares shall be fully Vested immediately upon such Change of Control. For purposes of the Plan, a "Change of Control" shall be deemed to have occurred if any of the following conditions have occurred: (1) the merger or consolidation of the Company with another entity where the Company is not the surviving entity and where after the merger or consolidation (i) its stockholders prior to the merger or consolidation hold less than 50% of the voting stock of the surviving entity and (ii) its Directors prior to the merger or consolidation are less than a majority of the Board of the surviving entity; (2) the sale of all or substantially all of the Company's assets to a third party and subsequent to the transaction (i) its stockholders hold less than 50% of the stock of said third party and (ii) its Directors are less than a majority of the Board of said

third party; (3) a transaction or series of related transactions, including a merger of the Company with another entity where the Company is the surviving entity, whereby 50% or more of the voting stock of the Company is transferred to parties who are not prior thereto stockholders or affiliates of the Company; or (4) the Continuing Directors shall not constitute a majority of the Board of Directors of the Company. The term "Continuing Directors" shall mean a member of the Board of Directors of the Company who either was a member of the Board of Directors of the Company on the date this Plan was adopted by the Board of Directors or who subsequently became a director of the Company and whose initial appointment, initial election or initial nomination for election by the Company's shareholders subsequent to such date was approved by a vote of a majority of the Continuing Directors then on the Board of Directors of the Company.

To the extent that an option to purchase shares is not exercised by an optionee when it becomes initially exercisable, it shall not expire but shall be carried forward and shall be exercisable, on a cumulative basis, until the expiration of the exercise period. No partial exercise may be made for less than fifty (50) full shares of Common Stock.

Notwithstanding the foregoing, the Committee may in its discretion (i) specifically provide for another time or times of exercise (but not delay a vesting period) or (ii) accelerate the exercisability of any option subject to such terms and conditions as the Committee deems necessary and appropriate.

10. TERM AND EXERCISABILITY OF OPTIONS; RELATIONSHIP TO VESTING; NON-EMPLOYEE OPTIONS.

(a) TERM AND EXERCISABILITY.

(1) The term of each option shall be as stated in the optionee's Agreement, provided, however, that the term of an option shall not exceed ten (10) years from the date of the granting thereof, subject to earlier termination as provided in the Plan and the Agreement.

(2) Except as otherwise provided in the optionee's Agreement, or this Section 10, an option granted to any employee who ceases to be an employee of the Company or one of its subsidiaries shall terminate ninety (90) days after the date of such optionee ceases to be an employee of the Company or one of its subsidiaries, or on the last day of the term of the option, whichever occurs first.

(3) Except as otherwise provided in the optionee's Agreement, if such termination of employment is because of dismissal for cause or because the employee is in breach of any employment agreement, such option will terminate on the date the optionee ceases to be an employee of the Company or one of its subsidiaries, or on the last day of the term of the option, whichever occurs first.

(4) Except as otherwise provided in the optionee's Agreement, if such termination of the employment is because the optionee has become permanently disabled (within the meaning of Section 22(e)(3) of the Code), such option shall terminate on the

last day of the twelfth month from the date such optionee ceases to be an employee, or on the last day of the term of the option, whichever occurs first.

(5) Except as otherwise provided in the optionee's Agreement, in the event of the death of an optionee, any option granted to such optionee shall terminate on the last day of the twelfth month from the date of death, or on the last day of the term of the option, whichever occurs first.

(6) Except as otherwise provided in the optionee's Agreement, if such termination of employment is because of the retirement of the optionee on or after attaining the minimum age, completing the minimum number of years of service, and satisfying of all other conditions specified for retirement status under the Company's Retirement Policy Statement as in effect at the time of the grant of the option, such option will terminate on the date that is five (5) years after the date the optionee ceases to be an employee of the Company or one of its subsidiaries, or the last day of the term of the option, whichever occurs first.

(7) Notwithstanding subparagraphs (2) through (6) above, the Committee shall have the authority to extend the expiration date of any outstanding option in circumstances in which it deems such action to be appropriate.

(b) RELATIONSHIP TO VESTING. Except as otherwise provided in the optionee's agreement, an option granted to an employee who ceases to be an employee of the Company or one of its subsidiaries, whether by having become permanently disabled, as defined in Section 22(e)(3) of the Code, by death, or otherwise, shall be exercisable only to the extent that the right to purchase shares under such option has vested and accrued on the date that such optionee ceases to be an employee of the Company or one of its subsidiaries.

(c) NON-EMPLOYEE OPTIONS. The term of an option granted to a non-employee director, a consultant, or any other person who is not an employee of the Company or one of its subsidiaries shall be stated in the optionee's Agreement, provided, however, that the term of an option shall not exceed ten (10) years from the date of the granting thereof, subject to earlier termination as provided in the Plan and the Agreement. An option granted to a non-employee director, a consultant, or any other person who is not an employee of the Company or one of its subsidiaries shall be exercisable only to the extent so provided in the optionee's Agreement.

11. OPTIONS NOT TRANSFERABLE.

The right of any optionee to exercise any option granted to him or her shall not be assignable or transferable by such optionee otherwise than by will or the laws of descent and distribution, and any such option shall be exercisable during the lifetime of such optionee only by him; provided, however, that in the case of a non-qualified stock option, the Committee may permit transferability of such options on such terms and conditions as determined by the Committee and set forth in the Option Agreement. Any option granted under the Plan shall be null and void and without effect upon the bankruptcy of the optionee to whom the option is granted, or upon any attempted assignment or transfer, except as herein provided, including

without limitation any purported assignment, whether voluntary or by operation of law, pledge, hypothecation or other disposition, attachment, divorce, trustee process or similar process, whether legal or equitable, upon such option.

11A. RESTRICTED STOCK AWARDS.

(a) A restricted stock award entitles the recipient to acquire, at such purchase price as determined by the Committee, shares of Common Stock subject to such restrictions and conditions as the Committee may determine at the time of grant. Conditions may be based on continuing employment (or other service relationship) and/or achievement of pre-established performance goals and objectives. The grant of a restricted stock award is contingent on the grantee executing the restricted stock award agreement. The terms and conditions of each such agreement shall be determined by the Committee, and such terms and conditions may differ among individual restricted stock awards and grantees.

(b) Upon execution of a written instrument setting forth the restricted stock award and payment of any applicable purchase price, a grantee shall have the rights of a stockholder with respect to the voting of the restricted stock, subject to such conditions contained in the written instrument evidencing the restricted stock award. Unless the Committee shall otherwise determine, certificates evidencing the restricted stock shall remain in the possession of the Company until such restricted stock is vested as provided in Section 11A(d) below, and the grantee shall be required, as a condition of the grant, to deliver to the Company a stock power endorsed in blank.

(c) Restricted stock may not be sold, assigned, transferred, pledged or otherwise encumbered or disposed of except as specifically provided herein or in the restricted stock award agreement. If a grantee's employment (or other service relationship) with the Company and its subsidiaries terminates for any reason, the Company shall have the right to repurchase restricted stock that has not vested at the time of termination at its original purchase price, from the grantee or the grantee's legal representative.

(d) The Committee at the time of grant shall specify the date or dates and/or the attainment of pre-established performance goals, objectives and other conditions on which the non-transferability of the restricted stock and the Company's right of repurchase or forfeiture shall lapse. Subject to the power of the Committee to accelerate vesting upon a Change of Control, the vesting period for restricted stock shall be at least three years, except that in the case of restricted stock that becomes transferable and no longer subject to risk of forfeiture upon the attainment of pre-established goals, objectives and other conditions, the vesting period shall be at least one year. Subsequent to such date or dates and/or the attainment of such pre-established performance goals, objectives and other conditions, the shares on which all restrictions have lapsed shall no longer be restricted stock and shall be deemed "vested." Except as may otherwise be provided by the Committee either in the restricted stock award agreement or, subject to Section 19 below, in writing after the restricted stock award agreement is issued, a grantee's rights in any shares of restricted stock that have not vested shall automatically terminate upon the grantee's termination of employment (or other service relationship) with the Company and its subsidiaries and such shares shall be subject to the Company's right of repurchase as provided in Section 11A(c) above.

(e) The restricted stock award agreement may require or permit the immediate payment, waiver, deferral or investment of dividends paid on the restricted stock.

12. RECAPITALIZATIONS, REORGANIZATIONS AND THE LIKE.

(a) In the event that the outstanding shares of the Common Stock of the Company are changed into or exchanged for a different number or kind of shares or other securities of the Company or of another corporation by reason of any reorganization, merger, consolidation, recapitalization, reclassification, stock split-up, combination of shares, or dividends payable in capital stock, appropriate adjustment shall be made in the number and kind of shares as to which options or restricted stock awards may be granted under the Plan and as to which outstanding options or portions thereof then unexercised shall be exercisable and as to the repurchase price per share subject to each outstanding restricted stock award, to the end that the proportionate interest of the optionee or restricted stock holder shall be maintained as before the occurrence of such event; such adjustment in outstanding options shall be made without change in the total price applicable to the unexercised portion of such options and with a corresponding adjustment in the option price per share.

(b) In addition, unless otherwise determined by the Committee in its sole discretion, in the case of any Change of Control of the Company, the purchaser(s) of the Company's assets or stock may, in his, her or its discretion, deliver to the optionee the same kind of consideration that is delivered to the stockholders of the Company as a result of such sale, conveyance or Change of Control, or the Committee may cancel all outstanding options in exchange for consideration in cash or in kind, which consideration in both cases shall be equal in value to the value of those shares of stock or other securities the optionee would have received had the option been exercised (to the extent then exercisable) and no disposition of the shares acquired upon such exercise been made prior to such Change of Control, less the option price therefor. Upon receipt of consideration by the optionee, his or her option shall immediately terminate and be of no further force and effect. The value of the stock or other securities the optionee would have received if the option had been exercised shall be determined in good faith by the Committee, and in the case of shares of the Common Stock of the Company, in accordance with the provisions of Section 7 hereof. The Committee shall also have the power and right to accelerate the exercisability of any options, or to accelerate the vesting of any restricted stock awards, notwithstanding any limitations in this Plan or in the Agreement upon such Change of Control. Upon such acceleration, any options or portion thereof originally designated as incentive stock options that no longer qualify as incentive stock options under Section 422 of the Code as a result of such acceleration shall be redesignated as non-qualified stock options.

(c) Upon dissolution or liquidation of the Company, all options and restricted stock awards granted under this Plan shall terminate, but each optionee (if at such time in the employ of or otherwise associated with the Company or any of its subsidiaries) shall have the right, immediately prior to such dissolution or liquidation, to exercise his or her option to the extent then exercisable.

(d) No fraction of a share shall be purchasable or deliverable upon the exercise of any option or the vesting of any restricted stock award, but in the event any

adjustment hereunder of the number of shares covered by the option or restricted stock award shall cause such number to include a fraction of a share, such fraction shall be adjusted to the nearest smaller whole number of shares.

13. NO SPECIAL EMPLOYMENT RIGHTS.

Nothing contained in the Plan or in any option or restricted stock award granted under the Plan shall confer upon any optionee or restricted stock holder any right with respect to the continuation of his or her employment by the Company (or any subsidiary thereof) or interfere in any way with the right of the Company (or any subsidiary thereof), subject to the terms of any separate employment agreement to the contrary, at any time to terminate such employment or to increase or decrease the compensation of the optionee or restricted stock holder from the rate in existence at the time of the grant of an option or restricted stock award. Whether an authorized leave of absence, or absence in military or government service, shall constitute termination of employment shall be determined by the Committee at the time.

14. WITHHOLDING.

The Company's obligation to deliver shares upon the exercise of any option or vesting of any restricted stock award granted under the Plan and any payments or transfers under Section 12 hereof shall be subject to the optionee or restricted stock holder's satisfaction of all applicable Federal, state and local income, excise, employment and any other tax withholding requirements.

15. RESTRICTIONS ON ISSUE OF SHARES.

(a) Notwithstanding the provisions of Section 8, the Company may delay the issuance of shares covered by the exercise of an option or restricted stock award and the delivery of a certificate for such shares until one of the following conditions shall be satisfied:

(1) The shares with respect to the restricted stock award or with respect to which such option has been exercised are at the time of the issue of such shares effectively registered or qualified under applicable Federal and state securities acts now in force or as hereafter amended; or

(2) Counsel for the Company shall have given an opinion, which opinion shall not be unreasonably conditioned or withheld, that such shares are exempt from registration and qualification under applicable Federal and state securities acts now in force or as hereafter amended.

(b) It is intended that all exercises of options or grant of restricted stock awards shall be effective, and the Company shall use its best efforts to bring about compliance with the above conditions within a reasonable time, except that the Company shall be under no obligation to qualify shares or to cause a registration statement or a post-effective amendment to any registration statement to be prepared for the purpose of covering the issue of shares in respect of which any option may be exercised or with respect to any restricted stock award, except as otherwise agreed to by the Company in writing.

16. PURCHASE FOR INVESTMENT; RIGHTS OF HOLDER ON SUBSEQUENT REGISTRATION.

Unless the shares to be issued upon the vesting of a restricted stock award or exercise of an option granted under the Plan have been effectively registered under the Securities Act of 1933, as now in force or hereafter amended, the Company shall be under no obligation to issue any shares covered by any restricted stock award or option unless the person who receives such restricted stock award or exercises such option, in whole or in part, shall give a written representation and undertaking to the Company which is satisfactory in form and scope to counsel for the Company and upon which, in the opinion of such counsel, the Company may reasonably rely, that he or she is acquiring the shares issued pursuant to such restricted stock award or to such exercise of the option for his or her own account as an investment and not with a view to, or for sale in connection with, the distribution of any such shares, and that he or she will make no transfer of the same except in compliance with any rules and regulations in force at the time of such transfer under the Securities Act of 1933, or any other applicable law, and that if shares are issued without such registration, a legend to this effect may be endorsed upon the securities so issued. In the event that the Company shall, nevertheless, deem it necessary or desirable to register under the Securities Act of 1933 or other applicable statutes any shares with respect to a restricted stock award or to which an option shall have been exercised, or to qualify any such shares for exemption from the Securities Act of 1933 or other applicable statutes, then the Company may take such action and may require from each optionee or restricted stock holder such information in writing for use in any registration statement, supplementary registration statement, prospectus, preliminary prospectus or offering circular as is reasonably necessary for such purpose and may require reasonable indemnity to the Company and its officers and directors and controlling persons from such optionee or holder against all losses, claims, damages and liabilities arising from such use of the information so furnished and caused by any untrue statement of any material fact therein or caused by the omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading in the light of the circumstances under which they were made.

17. MODIFICATION OF OUTSTANDING OPTIONS.

The Committee may authorize the amendment of any outstanding option or restricted stock award with the consent of the optionee or restricted stock holder when and subject to such conditions as are deemed to be in the best interests of the Company and in accordance with the purposes of this Plan.

18. APPROVAL OF STOCKHOLDERS.

The Plan shall be subject to approval by the vote of stockholders holding at least a majority of the voting stock of the Company present, or represented, and entitled to vote at a duly held stockholders' meeting, or by written consent of the stockholders as provided for under applicable state law, within twelve (12) months after the adoption of the Plan by the Board of Directors and shall take effect as of the date of adoption by the Board of Directors upon such approval. The Committee may grant options under the Plan prior to such approval, but any such option shall become effective as of the date of grant only upon such approval and, accordingly, no such option may be exercisable prior to such approval.

19. TERMINATION AND AMENDMENT.

Unless sooner terminated as herein provided, the Plan shall terminate ten (10) years from the date upon which the Plan was duly adopted by the Board of Directors of the Company. The Board of Directors may at any time terminate the Plan or make such modification or amendment thereof as it deems advisable; provided, however, that except as provided in this Section 19, the Board of Directors may not, without the approval of the stockholders of the Company obtained in the manner stated in Section 18, increase the maximum number of shares for which options or restricted stock awards may be granted or change the designation of the class of persons eligible to receive options or restricted stock awards under the Plan, or make any other change in the Plan which requires stockholder approval under applicable law or regulations.

20. RESERVATION OF STOCK.

The Company shall at all times during the term of the Plan reserve and keep available such number of shares of stock as will be sufficient to satisfy the requirements of the Plan and shall pay all fees and expenses necessarily incurred by the Company in connection therewith.

21. LIMITATION OF RIGHTS IN THE OPTION SHARES.

An optionee shall not be deemed for any purpose to be a stockholder of the Company with respect to any of the options except to the extent that the option shall have been exercised with respect thereto and, in addition, a certificate shall have been issued theretofore and delivered to the optionee.

22. NOTICES.

Any communication or notice required or permitted to be given under the Plan shall be in writing, and mailed by registered or certified mail or delivered by hand, if to the Company, to its principal place of business, attention: President, and, if to an optionee or restricted stock holder, to the address as appearing on the records of the Company.

CERTIFICATION

I, James R. Bertelli, President and Chief Executive Officer of Mercury Computer Systems, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mercury Computer 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: February 12, 2004

/s/ JAMES R. BERTELLI

James R. Bertelli
PRESIDENT/CHIEF EXECUTIVE OFFICER
[PRINCIPAL EXECUTIVE OFFICER]

CERTIFICATION

I, Joseph M. Hartnett, Vice President, Controller and Interim Chief Financial Officer of Mercury Computer Systems, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mercury Computer 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: February 12, 2004

/s/ JOSEPH M. HARTNETT

Joseph M. Hartnett
VICE PRESIDENT, CONTROLLER
AND INTERIM CHIEF FINANCIAL OFFICER
[PRINCIPAL FINANCIAL OFFICER]

Mercury Computer Systems, Inc.

Certification Pursuant To
18 U.S.C. Section 1350,
As Adopted Pursuant To
Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report of Mercury Computer Systems, Inc. (the "Company") on Form 10-Q for the period ended December 31, 2003 as filed with the Securities and Exchange Commission (the "Report"), I, James R. Bertelli, President and Chief Executive Officer of the Company, certify, pursuant to Section 1350 of Chapter 63 of Title 18, United States Code, that the Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, as amended, and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 12, 2004

/s/ JAMES R. BERTELLI

James R. Bertelli
PRESIDENT/CHIEF EXECUTIVE OFFICER

Mercury Computer Systems, Inc.
Certification Pursuant To
18 U.S.C. Section 1350,
As Adopted Pursuant To
Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report of Mercury Computer Systems, Inc. (the "Company") on Form 10-Q for the period ended December 31, 2003 as filed with the Securities and Exchange Commission (the "Report"), I, Joseph M. Hartnett, Vice President, Controller and Interim Chief Financial Officer of the Company, certify, pursuant to Section 1350 of Chapter 63 of Title 18, United States Code, that the Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, as amended, and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 12, 2004

/s/ JOSEPH M. HARTNETT

Joseph M. Hartnett
VICE PRESIDENT, CONTROLLER AND
INTERIM CHIEF FINANCIAL OFFICER