

CEVA INC  
Form 10-K/A  
March 31, 2005

**The following items were the subject  
of a Form 12b-25 and are included  
herein: Items 6, 7 and 8; and Item 15  
-- Exhibits 23.1, 23.2, 31.1, 31.2, 32  
and Financial Statement Schedules**

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

**FORM 10-K/A**

**FOR ANNUAL OR TRANSITION REPORTS PURSUANT TO  
SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

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

**For the Fiscal Year Ended December 31, 2004**

**or**

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

**Commission File Number 000-49842**

**CEVA, INC.**

**(Exact name of Registrant as specified in its charter)**

**Delaware**

**77-0556376**

(State or other jurisdiction of  
incorporation or organization) (I.R.S. Employer  
Identification No.)  
2033 Gateway Place, Suite 150

San Jose, California 95110-1002

(Address of principal executive offices, including Zip Code)

(408) 514-2900

(Registrant's telephone number, including area code)

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

None

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

Common Stock, par value \$0.001 per share

(Title of Class)

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

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

The aggregate market value of voting stock held by non-affiliates of the Registrant as of the last day of the Registrant's most recent second quarter, June 30, 2004, was approximately \$86 million (based upon the closing price for shares of the Registrant's common stock of \$7.91, as reported by The NASDAQ National Market on that date). Shares of common stock held by each officer, director and holder of 5% or more of the outstanding common stock of the Registrant have been excluded from this calculation in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 25, 2005, there were 18,733,053 shares of Common Stock outstanding.

#### DOCUMENT INCORPORATED BY REFERENCE:

Portions of the registrant's definitive Proxy Statement for its Annual Meeting of Stockholders for the year ended December 31, 2004 (the 2005 Proxy Statement), are incorporated by reference into Parts II and III hereof.



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Financial Statements

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## **FORWARD-LOOKING STATEMENTS AND INDUSTRY DATA**

This Annual Report includes forward-looking statements that are subject to a number of risks and uncertainties. All statements, other than statements of historical facts, included in this Annual Report regarding our strategy, future operations, financial position, estimated revenues, projected costs, prospects, plans, and objectives of management are forward-looking statements. The words will, believe, anticipate, intend, estimate, expect, project, and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements in this report contain these identifying words. We cannot guarantee future results, levels of activity, performance or achievements and you should not place undue reliance on our forward-looking statements. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or strategic alliances. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including the risks described in Management's Discussion and Analysis of Financial Condition and Results of Operations Factors That Could Affect Our Operating Results and elsewhere in this Annual Report. We do not assume any obligations to update any of the forward-looking statements we make.

This report contains market data prepared by third parties, including Gartner-Dataquest, Forward Concepts and the Semiconductor Industry Association. Actual market results may differ from the projections of such organizations.

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The financial information in this annual report includes the results of CEVA, Inc. and its subsidiaries (the Company or CEVA). CEVA (formerly known as ParthusCeva) was formed through the combination of Parthus Technologies plc and CEVA in November 2002. For periods prior to November 1, 2002, the financial statements of CEVA present the financial position, results of operations and cash flows of the licensing business and operations of DSPG, which have been carved out from the financial statements of DSPG using the historical results of operations and historical bases of the assets and liabilities of the DSPG business that it comprises. The consolidated financial statements reflect the assets, liabilities, results of operations, changes in stockholders' equity and related company investment, and cash flows (the Company's Business) as if CEVA had been a separate entity for all periods presented. Unless otherwise indicated, the financial information in this annual report includes the results of the business of Parthus Technologies plc only for the period following the combination on November 1, 2002.

Our website address is [www.ceva-dsp.com](http://www.ceva-dsp.com). Copies of our filings with the Securities and Exchange Commission (SEC) are made available on our website as soon as practicable after filing and are also available at the SEC's website, [www.sec.gov](http://www.sec.gov).



## PART I

### ITEM 1. BUSINESS

#### Company Overview

Headquartered in San Jose, California, CEVA Inc., is one of the world's leading licensors of Digital Signal Processor (DSP) cores and related application solutions to the semiconductor and electronics industry. For more than ten years, CEVA has been licensing DSP cores and application-specific intellectual property (IP) to leading semiconductor and electronics companies worldwide.

We design and license high performance, low-cost, power-efficient embedded DSP cores and integrated application solutions. We license our technology as Intellectual Property (IP) to leading electronics companies, which in turn manufacture, market and sell DSP application specific integrated circuits (ASICs) and application specific standard products (ASSPs) based on CEVA technology to systems companies for incorporation into a wide variety of end products. Our IP is primarily deployed in high volume wireless (e.g. cellular baseband and application solutions), portable consumer multimedia (e.g. portable digital players), consumer home multimedia (e.g. DVD systems, gaming consoles), storage markets (e.g. hard disk drive), and communication markets (e.g. serial comms).

Our business model is IP licensing and per-unit royalty. We have created a strong franchise of licensing partners who rely on our technology to deploy their silicon solutions. Today our technologies are widely licensed and power some of the world's leading wireless and consumer electronics brands including Atmel, Broadcom, Cirrus Logic, Creative, Eonex, Fujitsu, Hitachi, Infineon Technologies, Kawasaki, LG, LSI Logic, Maxim, Mitsubishi, Motorola, National Semiconductor, NEC, nVidia, Ningo Bird, Oki, Panasonic, Philips Semiconductors, Renesas, Samsung, Seiko-Epson, Sharp Microelectronics, Siemens, Sony, Sony-Ericsson, STMicroelectronics, UMC and Zoran. In 2004 our licensees shipped 106 million silicon devices that had our IP embedded, an increase of 94% over 2003 shipments of 55 million units.

CEVA was created through the merger of the DSP IP licensing division of DSP Group and Parthus Technologies plc in November 2002. We have 227 employees worldwide, with research and development facilities in Ireland, Israel and the United Kingdom, and sales and support offices throughout Europe, Israel, Asia and the United States. CEVA is traded on both the NASDAQ (CEVA) and London Stock Exchange (CVA).

#### Industry Background

##### *Digital Signal Processor Cores*

Digital Signal Processing is one of the fastest-growing sectors of the semiconductor industry. DSP is fundamental to all communication (wireless, broadband, Voice over Internet Protocol (VoIP)), and to all digital multimedia processing (audio, video, image). DSPs use complex algorithms and signal-compression techniques to provide real-time, power-efficient processing of real-world analog signals that have been converted into digital form. For example in wireless, DSP converts an analog signal, such as the human voice, to digital form. DSPs power the communication and multimedia functions of a wide array of devices, including the baseband modems of cellular phones, the digital encode and decode of digital multimedia signals for devices such as portfolio audio/video players,



digital still cameras, digital camcorders, digital DVDs/DVRs, HDTVs, set-top boxes, and the hard disk drives used for PC s and consumer electronic devices.

As the number of electronic devices that require the processing of digital data has grown, so has the demand for reliable and ever more sophisticated DSP cores and associated technology built around them. In 2005 Forward concepts estimated total DSP semiconductor shipments to have grown year-over-year by 27% from \$6.3 billion to a total of \$7.8 billion.

*Semiconductor Intellectual Property (SIP)*

The demand for wireless devices and multimedia applications has grown substantially in recent years. As consumers demand electronic products with more connectivity, portability and capability, system OEM companies which manufacture these products are demanding embedded DSPs that support increasingly complex functions at low cost, that use power efficiently, that can be rapidly implemented to shorten time-to-market, and that are available in volume from multiple sources.

Integrated circuit (IC) design teams face ever growing pressure to make products smaller, more reliable, less expensive, with greater features and performance, all in the face of decreasing product life cycles, and

constrained battery power. While semiconductor manufacturing processes have advanced significantly to allow a substantial increase in the number of circuits placed on a single chip, design capabilities resources have not kept pace with the advances in this technology resulting in a growing design gap between their increasing manufacturing potential and restrained design capabilities.

To address this design gap, many semiconductor designers and manufacturers are increasingly choosing to license proven intellectual property (IP), such as processor cores, memory and application-specific logic, from third party Semiconductor Intellectual Property (SIP) companies rather than to develop those technologies internally. The SIP industry is a relatively new and emerging trend in the market. Gartner-Dataquest, a market research firm, reports that the market for semiconductor intellectual property was forecast to be worth \$1 billion in 2003.

### **CEVA Solution**

CEVA addresses the requirements of the embedded communications and multimedia markets by designing and licensing programmable DSP cores, system platform, software and system solutions tools which enable the rapid design of embedded DSP and application specific solutions for use across a wide variety of applications. Our solution includes a family of programmable DSP cores with a range of cost, power-efficiency and performance points; associated system-on-chip (SoC) system platform (the essential SoC hardware and software infrastructure integrated with the core); and a portfolio of complete system-solutions in the areas of video processing, audio processing, speech processing, GPS location, VoIP communications and Bluetooth communications. Our services division assists our customers in the deployment of their CEVA based solutions.

Given the complexity of applications for DSP, there is increasing industry demand to license complete solutions that integrate the DSP core, the associated SoC infrastructure and the particular application logic and software as it is usually not cost-effective for most semiconductor companies and designers to develop the technology in-house. Therefore, companies increasingly rely on licensing other intellectual property, such as DSP cores, from third parties.

### **IP Business Model**

Our objective is that our DSP core becomes the global standard in the embedded DSP market. To enable this goal, we have and continue to license on a worldwide basis to semiconductor and system OEM companies that design, manufacture and source CEVA based silicon solutions combined with their own differentiating technology. We believe our business model offers us some key advantages. By not focusing on manufacturing or selling of silicon products, we are free to widely license our technology, and free to focus most of our resources on R&D and next generation DSP technologies. By choosing to license the programmable DSP core, manufacturers can achieve the advantage of creating their own differentiated solutions, and develop their own unique product roadmaps. Through our extensive licensing, we have established a worldwide community developing CEVA based solutions, and therefore we

can leverage their strengths, customer relationships, proprietary technology advantages, and existing sales and marketing infrastructure. In addition, as our intellectual property is widely licensed and deployed, system OEM companies can obtain CEVA based chips from a wide range of suppliers, thus reducing dependence on any one supplier, fostering price competition which thereby helps contain the cost of CEVA based products.

We operate a licensing and royalty business model. We typically charge a license fee for access to our technology, and a royalty fee for each unit of silicon which incorporates our technology. License fees are invoiced in accordance with contract terms. Royalties are invoiced one quarter in arrears and are generally a percentage of the sales price of the CEVA based silicon product.

CEVA licenses IP to semiconductors who develop and market system-on-chip solutions with embedded DSP cores. According to Forward Concepts, an independent research company, this end silicon market of DSP solutions was worth \$7.9 billion on a worldwide basis in 2004, and achieved almost 30% growth over 2003.

## Strategy

We believe that the growth in DSP based solutions will drive demand for our technology. We believe that the growing complexity of applications will drive demand for licensing of more powerful and sophisticated cores and solutions to meet the demands of smart, digital connected devices. We also believe that the increased cost, complexity and time-to-market pressures of modern DSP applications, have led companies to license completed system solutions rather than just the core. As CEVA offers expertise in DSP cores combined with integrated system-solutions, we believe we are well positioned to take full advantage of these major industry shifts. To do so we intend to:

***Continue to develop sophisticated cores and SoC platforms.*** We seek to enhance our existing family of DSP cores and SoC platforms with additional features, performance and capabilities.

***Provide an integrated system-solution.*** We seek to offer integrated IP solutions which combine application specific software and dedicated logic such as video processing or GPS - built around our DSP cores, and delivered to our licensing partners as a complete and verified system solution.

***Provide an integrated, open-standard solution*** We seek to offer integrated IP solutions which combine application specific software and logic such as video processing or GPS - built around our DSP cores which further reduces the cost, risk and time-to-market for our licensing partners.

***Capitalize on our relationships and leadership.*** We seek to expand our worldwide community of semiconductor and system OEM licensees who are developing CEVA based solutions.

***Capitalize on our IP licensing and royalty business model*** We seek to maximize the advantages of our IP model which we believe is the best vehicle for pervasive adoption of our technology. Furthermore, by not having to focus on manufacturing or selling of silicon products, we are free to focus most of our resources on Research and Development.



## Products

We are one of the world's leading licensors of DSP cores and related application solutions. We offer a comprehensive family of programmable DSP cores; associated SoC system platform (the essential SoC hardware and software infrastructure integrated with the core); and a portfolio of complete system-solutions in the areas of video processing, audio processing, speech processing, GPS location, VoIP communications and Bluetooth communications. Our services division assists our customers in the deployment of their CEVA based solutions.

The diagram below illustrates how our portfolio of cores, system-platforms and systems-solutions integrate into a typical system-on-chip.

<b>Product</b>	<b>Description</b>	<b>Market</b>
<i>CEVA DSP Cores</i>		
CEVA-X	16/32 bit VLIW core	2.5G/3G Wireless, portfolio and home multimedia

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CEVA-Teak	16 bit DSP dual MAC core	2.5G wireless, portable multimedia
CEVA-TeakLite-II	16 bit DSP single MAC core	2.5G wireless, portfolio audio, storage
<b><i>CEVA System-Platforms</i></b>		
Xpert-Tools	Compiler, debugger, API/bios, middleware	All CEVA DSPs
CEVA-XS1100	CEVA-X based system-on-chip platform	Wireless Modems
CEVA-XS1200	CEVA-X based system-on-chip platform	Multimedia
Xpert-Teak	CEVA-Teak based system-on chip solution	2.5G wireless, portable multimedia
Xpert-Creator	Standard software framework for plug and play software applications with CEVA DSPs	All CEVA DSPs
<b><i>CEVA Solutions</i></b>		
CEVA SATA	Serial ATA high-speed communications	Storage
CEVA Blue	Bluetooth communications solution	Wireless, portable consumer multimedia
CEVA GPS	Low signal GPS solution	Wireless, automotive, telematics
CEVA Mobile-Multimedia	Video and audio encode/decode software	2.5/3G Wireless, portfolio multimedia devices
CEVA VoIP	Voice Over Internet Protocol	Communications
CEVA Services	IP Integration Services	CEVA IP licensees

## ***CEVA DSP Cores***

We market a family of synthesizable programmable DSP cores, each delivering a different balance of performance, power dissipation and cost, allowing customers to select a core ideally suited to their target application. The ability to match processing power to the application is an important consideration when designers select a DSP supplier. Our family of cores is largely software compatible meaning that software from one core can be applied to another which significantly reduces investment in code development, tools and designer training.

Our current portfolio of programmable DSP cores includes:

***CEVA-X.*** CEVA-X is a scalable VLIW-SIMD DSP architecture delivering very high levels of performance at low power consumption. Uniquely, CEVA-X is designed as a multipurpose architecture allowing multiple cores with the optimal performance/price/power point requirements to multiple markets such as 2.5G/3G multimedia phones, PDAs, digital cameras and camcorders, DTV and HD-DVD. Combined with CEVA-X's extendibility the architecture can be configured to either high-performance environments or low-power environments; its performance the architecture is ranked by independent benchmarks as the fastest DSP core currently available for license. CEVA-X enables licensees to efficiently develop software using high-level languages such as C and C++ which reduces the cost of development.

CEVA-X1620, the first implementation of the CEVA-X architecture family, is a 16-bit data width, dual MAC DSP with four 40-bit arithmetic units. Demonstration CEVA-X1620 silicon runs at 550MHz (TSMC 0.13μ). CEVA-X1620 is complemented by a Development Platform and Software Development Kit (SDK). All components of CEVA-X tools are developed in-house by CEVA to deliver optimal performance.

***CEVA-Teak.*** CEVA-Teak is a 16-bit fixed-point general-purpose DSP core. Its dual MAC architecture features high-performance and bandwidth for complex signal processing implementations. The core is designed for portable multimedia and wireless communication markets.

***CEVA-TeakLite-II.*** CEVA-TeakLite-II, a single Multiply-Accumulate (MAC) 16-bit fixed point DSP core. The core extends the architecture of CEVA-TeakLite and CEVA-Oak, the most established and successful DSP cores to date in CEVA's DSP family. TeakLite-II achieves a 30% increase in performance compared to its predecessor core, and delivers superior code compactness in a small silicon die size. CEVA-TeakLite-II is positioned to meet high volume, but very cost sensitive markets such as 2G/2.5G Wireless Handsets, Portable Media Players, Hard Disks, Optical Drivers, and Digital Cordless Phones. TeakLite-II is fully compatible to both CEVA-TeakLite and CEVA-Oak DSPs at assembly and binary levels which reduces our customers software development costs.

We deliver our technology in two ways either in the form of a mask-level chip layout (called a hard core), or in the form of a hardware description language definition in Verilog or VHDL (called a soft core or a synthesizable core). All CEVA DSP cores are soft cores that can be manufactured on any process, and all are accompanied by a complete set of tools and an integrated development environment. An extensive third-party network supports CEVA DSP cores with a wide range of software and application IP. In addition, we provide the necessary Development Boards, Software Development Toolkits and Software debug tools, which facilitate system design, debug and software



development.

***CEVA SoC Platforms***

Designers today face escalating design costs and design timelines combined with ever decreasing probability of right-first-time silicon. To further reduce the cost, complexity and associated risk in bringing products to market, we have introduced a range of system platforms which combine many hardware and software elements which are essential to SoC s deploying CEVA DSP cores. Our system platforms are comprised of:

**Hardware Infrastructure** multipurpose DSP sub-systems that integrate a CEVA DSP core, related peripherals and system interfaces such as on-chip data and program memories, high-performance DMA controller, Buffered Time Division Multiplexing Port (BTDMP), high-throughput Host Processor Interface (HPI), and other interfaces.

**Software Environment** Xpert-Creator software framework eases the integration burden by providing a software development environment and software framework for plug-and-play algorithm integration into multi-tasking solutions such as those demanded by wireless and media processing.

Our family currently includes three SoC platforms:

CEVA-X System1100 is a low-cost platform optimized for wireless and general purpose DSP solutions and includes the following main features; sophisticated power management unit for dynamic low-power consumption; complete set of hardware peripherals extendible through Advanced Peripheral Bus (APB); host controller connectivity through Advanced High Performance Bus (AHB) compliant bridges; two level memory architecture enabling shared memory between CEVA DSP and ARM cores, and code replacement unit enabling on-the-fly firmware program bypasses.

CEVA-X System1200 integrates additional features to enhance the system processing power for applications such as digital multimedia devices and includes programmable and configurable 3-D DMA co-processor; tightly coupled hardware accelerators to integrate customers own extensions; flexible and glue-less interface TDM and SPI ports for streaming audio samples.

Xpert-Teak is a complete DSP subsystem for low-power, low-cost SoC designs targeted at applications such as wireless baseband and portfolio multimedia markets. Xpert-Teak includes multiple hardware peripherals and incorporates on-chip data and program memories, high-performance DMA controller, Buffered Time Division Multiplexing Port (BTDM), high-throughput Host Processor Interface (HPI), and other interfaces.

### ***CEVA Solutions***

CEVA Solutions consist of a family of application specific full system solutions. System solutions typically integrate a CEVA DSP core, hardware subsystem and application specific (e.g. video processing) software and logic. Our family of system-solutions spans multimedia (audio, video, image), location (GPS), communication (VoIP), connectivity (Bluetooth), and high-speed serial communications (SATA). Our system solutions fundamentally reduce the complexity, cost of ownership, and time-to-market for products. As a result, we capture a higher license fee for our system solutions.

**CEVA-Bluetooth**, solution delivers a complete and compliant Bluetooth v1.2 solution, integrating baseband, DSP processor, RAM, ROM and complete host controller software stack. Xpert-Blue licensees benefit from rapid time-to-certification and time-to-market for Bluetooth enabled products.

**CEVA Mobile-Media**, a software-programmable audio, video and image solution that supports all key standards for mobile multimedia applications for next generation cell phones and portfolio digital multimedia devices. The solution

integrates CEVA's DSPs (CEVA-Teak™ or CEVA-X™), the associated DSP system platforms, a media software framework and a complete suite of video (H.264 and MPEG4, decode/encode), audio (MP3, WMA, aacPlus and various voice codes) and imaging libraries. Programmable for a wide range of multimedia standards, resolutions and frame rates, the solution allows licensees to retarget a single silicon platform for any multimedia processing requirements, thus negating the need for costly, time-consuming silicon re-spins.

**CEVA Mobile-Media** is powered by the MediaMagic technology which is a range of CEVA patented innovations that by up to a factor of 10, reduces the computational power needed to run multimedia applications. MediaMagic includes algorithmic accelerators that use pattern recognition techniques, more than 30 dedicated multimedia DSP instructions, and a high performance 3-D DMA co-processor designed for multimedia parallel processing. MediaMagic is the industry's first media acceleration technology that achieves performance levels in software previously only achievable in a hardwired implementation.

**CEVA-GPS**, a complete GPS platform delivering precise location information (less than five meters within five seconds) to any device, including mobile phones, personal digital assistants (PDAs) and GPS-enabled vehicles, anywhere in the world. The highly integrated solution incorporates GPS logic and GPS software stacks. The solution supports all cellular air interfaces standards (CDMA, GSM/GPRS/EDGE, WCDMA/UMTS, Flash OFDM).

**CEVA-VoIP**, is a complete Voice-over-Internet-Protocol (VoIP) solution targeted at the residential and enterprise telecom markets. The solution is based on Xpert-Teak, which integrates added hardware peripherals capable of handling multiple, simultaneous, packet-voice channels on a single chip, and software, such as speech compression and decompression, echo cancellation, and associated telephone-signaling functions.

**CEVA-SATA**, a complete, verified Serial ATA licensable solution combining a SATA 1.5Gbps PHY or SATA 3.0Gbps PHY with a Link/Transport/Command Protocol stack, and is fully compliant to the Serial ATA Revision 1.0a specification. The SATA PHY is supplied in the form of a GDSII hard macro with simulation models and physical views. The SATA Protocol (PHY Control, Link, Transport and Command/DMA layers) is delivered in the form of an RTL package, and supported by a comprehensive test bench environment plus physical design scripts for realization on the target semiconductor processes.

### **CEVA Services**

CEVA Services is the consulting and integration division of CEVA that helps customers move efficiently and effectively from IP to silicon and provides maintenance and support. Exploiting our unique knowledge in signal processing and communications our services division helps to reduce the cost and time-to-market for customers advanced SoC solutions for wireless, digital multimedia, communications and storage markets. Hard IP is the incorporation of intellectual property into reference designs (either as silicon chips or printed circuit boards).

### **End Markets**

We target our portfolio of cores, platforms and solutions at five principal markets:

**Cellular:** The cellular handset market is currently the largest market for DSP cores technology. Cellular telephones use DSP cores for voice compression, by which the human voice is compressed after being digitized, and channel coding, by which DSP techniques are used to encode the information. Our DSP cores are currently used in all types of digital cellular telephones, and we believe they will continue to be used in the next generations of cellular telephones (2.5G and 3G). Many of these next-generation phones incorporate GPS, Bluetooth, video, audio and data features in addition to voice, extending the market for our technologies.

**Consumer Portable Multimedia:** Portable consumer electronics constitute the fastest-growing market for DSP cores technology. Devices such as digital audio players, digital video consoles, digital still cameras, digital cameras, and GPS receivers, all require DSP for their high fidelity audio, video and image processing.

**Consumer Home Multimedia:** The next shift from analog to digital based technology is home entertainment the growth of DVDs, DVRs, Set-top boxes, HDTV and gaming consoles drives the demand for highly advanced signal

processing of audio, video, image and security (encryption and digital rights management).

**Storage:** Storage is one of the electronics industry's fastest growing markets and spans both the serial interface standards to memory (SATA, SAS, SGMII), and the DSP powered disk drive controller chip controls the mechanism that reads and writes data from a memory disk platter.

**Wireline Communications:** The growth of broadband Internet has driven a range of new communication standards including digital subscriber line (DSL) technology; VoIP, video-over-IP, and new serial communication standards such as SATA, SAS and SGMII. DSP technology and serial communications is a key element to these technologies.

## **Customers**

We have licensed our cores, platforms and solutions to leading semiconductor companies throughout the world. These companies incorporate our IP into application-specific chips or custom-designed chips that they manufacture, market and sell to original equipment manufacturers (OEMs) of a variety of electronic products. We also license our cores and application IP to OEMs directly. Included among our licensees are the following customers; Atmel, Broadcom, Cirrus Logic, Eonex, Fujitsu, Hitachi, Infineon Technologies, Kawasaki, LSI Logic, Maxim, Mitsubishi, Motorola, National Semiconductor, NEC, nVidia, Oki, Philips Semiconductors, Renesas, Samsung, Seiko-Epson, Sharp Microelectronics, Sony, STMicroelectronics, UMC and Zoran. The majority of our licenses have royalty components, of which 15 were producing royalty revenues at the end of 2004. One customer accounted for 12% of our total revenues in 2004. The identity of our greater-than-10% customers varies from

period-to-period, and we do not believe that we are materially dependent on any one or any small number of licensees. Information on the geographic breakdown of our revenues is contained in note 8 to our consolidated financial statements, which appear elsewhere in this annual report.

## **Sales and Marketing**

We license our technology through a direct sales force. As of December 31, 2004, we had 21 employees in sales and marketing. We have sales offices and representation in 13 locations worldwide.

Maintaining close relationships with our customers is a central part of our strategy. We typically launch each new core, platform or solution upgrade with a signed license agreement with a blue-chip customer, which helps ensure that we are clearly focused on viable applications that meet broad industry needs. Staying close to our customers and strengthening these relationships is a significant part of our strategy. It allows us to create a roadmap for the future development of existing cores and application IP, and it helps us to anticipate the next potential applications for the market. We seek to use these relationships to deliver new products in a faster time to market.

We use a variety of marketing initiatives to stimulate demand and brand awareness in our target markets. These marketing efforts include contacts with industry analysts, presenting at key industry trade shows and conferences, distributing global press releases, organizing customer seminars, posting information on our website, issuing periodic newsletters and producing marketing materials. Our marketing group runs competitive benchmarking analyses to help us maintain our competitive position.

## **Technical Support**

We offer technical support services through our offices in Israel, Ireland, the United Kingdom and the United States. Our distributors in Asia also maintain engineers who provide technical support services for our products. Our technical support services include:

assistance with implementation, responding to customer-specific inquiries, training and, when and if they become available, distributing updates and upgrades of our products;

application support, consisting of providing general hardware and software design examples, ready-to-use software modules and guidelines to our licensees to assist them in using our technology; and

design services, consisting of creating customer-specific implementations of our DSP cores and application IP offerings.

We believe that our technical support services are key factors in our licensees' ability to embed our cores and application IP in their designs and products. Our technology is highly complex, combining sophisticated DSP cores architecture, integrated circuit designs and development tools. Effective customer support is critical in helping our customers to implement our solutions and helps to shorten the time to market for their applications. Our support organization is made up of experienced engineers and professional support personnel. We conduct detailed technical training for our licensees and their customers and meet with them on a regular basis to closely track the implementation of our technology.

## **Research and Development**

Our research and development team is focused on improving and enhancing our existing products as well as developing new products to broaden our offering and market opportunity. These efforts are largely driven by current and anticipated customer needs.

Our research and development and customer technical support teams consist of 170 engineers working in six development centers located in Israel, Ireland, and the United Kingdom. This team consists of engineers who possess significant experience in developing DSP cores and solutions. In addition, we engage third party contractors with specialized skills sets as required to support our research and development. Our research and development expenses, net of related research grants, were in excess of \$17 million in 2003 and 2004, and \$8.4 million in 2002.

We encourage our research and development personnel to maintain active roles in the various international organizations that develop and maintain standards in the electronics and related industries. This involvement allows us to influence the development of new standards; keeps us informed as to important new developments regarding

standards; and allows us to demonstrate our expertise to existing and potential customers who also participate in these standards-setting bodies.

## **Competition**

The markets in which we operate are intensely competitive. They are subject to rapid change and are significantly affected by new product introductions. We compete with other suppliers of licensed DSP cores and solutions. We believe that the principal competitive elements in our field are processor performance, overall system cost, power consumption, flexibility, reliability, software availability, ease of implementation, customer support and reputation gained in over 10 years of successful DSP deployment. We believe that we compete effectively in each of these areas, but can offer no assurance that we will have the financial resources, technical expertise, and marketing or support capabilities to compete successfully in the future.

The market is dominated by large, fully integrated semiconductor companies that have significant brand recognition, a large installed base and a large network of support and field application engineers. We face direct and indirect competition from:

intellectual property vendors that offer programmable DSP cores;

intellectual property vendors of general purpose processors with DSP extensions;

internal design groups of large chip companies that develop proprietary DSP solutions for their own application-specific chips; and

semiconductor companies that offer off-the-shelf programmable DSP chips.



We face direct competition mainly from various private intellectual property companies such as StarCore, a venture formed by Infineon Technologies, Agere Systems and Motorola. In addition, some large chip manufacturing companies such as ZSP, a division of LSI Logic, make their proprietary DSP technology available for license to create a second source for their technology.

In recent years, we have also faced competition from companies that offer microcontroller/microprocessor intellectual property. These companies' products are used for control and system functions in various applications, including personal digital assistants and video games. Embedded systems typically incorporate both microprocessors responsible for system management and a programmable DSP that is responsible for communication and video/audio/voice compression. Recently, companies such as ARC, ARM Holdings, and MIPS, have added a DSP extension to their products in addition to the microcontroller functions, which may successfully compete with our designs in applications that involve low-to-moderate DSP performance requirements.

With respect to certain large potential customers, we also compete with internal engineering teams, which may design programmable DSP core products in-house. These companies, which include Fujitsu, NEC and Philips, both license our designs for some applications and use their own proprietary cores for other applications. In the future, such companies may also choose to license their proprietary DSP cores to third parties and, as a result, become direct competitors.

We also compete indirectly with several general-purpose semiconductor companies, such as Agere Systems, Analog Devices, Motorola and Texas Instruments. OEMs may prefer to buy general-purpose chips from large, established semiconductor companies rather than license our products. In addition, these companies are major competitors of many of the semiconductor companies that license our technologies. It is also possible that in the future these companies may choose to license their proprietary DSP cores to third parties and compete directly with us.

Aside from the in-house research and development groups, we do not compete with any individual company across the range of our market offerings. Within particular market segments, however, we do face competition to a greater or lesser extent from other industry participants. For example, in the following specific areas we compete with the companies indicated:

in the Bluetooth technology area with NewLogic;

in the GPS market with SiRF, Snaptrack and Trimble; and

in the multimedia market with ARM and Hantro.

### **Proprietary Rights**

Our success and ability to compete are dependent on our ability to develop and maintain the proprietary aspects of our intellectual property and to operate without infringing the proprietary rights of others. We rely on a combination of patent, trademark, trade secret and copyright laws and contractual restrictions to protect the proprietary aspects of our technology. These legal protections afford only limited protection of our technology. We also seek to limit disclosure of our intellectual property and trade secrets by requiring employees and consultants with access to our proprietary information to execute confidentiality agreements with us and by restricting access to our source code and other intellectual property. Due to rapid technological change, we believe that factors such as the technological and creative skills of our personnel, new product developments and enhancements to existing products are more important than specific legal protections of our technology in establishing and maintaining a technology leadership position.

We have an active program to protect our proprietary technology through the filing of patents. Our patents relate to our DSP cores, DSP subsystems and Application IP technology. We hold 36 patents in the United States and 10 patents in the EMEA region with expiration dates between 2013 and 2023. We have 31 patent applications pending in the United States, 12 pending patent applications in the EMEA region and 7 pending patent applications in Asia.

We actively pursue foreign patent protection in other countries where we feel it is prudent to do so. Our policy is to apply for patents or for other appropriate statutory protection when we develop valuable new or improved technology. The status of patents involves complex legal and factual questions, and the breadth of claims allowed is uncertain. Accordingly, we cannot be assured that any patent application filed by us will result in a patent being issued, or that

our issued patents, and any patents that may be issued in the future, will afford adequate protection against competitors with similar technology; nor can we be assured that patents issued to us will not be infringed or that others will not design around our technology. In addition, the laws of certain countries in which our products are or may be developed, manufactured or sold may not protect our products and intellectual property rights to the same extent as the laws of the United States. We can provide no assurance that our pending patent applications or any future applications will be approved or will not be challenged by third parties, that any issued patents will effectively protect our technology, or that patents held by third parties will not have an adverse effect on our ability to do business.

The semiconductor industry is characterized by frequent litigation regarding patent and other intellectual property rights. Questions of infringement in the semiconductor field involve highly technical and subjective analyses. Litigation may in the future be necessary to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. We cannot assure you that we would be able to prevail in any such litigation, or be able to devote the financial resources required to bring such litigation to a successful conclusion.

In any potential dispute involving our patents or other intellectual property, our licensees could also become the targets of litigation. We are generally bound to indemnify licensees under the terms of our license agreements. Although our indemnification obligations are generally subject to a maximum amount, these obligations could nevertheless result in substantial expenses. In addition to the time and expense required for us to indemnify our licensees, a licensee's development, marketing and sale of products embodying our solutions could be severely disrupted or shut down as a result of litigation.

We also rely on trademark, copyright and trade secret laws to protect our intellectual property. We have applied for the registration in the United States of our trademark in the name CEVA and the related CEVA logo, and currently market our DSP cores and other technology offerings under this trademark.

## Employees

The table below presents the number of employees of CEVA as of December 31, 2004, by function and geographic location.

	<b>Number</b>
<b>Total employees</b>	<b>227</b>
<b>Function</b>	
Research and development	163
Sales and marketing	21
Technical support	7
Administration	36
<b>Location</b>	
Israel	93
Ireland	77
United Kingdom	23
United States	21
Elsewhere	13

Our employees are not represented by any collective bargaining agreements, and we have never experienced a work stoppage. We believe our employee relations are good.

A number of our employees are located in Israel. Certain provisions of Israeli law and of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations (the Israeli federation of employers organizations) apply to our Israeli employees.

In 2004, we finalized and adopted a new Code of Business Conduct and Ethics regarding the standards of conduct of our directors, officers and employees and the Code is available on our website at [www.ceva-dsp.com](http://www.ceva-dsp.com).

## **Corporate History**

Our company was incorporated in Delaware on November 22, 1999 under the name DSP Cores, Inc. It changed its name to ParthusCeva, Inc. in November 2002 and to CEVA, Inc. in December 2003. Further details are contained in item 7 - Business Overview.

## **Available Information**

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to reports pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are available, free of charge, on our website at [www.ceva-dsp.com](http://www.ceva-dsp.com), as soon as reasonably practicable after such reports are electronically filed with the Securities and Exchange Commission and are also available of the SEC's website at [www.sec.gov](http://www.sec.gov).

Our website and the information contained therein or connected thereto are not intended to be incorporated into this Annual Report on Form 10-K.

**ITEM 2. PROPERTIES**

Our headquarters are located in San Jose, California and we have principal offices in Herzeliya, Israel and Dublin, Ireland.

We lease land and buildings for our executive offices, engineering, sales, marketing, administrative and support operations and design centers. The following table summarizes information with respect to the principal facilities leased by us as of December 31, 2004:

<b>Location</b>	<b>Area (Sq. Feet)</b>	<b>Principal Activities</b>
San Jose, CA, U.S.	9,450	Headquarters; sales; marketing; administration
Herzeliya, Israel	15,800	Research and development; administration
Dublin, Ireland	26,600	Research and development; administration
Cork, Ireland	10,000	Research and development
Limerick, Ireland	4,000	Research and development
Belfast, Northern Ireland	2,600	Research and development
Daventry, England	2,120	Research and development

In connection with the re-alignment of our business described in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, we have reviewed and continue to evaluate our property needs and to consider appropriate steps to most efficiently house our operations. We have made provisions in our financial statements for the underutilized building operating lease obligations we anticipate. We believe that these facilities are suitable and adequate to meet our current operating needs.

**ITEM 3. LEGAL PROCEEDINGS**

From time to time, we are involved in litigation relating to claims arising out of our operations in the normal course of business. We are not a party to any legal proceedings, the adverse outcome of which, in management's opinion, would have a material adverse effect on our results of operations or financial position.

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

None.

## EXECUTIVE OFFICERS OF THE REGISTRANT

Below are the names, ages and principal recent business experience of our current executive officers as of March 2, 2005. All such persons have been appointed by our board of directors to serve until their successors are appointed and qualified or until their earlier resignation or removal.

*Chester J. Silvestri*, age 56, has served as our Chief Executive Officer and President and as a member of our Board of Directors since June 2003 and as Chairman of our Board of Directors since February 2004. Mr. Silvestri has more than 25 years experience in the semiconductor industry, beginning as a design engineer and progressing through R&D, marketing, sales and executive management positions. From January to May 2003, Mr. Silvestri was a private investor and previously, from 1999 to 2002, Mr. Silvestri held the position of CEO of Arcot Systems, a developer of credit card authentication software. Previously Mr. Silvestri held the position of chief operating officer of Tripath Technology, Inc., president of the Microelectronic Division of SUN Microsystems, Inc., and vice president and general manager of the Technology Licensing division of MIPS Computer Systems, Inc.

*Gideon Wertheizer*, age 48, has held various positions with CEVA since November 2002 and currently serves as our Executive Vice President, CEVA DSP Cores. Previously he served as our Executive Vice President Business Development & Chief Technology Officer, and as our Chief Executive Officer & President. Prior to joining us, Mr. Wertheizer was with DSP Group from 1990, ultimately as Executive Vice President of Intellectual Property.

*Christine Russell*, age 55, has served as our Chief Financial Officer, Treasurer and Secretary since October 2003. Ms. Russell has been a financial executive in technology businesses for more than 20 years, most recently from 1997 to 2003 as CFO of Persistence Software, Inc., a Nasdaq listed company. Previously, from 1995 to 1997 Ms. Russell was CFO of Cygnus Solutions (RedHat), a provider of development tools and platforms for embedded technologies, and served in various financial executive positions with Xerox for 8 years. Ms. Russell is a director and chair of the audit committee of Peak International, Ltd. Ms Russell also serves on the Ethics and Eligibility Committee of Financial Executives International, a professional group of over 15,000 CFOs, Controllers and Treasurers.

*Issachar Ohana*, age 39, has served as our Vice President, Worldwide Sales since November 2002. Prior to joining us, Mr. Ohana was with DSP Group beginning in August 1994 as a VLSI design engineer. He was appointed Project Manager of DSP Group's research and development in July 1995, Director of Core Licensing in August 1998, and Vice President Sales of the Core Licensing Division in May 2000.





**PART II****ITEM 5.****MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock began trading on The NASDAQ National Market and the London Stock Exchange on November 1, 2002. Our common stock currently trades under the ticker symbol **CEVA** on NASDAQ and under the ticker symbol **CVA** on the London Stock Exchange. As of March 25, 2005, there were 8,643 holders on record of our common stock, some of whom are holders in nominee name for the benefit of different shareholders. The closing price of our common stock on The NASDAQ National Market on March 24, 2005 was \$7.54 per share. The following table sets forth, for the periods indicated, the range of high and low closing prices per share of our common stock, as reported on The NASDAQ National Market.

	<b>Price Range of Common Stock</b>	
	<b>High</b>	<b>Low</b>
<b>2002</b>		
Fourth Quarter (from November 1)	\$ 7.01	\$ 4.47
<b>2003</b>		
First Quarter	\$ 5.89	\$ 2.95
Second Quarter	\$ 8.18	\$ 3.18
Third Quarter	\$ 10.23	\$ 7.37
Fourth Quarter	\$ 10.41	\$ 7.37
<b>2004</b>		
First Quarter	\$ 11.83	\$ 8.64
Second Quarter	\$ 10.01	\$ 7.72
Third Quarter	\$ 8.44	\$ 6.65
Fourth Quarter	\$ 9.11	\$ 7.50

We have never paid any cash dividends. We intend to retain future earnings, if any, to fund the development and growth of our business and currently do not anticipate paying cash dividends in the foreseeable future.

Information as of December 31, 2004 regarding options granted under our option plans and remaining available for issuance under those plans is contained in the definitive 2005 Proxy Statement and incorporated herein by reference.

**2005 Annual Meeting of Stockholders**

We anticipate that the 2005 annual meeting of our stockholders will be held on May 9, 2005.

**ITEM 6. SELECTED FINANCIAL DATA**

CEVA was formed through the combination of Parthus Technologies plc and CEVA in November 2002. Prior to that date, our DSP cores licensing business was part of DSP Group, Inc. With respect to periods prior to November 1, 2002, the financial data below have been prepared as if the separation of this business had been in effect throughout the relevant periods. The financial statements show this business as an entity carved out from the consolidated financial statements of DSP Group using the historical results of operations and historical bases of assets and liabilities of this business, as described in note 1 to our financial statements, which appear elsewhere in this Annual Report. The financial data below include the results of the business of Parthus Technologies plc only for the period following the combination on November 1, 2002.

The following selected financial data should be read in conjunction with, and are qualified by reference to, our consolidated financial statements and the related notes, as well as our Management's Discussion and Analysis of Financial Condition and Results of Operations, both appearing elsewhere in this Annual Report.

	<b>Year Ended December 31,</b>				
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
	<b>(in thousands)</b>				
<b>Consolidated Statements of Operations Data:</b>					
Revenues:					
Licensing and royalties	\$ 19,951	\$ 20,959	\$ 14,739	\$ 29,795	\$ 32,271
Other revenue	2,959	4,285	4,457	7,041	5,402
Total revenues	22,910	25,244	19,196	36,836	37,673
Cost of revenues	410	1,251	2,168	6,061	5,178
Gross profit	22,500	23,993	17,028	30,775	32,495
Operating expenses:					
Research and development, net	4,835	5,095	8,414	17,382	17,276
Sales and marketing	2,466	2,911	3,356	6,058	6,965
General and administrative	2,810	2,839	3,557	6,109	5,863
Amortization of intangible assets			189	1,127	892
In-process research and development			15,771		
Reorganization, restructuring and severance charge			6,442	8,620	
Impairment of assets				3,233	
Total operating expenses	10,111	10,845	37,729	42,529	30,996
Operating income (loss)	12,389	13,148	(20,701 )	(11,754 )	1,499

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Other income (expense), net	322	462	(207 )	63	796
Income (loss) before taxes on income	12,711	13,610	(20,908 )	(11,691 )	2,295
Taxes on income	3,438	3,255	1,014	300	645
Net income (loss)	\$ 9,273	\$ 10,355	\$ (21,922 )	\$ (11,991 )	\$ 1,650
Basic and diluted net income (loss) per share	\$ 1.03	\$ 1.15	\$ (2.15 )	\$ (0.66 )	\$ 0.09

	2000	2001	December 31, 2002 (in thousands)	2003	2004
<b>Consolidated Balance Sheet Data</b>					
Working capital	\$ 411	\$ 1,996	\$ 58,318	\$ 53,440	\$ 57,960
Total assets	9,615	12,197	135,182	119,433	119,163
Total stockholders equity	2,020	4,345	110,072	98,479	102,549

**ITEM 7.**

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

*You should read the following discussion together with the consolidated financial statements and related notes appearing elsewhere in this annual report. This discussion contains forward-looking statements that involve risks and uncertainties. Actual results may differ materially from those included in such forward-looking statements. Factors that could cause actual results to differ materially include those set forth under "Factors That Could Affect Our Operating Results", as well as those otherwise discussed in this section and elsewhere in this annual report. See "Forward-Looking Statements and Industry Data".*

**BUSINESS OVERVIEW**

CEVA, Inc. is the leading licensor of Digital Signal Processor (DSP) intellectual property and related technologies. We design, develop and support DSP cores and integrated application solutions that power wireless and digital multimedia products such as cellular phones, music players, digital television and personal digital assistants. Licensees of CEVA technology either source chips for these devices and applications from foundries or manufacture them in-house. We include among our customers more than 100 semiconductor and electronic equipment companies, including many of the world's leading companies in these fields.

We believe that our industry is moving towards open-standard DSP cores and away from traditional proprietary solutions. We also believe that increased semiconductor product complexity and demands for reduced time-to-market have led more companies to decide to license complete application IP solutions, rather than licensing individual components from multiple suppliers. We combine expertise in DSP with integrated application IP solutions and therefore, we believe, we are well positioned to take full advantage of these major industry shifts. To do so we intend to:

***Continue to develop sophisticated cores and frameworks.*** We seek to maximize our expertise in DSP for wireless and multimedia technologies to address critical customer demands. In particular, we seek to enhance our existing DSP cores and application IP with additional features and performance, while developing new offerings that will focus on other emerging applications across the range of end markets we serve.

***Provide an integrated, open-standard solution.*** We seek to maximize the competitive advantage provided by our ability to offer an integrated IP solution such as multimedia IP built around our DSP processor core architectures.

***Focus on large and growing markets.*** We believe that our expertise in programmable DSP cores and application IP favorably positions us to target growing segments of the consumer electronics market, such as wireless communications, mobile computing, automotive electronics and consumer entertainment. We intend to strengthen our relationships and expand licensing and royalty arrangements with customers in those markets and to extend our customer base with key industry leaders within each of those areas. We also seek to strengthen relationships and expand licensing and royalty arrangements with our existing customers and to extend our customer base with key industry companies in order to facilitate the development of our technology.

### ***Corporate Background***

CEVA was formed through a spin-off of the DSP cores licensing business of DSP Group and its combination with Parthus Technologies plc (Parthus) in November 2002. At that time, (1) DSP Group contributed the DSP cores licensing business to CEVA, which was then its wholly owned subsidiary; (2) DSP Group distributed all of the existing common stock of CEVA to the stockholders of DSP Group; and (3) CEVA immediately thereafter combined with Parthus. These transactions are described in detail in the Report on Form 8-K of CEVA dated November 1, 2002, as amended.

With respect to periods prior to November 2002, the discussion below assumes that the separation of the DSP cores licensing business from DSP Group had been in effect throughout the relevant periods. Our financial statements for such periods show the DSP cores licensing business as an entity carved out from the consolidated financial statements of DSP Group using the historical results of operations and historical bases of assets and liabilities of this business, as described in note 1 to our financial statements included elsewhere in this annual report.

This information may not reflect what our financial position or results of operations actually would have been had we operated as a separate, stand-alone entity for such periods, and may not be indicative of our future financial position or results of operations. This discussion includes the results of the business of Parthus only for the period following the combination in November 2002.

## RESULTS OF OPERATIONS

The following table presents line items from our statement of operations as percentages of our total revenues for the periods indicated:

	<b>2002</b>	<b>2003</b>	<b>2004</b>
<b>Consolidated Statements of Operations Data:</b>			
Revenues:			
Licensing and royalties	76.8 %	80.9 %	85.7 %
Other revenue	23.2 %	19.1 %	14.3 %
Total revenues	100.0 %	100.0 %	100.0 %
Cost of revenues	11.3 %	16.5 %	13.7 %
Gross profit	88.7 %	83.5 %	86.3 %
Operating expenses:			
Research and development, net	43.8 %	47.2 %	45.9 %
Sales and marketing	17.5 %	16.4 %	18.5 %
General and administrative	18.4 %	16.6 %	15.6 %
Amortization of other intangible assets	1.0 %	3.0 %	2.3 %
In-process research and development	82.2 %		
Reorganization, restructuring and severance charge	33.6 %	23.4 %	
Impairment of assets		8.8 %	
Total operating expenses	196.5 %	115.4 %	82.3 %
Operating income (loss)	(107.8 )%	(31.9 )%	4.0 %
Other income (expense), net	(1.1 )%	0.2 %	2.1 %
Income (loss) before taxes on income	(108.9 )%	(31.7 )%	6.1 %
Taxes on income	(5.3 )%	(0.8 )%	(1.7 )%
Net income (loss)	(114.2 )%	(32.5 )%	4.4 %

## Discussion and Analysis



Below we provide information on the significant line items in our statement of operations for each of the past three fiscal years, including the percentage changes year-on-year, as well as an analysis of the principal drivers of change in these line items from year-to-year.

### **Revenues**

#### *Total Revenues*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Total revenues (in millions)	\$ 19.2	\$ 36.8	\$ 37.7
<i>Change year-on-year</i>		91.9 %	2.3 %

The increase in total revenues from 2003 to 2004 principally reflects a combination of higher licensing and royalty revenues from our DSP-centric IP, offset by the elimination of Hard IP and certain other non strategic IP revenues in 2004 following the decision in December 2003 to cease these manufacturing product lines.

The increase in total revenues from 2002 to 2003 reflected both increased licensing and royalty revenue and a full year of revenues from our design and consulting services and our Hard IP manufacturing product line following the combination with Parthus in November 2002. We ceased our Hard IP manufacturing product line and certain non-strategic technology areas in the fourth quarter of 2003 as part of our strategic realignment; we had recorded approximately \$1.0 million in revenue quarterly from these products in recent periods.

In 2004 and 2003 revenue from a separately identifiable customer accounted for 12% and 10% of total revenues, respectively. Revenues from two customers accounted for 13% and 11% of total revenues respectively in 2002. Because of the nature of our license agreements and the associated large initial payments due, the identity of major customers generally varies from quarter to quarter.

The Company and its subsidiaries (the Company) generate their revenues from licensing intellectual property, which in certain circumstances is modified to customer-specific requirements. Revenues from license fees that involve customization of the Company's IP to customer specifications are recognized in accordance with Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. The Company accounts for all of its other IP license revenues in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended.

The Company generates royalties from its licensing activities in two manners: royalties paid by our customers over the period in which they ship units which we refer to as per unit royalties and royalties which are paid in a lump sum which cover a fixed number of future unit shipments which we refer to as prepaid royalties. The prepaid royalties may be negotiated as part of an initial license agreement or may be subsequently negotiated with an existing licensee who has begun making unit shipments and has used up all of the prepayments covered in their initial license agreement. In the latter case, we negotiate an additional lump sum payment to cover a fixed number of additional future unit shipments. In either case, these prepaid royalties are non-refundable payments and are recognized upon invoicing for payment, provided that no future obligation exists. Prepaid royalties are recognized under our licensing revenue line and accounted for 19.1% of total revenue in 2004, compared to 6.5% of total revenue in 2003 and 17.6% of total revenue in 2002. All of the prepaid royalties recognized in 2004 were subsequently negotiated with existing prepaid licensees compared to 79% in 2003 and 57% in 2002. Only royalty revenue from customers who are paying as they ship units is recognized in our royalty revenue line. These per unit royalties are invoiced and recognized on a quarterly basis as we receive quarterly shipment reports from our licensees.

#### *Licensing and Royalty Revenues*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Licensing and royalty revenues (in millions)	\$ 14.7	\$ 29.8	\$ 32.3
<i>Change year-on-year</i>		102.2 %	8.3 %
<b><i>of which:</i></b>			
Licensing revenues (in millions)	\$ 12.3	\$ 25.7	\$ 26.3
<i>Change year-on-year</i>		109.2 %	2.0 %
Royalty revenues (in millions)	\$ 2.4	\$ 4.1	\$ 6.0
<i>Change year-on-year</i>		66.5 %	48.7 %

The increase in licensing revenue from 2003 to 2004 reflects increased revenues from our DSP-centric IP offset by lower revenues from our application solutions IP as we ceased certain non-strategic solutions IP following the strategic re-alignment of our operations in the fourth quarter of 2003. The strategic re-alignment allowed us to better focus on our key strengths, DSP cores and application specific full system solutions in 2004. The increase in licensing revenues from 2002 to 2003 reflected increased revenues from our DSP cores and application technologies reflecting the full year sales activity of the combined CEVA and Parthus businesses. Licensing and royalty revenues accounted

for 85.7% of our total revenues in 2004, compared with 80.9% and 76.8% of total revenues in 2003 and 2002, respectively. In 2004 we signed 24 new license agreements compared to 25 in 2003. Included in the license agreements in 2004 were five new licensees for our flagship CEVA X DSP technology compared to two in 2003. There were no new prepaid customers in 2004, compared to one new prepaid customer in 2003. Two significant existing prepaid customers extended their prepaid shipment threshold with additional advance payments in both 2004 and 2003.

The increase in royalty revenue from 2003 to 2004 was driven by increases in the underlying unit shipments of customers' products incorporating our IP. In particular licensees of our Ceva Teak and Teaklite cores continued to report increased unit shipments in 2.5G cellular and DVD Servo product areas. The increase in royalty revenues from 2002 to 2003 reflects increased unit shipments of our CEVA-Teak core by licensees in 2.5G cellular and DVD Servo product areas, offset to some extent by a decrease in the unit shipments of lower royalty-generating end-of-life 2G products.

We had 23 customers shipping units at December 31, 2004 compared with 25 at December 31, 2003 of which 15 customers were paying per unit royalty and 8 were in prepaid royalty at December 31, 2004 compared to 17 and 8 at December 31, 2003. In 2004 two customers commenced shipments while four customers ceased

shipping and one customer moved from prepaid volumes to per unit royalty during the year. Six customers, including those in prepaid royalty shipped in excess of 5 million units in 2004, compared to five customers in 2003 and three customers in 2002.

The five largest customers paying per unit royalty accounted for 67.2% of total royalty revenues in 2004 compared to 86.7% in 2003. In 2004 the average cents earned from customers paying per unit royalty was \$0.15 cents per unit compared to \$0.13 cents in 2003.

Both our per unit and prepaid royalty customers reported sales of 106.0 million chips incorporating our technology in 2004, compared with 54.7 million in 2003 and 81.1 million in 2002. The increase in units shipped in 2004 compared to 2003 reflects increased unit shipments of our CEVA-Teak core by licensees in 2.5G cellular and DVD Servo product areas. The decrease in units shipped in 2003 compared to 2002 reflects the reduction of shipments of 2G products in 2003 by one customer as it transitioned to 2.5G products, offset to some extent by increased unit shipments of 2.5G, cellular and DVD Servo products by other customers.

#### *Other Revenues*

Other revenues includes design and consulting services and maintenance and support for licensees.

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Other revenues (in millions)	\$ 4.5	\$ 7.0	\$ 5.4
<i>Change year-on-year</i>		58.0 %	(23.3) %

The decrease in other revenues in 2004 compared to 2003 principally reflects the elimination of Hard IP revenue following the decision in December 2003 to cease our Hard IP manufacturing product line.

The increase in other revenues from 2002 to 2003 was primarily due to revenues generated in design and consulting services and Hard IP manufacturing of \$3.5 million reflecting the full year sales activity of the combined CEVA and Parthus businesses.

#### *Geographic Revenue Analysis*

	<b>2002</b>		<b>2003</b>		<b>2004</b>	
	<b>(in millions, except percentages)</b>					
United States	\$ 7.2	37.6 %	\$ 17.4	47.2 %	\$ 11.2	29.5 %
Europe, Middle East, Africa	\$ 7.6	39.4 %	\$ 11.4	31.0 %	\$ 16.6	44.1 %
Asia	\$ 4.4	23.0 %	\$ 8.0	21.8 %	\$ 9.9	26.4 %

Due to the nature of our license agreements and the associated potential large individual contract amounts, the geographic split of revenues both in absolute and percentage terms generally varies from year to year.

Revenues increased in absolute and percentage terms in EMEA and Asia regions from 2003 to 2004, reflecting greater

sales activity and penetration in these markets. The decrease in revenues in absolute and percentage terms in the United States reflects a reduction in IP application solutions revenues as certain non-strategic solution technologies were ceased following the strategic re-alignment of our operations in the fourth quarter of 2003.

***Cost of Revenues***

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Cost of revenues (in millions)	\$ 2.2	\$ 6.1	\$ 5.2
<i>Change year-on-year</i>		179.6 %	(14.6 )%

Cost of revenues accounted for 13.7% of total revenues in 2004, compared with 16.5% in 2003 and 11.3% in 2002. The absolute and percentage decrease in cost of revenues in 2004 compared to 2003 reflects the shift in revenue mix with increased higher gross margin license and royalty revenue and no Hard IP revenue following the decision in December 2003 to cease our lower margin Hard IP manufacturing product line. Historically margins for Hard IP were below 50%.

The absolute and percentage increase in cost of revenues in 2003 compared to 2002 reflected the change in revenue mix following the combination with Parthus; the increase in cost of revenues as a percentage of total revenues was primarily due to a decrease in the portion of revenues derived from higher gross margin royalties.

Cost of revenues includes related labor costs and, where applicable related overhead and material costs.

### *Operating Expenses*

<u>(in millions)</u>	<b>2002</b>	<b>2003</b>	<b>2004</b>
Research and development, net	\$ 8.4	\$ 17.4	\$ 17.3
Sales and marketing	\$ 3.3	\$ 6.1	\$ 6.9
General and Administration	\$ 3.6	\$ 6.1	\$ 5.9
Amortization of intangible assets	\$ 0.2	\$ 1.1	\$ 0.9
In-process research and development	\$ 15.8	\$	\$
Reorganization, restructuring and severance charge	\$ 6.4	\$ 8.6	\$
Impairment of assets	\$	\$ 3.2	\$
Total operating expenses	\$ 37.7	\$ 42.5	\$ 31.0
<i>Change year-on-year</i>		12.7 %	(27.1 )%

Total operating expenses decreased in 2004 compared to 2003 principally as a result of restructuring and impairment charges incurred in 2003. There were no similar charges in 2004. The increase in operating expenses from 2002 to 2003 was a result of higher average numbers of staff, facility costs and depreciation charges together with additional sales and marketing and administrative costs throughout 2003 following the combination with Parthus, higher restructuring charges in 2003 offset by a one-time non-cash charge relating to in-process research and development incurred in 2002.

Reorganization, restructuring and severance charges totaled \$8.6 million in 2003 and \$6.4 million in 2002. These charges in 2003 resulted from the transition of our executive management team to San Jose, severance costs and employee-related liabilities, and provision for underutilized building operating lease obligations in connection with the re-alignment of our business in the fourth quarter of 2003. In addition, we incurred a restructuring charge of \$6.4 million representing primarily severance costs and provision for underutilized building operating lease obligations following a headcount reduction in November 2002. We review our assumptions and estimates quarterly to ensure that they are both valid and applicable given the underlying market conditions.

There was a non-cash charge for impairment of assets of \$3.2 million in 2003 and a non-cash charge of \$15.8 million in connection with the write-off of in-process research and development in 2002.

*Research and Development Expenses, Net*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Research and development expenses, net (in millions)	\$ 8.4	\$ 17.4	\$ 17.3
<i>Change year-on-year</i>		106.6 %	(0.6 )%

The net movement in research and development expenses in 2004 compared with 2003 primarily reflects lower research grants from the MAGNET programs of the Chief Scientist of Israel and under the RTI funding program of Enterprise Ireland offset by lower costs arising from the decision to exit certain non-strategic technology areas and the resulting reduction in headcount and facility requirements as a result of the realignment of the business in December 2003. The average number of research and development personnel in 2004 was 163 compared to 189 in 2003 and 83 in 2002. The number of research and development personnel was 170 at December 31, 2004, compared with 154 at year-end 2003 and 190 at year-end 2002.

Research and development expenses increased in 2003 from 2002 primarily reflecting higher labor and associated costs resulting from increased average headcount and increased investment in design tools and sub-contract design throughout 2003 and late 2002 following the combination with Parthus in November 2002.

Research and development expenses, net of related government grants, were 45.9% of total revenues in 2004, compared with 47.2% in 2003 and 43.8% in 2002. We recorded net research grants from the MAGNET programs of the Chief Scientist of Israel and under the RTI funding program of Enterprise Ireland of \$346,000 in 2004 compared with \$2.0 million in 2003 and \$869,000 in 2002. Grants received from the Chief Scientist of Israel may become refundable if certain revenues are achieved for products developed under the MAGNET programs.

Research and development expenses consist primarily of salaries and associated costs connected with the development of our intellectual property. Because technological feasibility is generally not established until all design, coding and testing activities are completed, we expense all development costs as incurred. Work that we perform to develop technology for customers on a fee-for-services basis is not included in research and development expenses; nevertheless, we generally retain the right to use intellectual property developed in this manner. Research and development expenses include payments that we make to third parties to license technology from them when we incorporate their technology into our intellectual property as part of our research and development activities. Research and development expenses are net of related government research grants. We view research and development as a principal strategic investment and have continued our commitment to invest heavily in this area, which represents the largest of our ongoing operating expenses.

#### *Sales and Marketing Expenses*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Sales and marketing expenses (in millions)	\$ 3.3	\$ 6.1	\$ 6.9
<i>Change year-on-year</i>		80.5 %	15.0 %

The increase in sales and marketing expenses in 2004 compared to 2003 principally reflects additional sales and marketing efforts in Asia and also increased activity relating to the flagship CEVA X - DSP architecture. Sales and marketing expenses as a percentage of total revenues were 18.5% in 2004, compared with 16.4% in 2003 and 17.5% in 2002. The total number of sales and marketing personnel was 21 at December 31, 2004, compared with 20 at year-end 2003 and 21 at year-end 2002. The average number of sales and marketing personnel was 20 in 2003 and 2004.

The increase in sales and marketing expenses from 2002 to 2003 was primarily due to an increase in the number of sales and marketing personnel throughout 2003 and the later part of 2002 to support our increased sales and marketing efforts following the combination with Parthus. The average number of sales and marketing personnel in 2003 was 20 compared with 14 in 2002.



Sales and marketing expenses consist of salaries, commissions, travel and other costs associated with sales and marketing activity, as well as advertising, trade show participation, public relations and other marketing costs.

*General and Administrative Expenses*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
General and administrative expenses (in millions)	\$ 3.6	\$ 6.1	\$ 5.9
<i>Change year-on-year</i>		71.7 %	(4.0) %

The net movement in general and administrative expenses in 2004 compared with 2003 primarily reflects lower employee related costs and lower facility and IT consumable costs as a result of the realignment of the business in December 2003 offset by increased professional fees arising from Sarbanes Oxley compliance work. The average number of general and administrative personnel throughout 2004 was 36 compared with 33 in 2003 and 13 in 2002. The total number of general and administrative personnel was 36 at December 31, 2004, compared with 32 at year-end 2003 and year-end 2002.

The increase in general and administrative expenses in 2003 compared with 2002 reflected increased facility costs throughout 2003 and the later part of 2002 following our combination with Parthus. General and administrative expenses consist primarily of salaries, information systems and technology infrastructure, facilities costs, finance and human resources related costs, and depreciation.

*Amortization of Other Intangible Assets*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Amortization of other intangible assets (in millions)	\$ 0.2	\$ 1.1	\$ 0.9
<i>Change year-on-year</i>		496.3 %	(20.9 )%

The charges identified above were incurred in connection with the amortization of intangible assets acquired in the combination with Parthus. The decrease in the 2004 charge compared to 2003 reflects the impairment charge in December 2003 of certain technology acquired. As of December 31, 2004 and 2003, the amount of other intangible assets was \$2.6 and \$3.5 million, respectively. We anticipate ongoing expense in connection with the amortization of remaining intangibles of approximately \$222,000 per quarter.

*In-process Research and Development*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
In-process research and development charge (in millions)	\$ 15.8		

The in-process research and development charge in 2002 represented one-time non-cash charges of \$14.2 million arising in connection with the combination with Parthus and \$1.6 million relating to certain wireless design technology which had not reached technological feasibility and had no alternative future use. Both these amounts were expensed in the fourth quarter of 2002. The projects to develop these technologies were abandoned in 2003.

*Reorganization, Restructuring and Severance Charge*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Reorganization, restructuring and severance charge (in millions)	\$ 6.4	\$ 8.6	

Our management and board of directors approved reorganization and restructuring plans in 2003, which resulted in a total charge of \$8.6 million. In the first, third and fourth quarters of 2003, we recorded charges of \$1.4 million, \$1.4 million and \$5.8 million, respectively. The charges arose in connection with senior executive management

changes in connection with the implementation of our strategic initiative to strengthen our headquarters function in the U.S. Also included were severance charges and employee-related liabilities arising in connection with a head-count reduction of 40 employees, underutilized building operating lease charges and a charge for non-performing assets arising from a reduction in headcount and facility requirements. The reduction in headcount and facility requirements was a result of the realignment of the business to focus on DSP cores and integrated application technologies and the decision to cease manufacturing our hard IP products and certain non-strategic technology areas.

Management are required to make and review certain estimates and assumptions in assessing the underutilized building operating lease charges arising from the reduction in facility requirements. The underutilized building operating lease charge at December 31, 2003 was calculated by taking into consideration (1) the committed annual rental charge associated with the vacant square footage, (2) an assessment of the sublet rents that could be achieved based on current market conditions, vacancy rates and future outlook, (3) the estimated periods that facilities would be empty before being sublet, (4) an assessment of the percentage increases in the primary lease rent and the sublease rent at each five-year rent review, and (5) the application of a discount rate of 4.75% over the remaining period of the lease. These estimates are reviewed quarterly and would be revised if estimated future vacancy rates and sublet rents vary from our original estimates. Revisions to our estimates of this liability could materially impact our operating results and financial position in future periods if anticipated events and assumptions either change or do not materialize. We revised our assumptions at December 31, 2004 in respect of future vacancy rates and sublet rents in light of current market conditions and our discount rate based on projected interest rates now applicable. The revision to our estimates had no impact on our Consolidated Statement of Operations.

We incurred a restructuring charge of \$6.4 million following the rationalization of certain product lines in the fourth quarter of 2002 to enhance strategic focus and to further reduce costs. This principally resulted in

severance costs following a headcount reduction of 46 employees and underutilized building operating lease charges arising from a reduction in our facility requirements.

### *Impairment of Assets*

We recorded an impairment charge of \$910,000 in 2003 in respect of non-performing assets, as well as an impairment charge of \$973,000 in respect of certain technology acquired in the combination with Parthus and the Parthus name, which we abandoned as part of our corporate rebranding. These charges related to the realignment of our business, including the decision to cease manufacturing Hard IP products and certain non-strategic technology areas.

In December 2003, we also recognized an impairment charge of \$1.35 million in relation to a minority investment in a private company acquired on the combination with Parthus. Management assessed the carrying value of the investment after taking into consideration the potential discounted projected future cash flows, the valuation derived from the most recent proposed private placement, the liquidity of the investment and the general market conditions in which this private company operates.

### *Other Income, Net*

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Other income (loss), net (in millions)	\$ (0.20 )	\$ 0.06	\$ 0.80
<i>Change year-on-year</i>		130.4 %	1163.5 %
<b><i>of which:</i></b>			
Interest income (in millions)	\$ 0.28	\$ 0.75	\$ 0.76
<i>Change year-on-year</i>		171 %	1.2 %
Foreign exchange gain (loss) (in millions)	\$ (0.48 )	\$ (0.69 )	\$ 0.04
<i>Change year-on-year</i>		41.9 %	105.4 %

Other income consists of interest earned on investments and foreign exchange gains and losses. Interest earned in 2004 and 2003 amounted to approximately \$750,000 reflecting similar combined cash and marketable securities balances held throughout 2004 and 2003. The increase in interest earned in 2003 compared to 2002 reflects higher cash balances held throughout 2003 as a result of the cash contribution to CEVA by DSP Group in connection with the spin-off from DSP Group and the cash balances of Parthus at the time of the combination in November 2002.

Foreign exchange losses in 2002 and 2003 primarily reflect the impact of the appreciation of the euro against the U.S. dollar on our euro liabilities. As a result of the significant currency fluctuations experienced on our non-U.S. dollar denominated liabilities, we have sought to hold equivalent non-U.S. dollar cash balances to mitigate losses caused by currency fluctuations; this effort has resulted in a near neutral foreign exchange impact in 2004.

***Provision for Income Taxes***

	<b>2002</b>	<b>2003</b>	<b>2004</b>
Provision for income taxes (in millions)	\$ 1.0	\$ 0.3	\$ 0.6
<i>Change year-on-year</i>		(70.4 )%	115 %

The increase in provision for income taxes in 2004 reflects income earned domestically and in certain foreign jurisdictions. The reduction in the provision of income taxes in 2003 compared to 2002 reflects losses incurred domestically and in certain foreign jurisdictions. The provisions for income taxes in 2002 principally relate to the ten month period during which we were a wholly owned subsidiary of DSP Group.

## LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2004, the Company had approximately \$28.8 million in cash and cash equivalents and \$30.8 million in marketable securities, totaling \$59.6 million compared to \$59.1 million in cash and cash equivalents at December 31, 2003. During 2004, the Company invested \$34.7 million of its cash in certificates of deposits and U.S. government and agency securities with maturities from 4 to 12 months. These instruments are classified as marketable securities and the purchase and sale is considered part of operating cash flow.

Net cash used in operating activities in 2004 was \$29.8 million, compared with \$12.8 million of net cash used in operating activities in 2003 and \$1.9 million of net cash used in operating activities in 2002. Included in the operating cash outflow in 2004 was a net investment of \$30.7 million in marketable securities and \$1.9 million outflow in connection with restructuring and reorganization costs. Excluding these items net cash provided by operations during 2004 was \$2.8 million.

The net cash outflow from operating activities in 2003 of \$12.8 million included the settlement of merger-related costs of approximately \$3.1 million following the combination with Parthus and cash outflow in connection with restructuring and reorganization costs incurred in 2003 and the last quarter of 2002 amounting to approximately \$6.5 million. The net cash outflow from operating activities in 2002 of \$1.9 million principally reflects the settlement arrangements contained in our combination agreement with Parthus Technologies, pursuant to which trade receivables and other accounts receivables and prepaid expenses together with income taxes payable prior to November 1, 2002 were settled by DSP Group.

Cash flows from operating activities may vary significantly from quarter to quarter depending on the timing of our receipts and payments. Of the \$3.1 million of restructuring and reorganization costs accrued at December 31, 2004, we expect a cash outflow of approximately \$2.3 million in 2005, primarily relating to underutilized building rental payments and employee-related costs, including the repayment of government grants related to employee numbers. Our ongoing cash outflows from operating activities principally relate to payroll-related costs and obligations under our property leases and design tool licenses. Our primary sources of cash inflows are receipts from our accounts receivable and interest earned from our cash and marketable securities holdings. The timing of receipts from debtors is based upon the completion of agreed milestones or agreed dates as set out in the contracts.

CEVA became a stand-alone business in November 2002, when the separation and spin-off of the DSP cores licensing business from DSP Group and the combination with Parthus were effected. Immediately prior to the separation and spin-off, all of the year-end available cash from the operations of the DSP cores licensing business was transferred to DSP Group. As part of the assets contributed to us in the separation, DSP Group made a total net contribution to our company of \$45.6 million, including \$7.6 million in transaction expenses relating to the combination. Cash acquired in connection with the separation from DSP Group and on the acquisition of Parthus has been used to fund working capital requirements, as well as property and equipment expenditures, which to date have been relatively low due to the fact that our licensing business model requires no manufacturing facilities.

Capital equipment purchases of computer hardware and software used in engineering development, company vehicles, furniture and fixtures amounted to approximately \$3.1 million in 2004, \$2.7 million in 2003, and \$860,000 in 2002. The high level of capital expenditures in 2004 and 2003 was principally due to investments in new design tools and

tenant improvements associated with the move of our facility in Israel to new premises in the fourth quarter of 2003. Proceeds from the sale of property and equipment amounted to \$54,000 in 2004 compared with \$142,000 in 2003 and \$124,000 in 2002.

Cash outflow in 2002 of approximately \$1.6 million related to investment in the design and development of digital media solutions for both wireless infrastructures and computer product applications.

Net cash provided by financing activities of \$2.2 million in 2004 and \$398,000 in 2003 reflects proceeds from the issuance of shares upon exercise of employee stock options and issuance of shares under our employee stock purchase plan. Net cash provided by financing activities of \$35.7 million in 2002 reflects the issuance of shares and capital return of \$4.3 million to DSP Group as part of the combination with Parthus on November 1, 2002

We believe that our current cash on hand and marketable securities, along with cash from operations, will provide sufficient capital to fund our operations for at least the next 12 months. We cannot assure you, however, that the underlying assumed levels of revenues and expenses will prove to be accurate.

**Contractual Obligations**

The table below presents the principal categories of our contractual obligations as of December 31, 2004:

		<b>Payments Due by Period</b>				
		(\$ in thousands)				
		<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 years</b>	<b>3-5 years</b>	<b>More than 5-years</b>
Operating Lease Obligations	Leasehold properties	31,937	2,526	4,152	3,554	21,705
Operating Lease Obligations	Other	1,550	917	633		
Purchase Obligations		163	163			
<b>Total</b>		<b>33,650</b>	<b>3,606</b>	<b>4,785</b>	<b>3,554</b>	<b>21,705</b>

Operating leasehold obligations principally relate to our offices in Ireland, Israel and the United States. The most material of these obligations relates to the lease on our Harcourt Street offices in Dublin, which involves a total commitment of \$17.8 million over the remaining 17 years of the agreement. A portion of rental space is currently underutilized as a result of the re-alignment of our business and related headcount reductions in 2003, which is further discussed in note 10 to our audited consolidated financial statements, which appear elsewhere in this annual report.

Other operating lease obligations relate to license agreements entered into for maintenance of design tools of \$395,000 and obligations under motor vehicle leases of \$1.2 million.

Purchase obligations consist of capital commitments of \$130,000 and operating purchase order commitments of \$34,000.

**CRITICAL ACCOUNTING POLICIES, ESTIMATES AND ASSUMPTIONS**

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP). These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions upon which we rely are reasonable based upon information



available to us at the time that these estimates, judgments and assumptions are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. To the extent there are material differences between these estimates, judgments or assumptions and actual results, our financial statements will be affected. The significant accounting policies that we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue Recognition

Allowances for Doubtful Accounts

Accounting for Income Taxes

Goodwill

Other intangible assets

Reorganization, restructuring and severance charge

Foreign Currency

In many cases, the accounting treatment of a particular transaction is specifically dictated by U.S. GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting among available alternatives would not produce a materially different result. See Notes to the Consolidated Financial Statements, which contain additional information regarding our accounting policies and other disclosures required by U.S. GAAP.



## Revenue Recognition

Significant management judgments and estimates must be made and used in connection with the recognition of revenue in any accounting period. Material differences in the amount of revenue in any given period may result if these judgments or estimates prove to be incorrect or if management's estimates change on the basis of development of the business or market conditions. Management judgments and estimates have been applied consistently and have been reliable historically.

A portion of our revenue is derived from license agreements that entail the customization of our application IP to the customer's specific requirements. Revenues from initial license fees for such arrangements are recognized in accordance with Statement of Position 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*, based on the percentage of completion method over the period from signing of the license through to customer acceptance, as such IP requires significant modification or customization that takes time to complete. The percentage of completion is measured by monitoring progress using records of actual time incurred to date in the project compared with the total estimated project requirement, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management.

We believe that the use of the percentage of completion method is appropriate as we have the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and terms of settlement. In all cases we expect to perform our contractual obligations and our licensees are expected to satisfy their obligations under the contract. The complexity of the estimation process and the issues related to the assumptions, risks and uncertainties inherent with the application of the percentage of completion method of accounting affect the amounts of revenue and related expenses reported in our consolidated financial statements. A number of internal and external factors can affect our estimates, including labor rates, utilization and specification and testing requirement changes.

We account for our other IP license revenue in accordance with the provisions of SOP 97-2, *Software Revenue Recognition*, issued by the American Institute of Certified Public Accountants and as amended by SOP 98-4 and SOP 98-9 and related interpretations (collectively, *SOP 97-2*). We exercise judgment and use estimates in connection with the determination of the amount of software license and services revenues to be recognized in each accounting period.

Under SOP 97-2, revenues are recognized when: (1) collectability is probable; (2) delivery has occurred; (3) the vendor's fee is fixed or determinable; and (4) persuasive evidence of an arrangement exists. SOP 97-2 generally requires revenue earned on licensing arrangements involving multiple elements to be allocated to each element based on the relative fair value of the elements, as determined by vendor specific objective evidence. Vendor specific objective evidence of fair value for each element of an arrangement is based upon the normal pricing and discounting

practices for each element when sold separately, including the renewal rate for support services. We have also adopted SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions ( SOP 98-9 ), for multiple element transactions entered into after January 1, 2000. SOP 98-9 requires that revenue be recognized under the residual method when VSOE of fair value exists for all undelivered elements and VSOE does not exist for one of the delivered elements. The VSOE of fair value of the undelivered elements normally is determined based on the price charged for the undelivered element when sold separately.

We assess whether collectability is probable at the time of the transaction based on a number of factors, including the customer's past transaction history and credit worthiness. If we determine that the collection of the fee is not probable, we defer the fee and recognize revenue at the time collection becomes probable, which is generally upon the receipt of cash.

When a sale of our IP is made to a third party who also supplies us with goods or services under separate agreements, we evaluate each of the agreements to determine whether they are clearly separable, and independent of one another and that reliable fair value exists for either the sales or purchase element in order to determine the appropriate revenue recognition.

### **Allowances for Doubtful Accounts**

We make judgments as to our ability to collect outstanding receivables and provide allowances for the portion of receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding receivables. In determining the provision, we analyze our historical collection experience and current economic trends. We reassess these allowances each accounting period. Historically, our actual losses and credits have been consistent with these provisions. If actual payment experience with our customers is different than our estimates, adjustments to these allowances may be necessary resulting in additional charges to our statement of operations.

### **Accounting for Income Taxes**

Significant judgment is required in determining our worldwide income tax expense provision. In the ordinary course of a global business, there are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of cost reimbursement arrangements among related entities, the process of identifying items of revenue and expense that qualify for preferential tax treatment and segregation of foreign and domestic income and expense to avoid double taxation. Although we believe that our estimates are reasonable, the final tax outcome of these matters may be different than that which is reflected in our historical income tax provisions and accruals. Such differences could have a material effect on our income tax provision and net income (loss) in the period in which such determination is made.

Deferred tax assets and liabilities are determined using enacted tax rates for the effects of net operating losses and temporary differences between the book and tax bases of assets and liabilities. We have provided a valuation allowance on the majority of our net deferred tax assets, which includes federal and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Our accounting for deferred taxes under Statement of Financial Accounting Standards ( SFAS ) No. 109, Accounting for Income Taxes , involves the evaluation of a number of factors concerning the realizability of our deferred tax assets. In concluding that a valuation allowance was required, we primarily considered such factors as our history of operating losses and expected future losses in certain jurisdictions and the nature of our deferred tax assets. We provide valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. We currently believe that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses will not be realized in the foreseeable future. In the event that we were to determine that we would not be able to realize all or part of our deferred tax assets in the future, an adjustment to the deferred tax assets would be charged to earnings in the period in which we make such determination. Likewise, if we later determine that it is more likely than not that the net deferred tax assets would be realized, we would reverse the applicable portion of the previously provided valuation allowance. In order for us to realize our deferred tax assets we must be able to generate sufficient taxable income in the tax jurisdictions in which the deferred tax assets are located.

We do not provide for US Federal Income taxes on the undistributed earnings of our international subsidiaries because such earnings are re-invested and, in our opinion, will continue to be re-invested indefinitely. In addition, we operate within multiple taxing jurisdictions involving complex issues and we provide for tax liabilities on investment activity as appropriate.

In addition, we operate within multiple taxing jurisdictions and may be subject to audits in these jurisdictions. These audits can involve complex issues that may require an extended period of time for resolution. In management's opinion, adequate provisions for income taxes have been made.

### **Goodwill**

Under SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests based on estimated fair value in accordance with SFAS No. 142.

We conduct our annual test of impairment for goodwill in October of each year. In addition we test for impairment periodically whenever events or circumstances occur subsequent to our annual impairment tests that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Indicators we considered important which could trigger an impairment include, but are not limited to, significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of the acquired assets or the strategy for our overall business, significant negative industry or economic trends, a significant decline in our stock price for a sustained period and our market capitalization relative to net book value.

The goodwill impairment test, which is based on fair value, is performed on a reporting unit level. A reporting unit is defined by SFAS No. 131, *Disclosure About Segments of an Enterprise and Related Information*, as an operating segment or one level lower. We market our products and services in one segment and thus allocate goodwill to one reporting unit. Therefore, impairment is tested at the enterprise level using our market capitalization as fair value. Accordingly, in conducting the first step of this impairment test, we compare the carrying value of our assets and liabilities to our market capitalization. If the carrying value exceeds the fair value, the goodwill is potentially impaired and we then complete the second step in order to measure the impairment loss. If the fair value exceeds the carrying value, the second step in order to measure the impairment loss is not required.

In the second step of the impairment test, the fair value of all the unit's balance sheet assets and liabilities, as well as the Company's identifiable intangible assets, excluding goodwill, must be determined at the valuation date. We estimate the future cash flows to determine the fair value of these assets and liabilities. These cash flows are then discounted at rates reflecting the respective specific industry's cost of capital. The discounted cash flows are then compared to the carrying amount of the Company's assets and liabilities to determine if an impairment exists. If, upon review, the fair value is less than the carrying value, the carrying value is written down to estimated fair value.

Should our market capitalization decline, in assessing the recoverability of our goodwill, we may be required to make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. This process is subjective and requires judgment at many points throughout the analysis. If our estimates or their related assumptions change in subsequent periods or if actual cash flows are below our estimates, we may be required to record impairment charges for these assets not previously recorded.

In October 2004, we completed our annual impairment test and assessed the carrying value of goodwill as required by SFAS No. 142. The goodwill impairment test compared the carrying value of the Company (the reporting unit) with the fair value at that date. Because the market capitalization exceeded the carrying value significantly, no impairment arose. No indicators of impairment were identified between the date of the annual impairment test and year end.

### **Other Intangible Assets**

Other intangible assets represents costs of technology acquired from acquisitions which have reached technological feasibility. The costs of technology have been capitalized and are amortized to the Consolidated Statements of Operations over the period during which benefits are expected to accrue, currently estimated at five years. We are required to test our other intangible assets for impairment whenever events or circumstances indicate that the value of the assets may be impaired. Factors we consider important, which could trigger impairment include:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or the strategy for our overall business;

significant negative industry or economic trends;

significant decline in our stock price for a sustained period; and

significant decline in our market capitalization relative to net book value.

Where events and circumstances are present which indicate that the carrying value may not be recoverable, we will recognize an impairment loss. Such impairment loss is measured by comparing the fair value of the asset with its carrying value. The determination of the value of such intangible assets requires us to make assumptions regarding future business conditions and operating results in order to estimate future cash flows and other factors to determine the fair value of the respective assets. If these estimates or the related assumptions change in the future, we could be required to record additional impairment charges.

We recorded a \$1.1 million impairment charge in 2003 in respect of certain technology acquired in the combination with Parthus; the Parthus name, which we abandoned as part of our corporate re-branding; and steps connected with the realignment of our business, including the decision to cease Hard IP manufacturing and certain non-strategic technology areas. The impairment charge reflected the unamortized carrying value of this technology determined by an independent analysis on the combination with Parthus.



## **Reorganization, restructuring and severance charge**

In the first, third and fourth quarters of 2003, we recorded reorganization, restructuring and severance charges of \$1,380,000, \$1,402,000 and \$5,838,000, respectively. The charges arose in connection with the implementation of our strategic initiative to strengthen our headquarters function in the U.S., and the related resignations of our Ireland-based chief executive officer and chief financial officer and the resignations of our Chairman and Vice-Chairman from their executive management positions. Also included are severance charges for 40 employees, underutilized building operating lease obligations and commitment charges and a charge for redundant assets arising from a reduction in headcount and facility requirements.

We were required to make and are required to review certain estimates and assumptions in assessing the underutilized building operating lease charges arising from the reduction in facility requirements. The underutilized building operating lease charge was calculated by taking into consideration (1) the committed annual rental charge associated with the vacant square footage, (2) an assessment of the sublet rents that could be achieved based on current market conditions, vacancy rates and future outlook, (3) the estimated periods that facilities would be empty before being sublet, (4) an assessment of the percentage increases in the primary lease rent and the sublease rent at each five-year rent review, and (5) the application of a discount rate of 4.75% over the remaining period of the lease. These estimates are reviewed quarterly and would be revised if estimated future vacancy rates and sublet rents vary from our original estimates. We revised our assumptions at December 31, 2004 in respect of future vacancy rates and sublet rents in light of current market conditions and our discount rate based on projected interest rates now applicable. Revisions to our estimates of this liability could materially impact our operating results and financial position in future periods if anticipated events and assumptions either change or do not materialize.

## **Foreign Currency**

The U.S. dollar is the functional currency for the Company. The majority of our revenues and a portion of our expenses are transacted in U.S. dollars and our assets and liabilities together with our cash holdings are predominately denominated in U.S. dollars. However, a significant portion of our expenses are denominated in currencies other than the U.S. dollar, principally the euro and the Israeli NIS. Assets and liabilities denominated in foreign currencies are translated at year end exchange rates while revenues and expenses are translated at rates approximating those ruling at the dates of the related transactions. Increases in the volatility of the exchange rates of the euro and the NIS versus the U.S. dollar could have an adverse effect on the expenses and liabilities that we incur when translated into U.S. dollars. We review our monthly expected non-US dollar denominated expenditure and look to hold equivalent non-U.S. dollar cash balances to mitigate currency fluctuations and this has resulted in a neutral foreign exchange impact in 2004.

We incurred foreign exchange losses of approximately \$690,000 in 2003 and \$484,000 in 2002, arising principally on euro liabilities as a result of the appreciation of the euro against the U.S. dollar. As a result of such currency fluctuations and the conversion to U.S. dollars for financial reporting purposes, we may experience fluctuations in our operating results on an annual and a quarterly basis going forward. We have not in the past, but may in the future,

hedge against fluctuations in exchange rates. Future hedging transactions may not successfully mitigate losses caused by currency fluctuations. We expect to continue to experience the effect of exchange rate fluctuations on an annual and quarterly basis, and currency fluctuations could have a material adverse impact on our results of operations.

**Recently issued accounting standards:**

FASB Staff Position ( FSP ) No. 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 ( FSP 109-2 ), provides guidance under FASB Statement No. 109, Accounting for Income Taxes, with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the Jobs Act ) on enterprises' income tax expense and deferred tax liability. Foreign earnings are currently required for continued investment in the local jurisdiction. Accordingly, as provided for in FSP 109-2, The Company has not adjusted its tax expense or deferred tax liability to reflect the repatriation provisions of the Jobs Act.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ), which replaces SFAS No. 123, Accounting for Stock-Based Compensation, ( SFAS 123 ) and supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements

based on their fair values and is effective for public companies at the beginning of the first interim or annual period beginning after June 15, 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. We are required to adopt SFAS 123R in the third quarter of fiscal 2005, beginning July 1, 2005. Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. We are evaluating the requirements of SFAS 123R and expect that the adoption of SFAS 123R will have a material impact on our consolidated results of operations and earnings per share. We have not yet determined the method of adoption or the effect of adopting SFAS 123R, and we have not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

## **FACTORS THAT COULD AFFECT OUR OPERATING RESULTS**

*We caution you that the following important factors, among others, could cause our actual future results to differ materially from those expressed in forward-looking statements made by or on behalf of us in filings with the Securities and Exchange Commission, press releases, communications with investors and oral statements. Any or all of our forward-looking statements in this Annual Report, and in any other public statements we make, may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in the discussion below will be important in determining future results. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make in our reports filed with the Securities and Exchange Commission.*

## **RISKS RELATING TO OUR MARKETS**

**The industries in which we license our technology have experienced a challenging period of slow growth that has negatively impacted and could continue to negatively impact our business and operating results.**

The primary customers for our products are semiconductor design and manufacturing companies, system OEMs and electronic equipment manufacturers, particularly in the telecommunications field. These industries are highly cyclical and have been subject to significant economic downturns at various times, particularly in recent periods. These downturns are characterized by production overcapacity and reduced revenues, which at times may encourage semiconductor companies or electronic product manufacturers to reduce their expenditure on our technology. During 2001, the semiconductor industry as a whole experienced the most severe contraction in its history, with total semiconductor sales worldwide declining by more than 30%, according to the Semiconductor Industry Association. The market for semiconductors used in mobile communications was particularly hard hit, with the overall decline in sales worldwide estimated by Gartner Dataquest to have been well above 30%. These adverse conditions stabilized but did not improve during the course of 2002. During the course of 2003 and 2004, a recovery appeared to begin although this recovery began to slow in the later half of 2004. If this apparent recovery is not sustained through 2005 and beyond our business could be further materially and adversely affected.

**The markets in which we operate are highly competitive, and as a result we could experience a loss of sales, lower prices and lower revenue.**

The markets for the products in which our technology is used are highly competitive. Aggressive competition could result in substantial declines in the prices that we are able to charge for our intellectual property. It could also cause our existing customers to move their orders to our competitors. Many of our competitors are large companies that have significantly greater financial and other resources than we have.

In addition, we may face increased competition from smaller, niche semiconductor design companies in the future. Some of our customers may also decide to satisfy their needs through in-house design and production. We compete on the basis of price, product quality, design cycle time, reliability, performance, customer support, name recognition and reputation, and financial strength. Our inability to compete effectively on these bases could have a material adverse effect on our business, results of operations and financial condition.

**Our operating results fluctuate from quarter to quarter due to a variety of factors, including our lengthy sales cycle, and are not a meaningful indicator of future performance.**

In some quarters our operating results could be below the expectations of securities analysts and investors, which could cause our stock price to fall. Factors that may affect our quarterly results of operations in the future include, among other things:

the timing of the introduction of new or enhanced technologies, as well as the market acceptance of such technologies;

new product announcements and introductions by competitors;

the timing and volume of orders and production by our customers, as well as fluctuations in royalty revenues resulting from fluctuations in unit shipments by our licensees;

our lengthy sales cycle

the gain or loss of significant licensees; and

changes in our pricing policies and those of our competitors.

**We rely significantly on revenue derived from a limited number of licensees.**

We expect that a limited number of licensees, varying in identity from period-to-period, will account for a substantial portion of our revenues in any period. Moreover, license agreements for our DSP cores have not historically provided for substantial ongoing license payments, although they may provide for royalties based on product shipments. Significant portions of our anticipated future revenue, therefore, will likely depend upon our success in attracting new customers or expanding our relationships with existing customers. Our ability to succeed in these efforts will depend on a variety of factors, including the performance, quality, breadth and depth of our current and future products and our sales and marketing skills. Our failure to obtain future customer licenses would impede our future revenue growth.

**We depend on market acceptance of third-party semiconductor intellectual property.**

Our future growth will depend on the level of acceptance by the market of our third-party, licensable intellectual property model and the variety of intellectual property offerings available on the market, which to a large extent are not in our control. If the market shifts and third-party SIP is no longer desired by our customers, our business, results of operations and financial condition could be materially harmed.

**We depend on the success of our licensees to promote our solutions in the marketplace.**

We do not sell our technology directly to end-users; we license our technology primarily to semiconductor companies and to electronic equipment manufacturers, who then incorporate our technology into the products they sell. Because we do not control the business practices of our licensees, we do not influence the degree to which they promote our technology or set the prices at which they sell products incorporating our technology. We cannot assure you that our licensees will devote satisfactory efforts to promote our solutions. In addition, our unit royalties from licenses are totally dependent upon the success of our licensees in introducing products incorporating our technology and the success of those products in the marketplace. If we do not retain our current licensees and continue to attract new licensees, our business may be harmed.

**We depend on a limited number of key personnel who would be difficult to replace.**

Our success depends to a significant extent upon our key employees and senior management; the loss of the service of these employees could materially harm us. Competition for skilled employees in our field is intense. We cannot assure you that we will be successful in attracting and retaining the required personnel.

**RISKS RELATING TO OUR  
SEPARATION FROM DSP GROUP**

**We could be subject to joint and several liability for taxes of DSP Group.**

As a former member of a group filing consolidated income tax returns with DSP Group, we could be liable for federal income taxes of DSP Group and other members of the consolidated group, including taxes, if any, incurred by DSP Group on the distribution of our stock to the stockholders of DSP Group. DSP Group has agreed to indemnify us against these taxes, other than taxes for which we have agreed to indemnify DSP Group pursuant to the terms of the tax indemnification and allocation agreement and separation agreement we entered into with DSP Group.

**ADDITIONAL RISKS RELATING TO OUR BUSINESS**

**Our success will depend on our ability to manage our geographically dispersed operations successfully.**

Although we are headquartered in San Jose, California, most of our employees are located in Israel and Ireland. Accordingly, our ability to compete successfully will depend in part on the ability of a limited number of key executives located in geographically dispersed offices to integrate management, address the needs of our customers and respond to changes in our markets. If we are unable to effectively manage our remote operations, our business may be harmed.

**Our operations in Israel may be adversely affected by instability in the Middle East region.**

One of our principal research and development facilities is located in, and some of our directors and executive officers are residents of, Israel. Although substantially all of our sales currently are being made to customers outside Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel could significantly harm our business, operating results and financial condition.

In addition, certain of our officers and employees are currently obligated to perform annual reserve duty in the Israel Defense Forces and are subject to being called for active military duty at any time. Although we have operated effectively under these requirements since our inception, we cannot predict the effect of these obligations on the company in the future. Our operations could be disrupted by the absence, for a significant period, of one or more of

our officers or key employees due to military service.

**If we are unable to meet the changing needs of our end-users or to address evolving market demands, our business may be harmed.**

The markets for programmable DSP cores and application IP are characterized by rapidly changing technology, emerging markets and new and developing end-user needs, requiring significant expenditure for research and development. We cannot assure you that we will be able to introduce systems and solutions that reflect prevailing industry standards on a timely basis, to meet the specific technical requirements of our end-users or to avoid significant losses due to rapid decreases in market prices of our products, and our failure to do so may seriously harm our business. In addition, the reduction in the number of our employees in connection with our recent restructuring efforts could adversely affect our ability to attract or retain customers who require certain R&D capabilities from their IP providers.

**We may seek to expand our business through acquisitions that could result in diversion of resources and extra expenses.**

We may pursue acquisitions of businesses, products and technologies, or establish joint venture arrangements in the future that could expand our business. The negotiation of potential acquisitions or joint ventures, as well as the integration of acquired or jointly developed businesses, technologies or products could cause diversion of management's time and our resources. We may not be able to successfully integrate acquired businesses or joint ventures with our operations. If we were to make any acquisition or enter into a joint venture, we may not receive the intended benefits of the acquisition or joint venture. If future acquisitions or joint ventures disrupt our operations, or if we have difficulty integrating the businesses or technologies we acquire, our business, financial condition and results of operations could suffer.



**We may not be able to adequately protect our intellectual property.**

Our success and ability to compete depend in large part upon the protection of our proprietary technologies. We rely on a combination of patent, copyright, trademark, trade secret, mask work and other intellectual property rights, confidentiality procedures and licensing arrangements to establish and protect our proprietary rights. These agreements and measures may not be sufficient to protect our technology from third-party infringement, or to protect us from the claims of others. As a result, we face risks associated with our patent position, including the potential need to engage in significant legal proceedings to enforce our patents, the possibility that the validity or enforceability of our patents may be denied, the possibility that third parties will be able to compete against us without infringing our patents and the possibility that our products may infringe patent rights of third parties.

Our trade names or trademarks may be registered or utilized by third parties in countries other than those in which we have registered them, impairing our ability to enter and compete in these markets. If we were forced to change any of our brand names, we could lose a significant amount of our brand equity.

**Our business will suffer if we are sued for infringement of the intellectual property rights of third parties or if we cannot obtain licenses to these rights on commercially acceptable terms.**

Although we are not currently involved in any litigation, we are subject to the risk of adverse claims and litigation alleging infringement of the intellectual property rights of others. There are a large number of patents held by others, including our competitors, pertaining to the broad areas in which we are active. We have not, and cannot reasonably, investigate all such patents. From time to time, we have become aware of patents in our technology areas and have sought legal counsel regarding the validity of such patents and their impact on how we operate our business, and we will continue to seek such counsel when appropriate in the future. Claims against us may require us to enter into license arrangements or result in protracted and costly litigation, regardless of the merits of these claims. Any necessary licenses may not be available or, if available, may not be obtainable on commercially reasonable terms. If we cannot obtain necessary licenses on commercially reasonable terms, we may be forced to stop licensing our technology, and our business would be seriously harmed.

**Our business depends on OEMs and their suppliers obtaining required complementary components.**

Some of the raw materials, components and subassemblies included in the products manufactured by our OEM customers are obtained from a limited group of suppliers. Supply disruptions, shortages or termination of any of these sources could have an adverse effect on our business and results of operations due to the delay or discontinuance of orders for products containing our IP, especially our DSP cores, until those necessary components are available.

**The future growth of our business depends in part on our ability to license to system OEMs and small-to-medium-sized semiconductor companies directly and to expand our sales geographically.**

Historically a substantial portion of the revenues from the licensing of our products has been derived in any period from a relatively small number of licensees. Because of the substantial license fees we charge, our customers tend to be large semiconductor companies or vertically integrated system OEMs. Part of our current growth strategy is to broaden the adoption of our products by small to mid-size companies by offering different versions of our products, targeted at these companies. In addition we plan to continue expanding our sales to include additional geographies. Asia, in particular, is a region we have targeted for growth. If we are unable to effectively develop and market our intellectual property through these models, our revenues will continue to be dependent on a smaller number of licensees and a less geographically dispersed pattern of licensees, which could harm our business and results of operations.

**Our independent registered public accounting firm may decline to attest on the adequacy of our internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002.**

The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on internal controls over financial reporting in their annual reports on Form 10-K that contain an assessment by management of the effectiveness of the Company's internal controls over financial reporting. In addition, the Company's independent registered public accounting firm must attest to and report on management's assessment of the effectiveness of the internal controls

over financial reporting. Although we intend to diligently and vigorously review our internal controls over financial reporting in order to ensure compliance with the Section 404 requirements on an annual basis, if our independent registered public accounting firm is not satisfied with our internal controls over financial reporting or the level at which these controls are documented, designed, operated or reviewed, or if the independent registered public accounting firm interprets the requirements, rules and/or regulations differently from us, then they may decline to attest to management's assessment or may issue a report that is qualified. This could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our consolidated financial statements, which ultimately could negatively impact our stock price.

**Changes in accounting rules for stock-based compensation may adversely affect our operating results, our stock price and our competitiveness in the employee marketplace.**

We have a history of using employee stock options and other stock-based compensation to hire, motivate and retain our workforce. In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123R, Share-Based Payment, which will require us, starting in the second half of 2005, to measure compensation costs for all stock-based compensation (including stock options and our employee stock purchase plan) at fair value and to recognize these costs as expenses in our statements of operations. The recognition of these expenses in our statements of operations will result in lower net income (loss) per share, which could negatively impact our future stock price. In addition, if we reduced or alter our use of stock-based compensation to minimize the recognition of these expenses, our ability to recruit, motivate and retain employees may be impaired, which could put us at a competitive disadvantage in the employee marketplace.

**ADDITIONAL RISKS RELATING TO OUR  
INTERNATIONAL OPERATIONS**

**The Israeli tax benefits that we currently receive and the government programs in which we participate require us to meet certain conditions and may be terminated or reduced in the future, which could increase our costs.**

We enjoy certain tax benefits in Israel, particularly as a result of the Approved Enterprise status of our facilities and programs. To maintain our eligibility for these tax benefits, we must continue to meet certain conditions, relating principally to adherence to the investment program filed with the Investment Center of the Israeli Ministry of Industry and Trade and to periodic reporting obligations. We believe that we will be able to continue to meet such conditions. Should we fail to meet such conditions in the future, however, these benefits would be cancelled and we would be subject to corporate tax in Israel at the standard rate of 36% and could be required to refund tax benefits already received. In addition, we cannot assure you that these grants and tax benefits will be continued in the future at their current levels or otherwise. The termination or reduction of certain programs and tax benefits (particularly benefits available to us as a result of the Approved Enterprise status of our facilities and programs) or a requirement to refund

tax benefits already received may seriously harm our business, operating results and financial condition.

**Our corporate tax rate may increase, which could adversely impact our cash flow, financial condition and results of operations.**

We have significant operations in the Republic of Ireland and a substantial portion of our taxable income historically has been generated there. Currently, some of our Irish subsidiaries are taxed at rates substantially lower than U.S. tax rates. Although there is no expectation of any changes to Irish tax law, if our Irish subsidiaries were no longer to qualify for these lower tax rates or if the applicable tax laws were rescinded or changed, our operating results could be materially adversely affected. In addition, because our Irish and Israeli operations are owned by subsidiaries of a U.S. corporation, distributions to the U.S. corporation, and in certain circumstances undistributed income of the subsidiaries, may be subject to U.S. tax. Moreover, if U.S. or other foreign tax authorities were to change applicable foreign tax laws or successfully challenge the manner in which our subsidiaries' profits are currently recognized, our overall taxes could increase, and our business, cash flow, financial condition and results of operations could be materially adversely affected.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

A majority of our revenues and a portion of our expenses are transacted in U.S. dollars and our assets and liabilities together with our cash holdings are predominately denominated in U.S. dollars. However, the bulk of our

expenses are denominated in currencies other than the U.S. dollar, principally the euro and the Israeli NIS. Increases in the volatility of the exchange rates of the euro and the NIS versus the U.S. dollar could have an adverse effect on the expenses and liabilities that we incur when translated into U.S. dollars. We review our monthly expected non-US dollar denominated expenditure and look to hold equivalent non-U.S. dollar cash balances to mitigate currency fluctuations and this has resulted in a neutral foreign exchange impact in 2004.

We incurred foreign exchange losses of approximately \$687,000 in 2003 and \$484,000 in 2002, arising principally on euro liabilities as a result of the appreciation of the euro against the U.S. dollar. As a result of such currency fluctuations and the conversion to U.S. dollars for financial reporting purposes, we may experience fluctuations in our operating results on an annual and a quarterly basis going forward. We have not in the past, but may in the future, hedge against fluctuations in exchange rates. Future hedging transactions may not successfully mitigate losses caused by currency fluctuations. We expect to continue to experience the effect of exchange rate fluctuations on an annual and quarterly basis, and currency fluctuations could have a material adverse impact on our results of operations.

We invest our cash in high grade certificates of deposits and U.S. government and agency securities. Cash held by foreign subsidiaries is generally held in short-term time deposits denominated in the local currency.

Net interest income was \$759,000 in 2004, \$750,000 in 2003 and \$277,000 in 2002. We are exposed primarily to fluctuations in the level of U.S. and EMU interest rates. To the extent that interest rates rise, fixed interest investments may be adversely impacted, whereas a decline in interest rates may decrease the anticipated interest income for variable rate investments.

We are exposed to financial market risks, including changes in interest rates. We typically do not attempt to reduce or eliminate our market exposures on our investment securities because the majority of our investments are short-term. We do not have any derivative instruments.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

See the Index to Financial Statements and Supplementary Data on page F-1.

## **ITEM 9.**

**CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not Applicable.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures.**

Our management evaluated, with the participation of our chief executive officer and chief financial officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of December 31, 2004. Based on such evaluation, our chief executive officer and chief financial officer have concluded that, as of such date, our disclosure controls and procedures were not effective as a result of the factors identified in Item 9B below. The additional processes we are implementing to remediate the material weaknesses in our internal control over financial reporting described below also will remediate our disclosure controls and procedures.

**Management's Annual Report on Internal Control Over Financial Reporting.**

The Sarbanes-Oxley Act of 2002 (the Act) imposed many requirements regarding corporate governance and financial reporting. One requirement under section 404 of the Act, beginning with this annual report, is for management to report on the Company's internal controls over financial reporting and for our independent registered public accountants to attest to this report. In late November 2004, the Securities and Exchange Commission issued an exemptive order providing a 45 day extension for the filing of these reports and attestations by eligible companies. We elected to utilize this 45 day extension, therefore, this Form 10-K does not include these reports. These reports will be included in an amended Form 10-K expected to be filed in April 2005. During 2004, we spent considerable time and resources analyzing, documenting and testing our system of internal controls.

As previously reported in our Form 8-K filed on March 17, 2005, in preparing our financial statements for the three months and year ended December 31, 2004, management reviewed the license upgrade agreement and services agreement and determined that the agreements were separable and that each reflected the fair value of each element of these agreements. Management also contemporaneously reviewed the facts and circumstances of these agreements with our independent auditors. Subsequently, in January, our Audit Committee reviewed with management and with our independent auditors the revenue recognition treatment of the license upgrade agreement for the quarter ended December 31, 2004. Based on this review, we recognized \$846,000 of revenue related to this agreement, which was reflected in our operating results for its fourth fiscal quarter and fiscal year ended December 31, 2004 set forth in the press release previously furnished by us on a Form 8-K dated February 2, 2005. In connection with our independent auditors' final review of the audited financial statements to be included in this Annual Report on Form 10-K for the fiscal year ended December 31, 2004, our independent auditors informed us on March 9, 2005 that they were further reviewing the revenue recognition treatment of this license upgrade agreement. Our independent auditors subsequently confirmed on March 23, 2005 that the appropriate accounting treatment was the deferral of all the revenues to be derived from the license upgrade agreement to future periods.

In connection with management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004 and in light of the deferral in revenue associated with the license upgrade agreement described in Item 9B below, we have determined, in consultation with our independent auditors, that our internal controls related to revenue recognition has the following material weakness: our lack of timely evaluation of whether a license fee is fixed and determinable and collectible as required under SOP 97-2 in the context of where a customer is also a supplier or service provider. A material weakness is a significant deficiency (within the meaning of Public Company Accounting Oversight Board (the "PCAOB") Auditing Standard No. 2), or a combination of significant deficiencies, that results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by employees in the normal course of their assigned functions.

We are remediating the material weakness in internal control over financial reporting by adding the following processes to our current processes:

performing a comprehensive review of all past and future agreements when we are entering into a new revenue generating agreement with a customer where we have an existing relationship with this party such as an existing customer or supplier or service provider relationship.

requiring accounting and finance personnel to receive regular training and updates on revenue recognition;

retaining a third party accounting firm to consult on complicated technical accounting issues; and

retaining a consultant to oversee internal control on revenue recognition.

**Changes in Internal Control Over Financial Reporting.**

There were no changes in our internal control over financial reporting during the most recent fiscal quarter that has materially affected, or are reasonable likely to materially affect, our internal control over financial reporting. As described above, subsequent to the end of the most recent fiscal quarter, we are making the following changes in our internal controls:

performing a comprehensive review of all past and future agreements when we are entering into a new revenue generating agreement with a customer where we have an existing relationship with this party such as an existing customer or supplier or service provider relationship.

requiring accounting and finance personnel to receive regular training and updates on revenue recognition;

retaining a third party accounting firm to consult on complicated technical accounting issues; and

retaining a consultant to oversee internal control on revenue recognition.



## ITEM 9B. OTHER INFORMATION

As previously reported in our Form 8-K filed on March 17, 2005, during the quarter ended December 31, 2004, we entered into a license upgrade agreement with one of our existing customers who is developing wireless and multimedia software solutions around the licensed CEVA DSP core. We recognized as revenue under this agreement \$846,000, a portion of such license, for the quarter ended December 31, 2004. Separately, in January 2005, we entered into an engineering services agreement with the same party to develop a suite of audio software to support our multimedia solutions licensing business.

As previously reported in our Form 8-K filed on March 17, 2005, in preparing our financial statements for the three months and year ended December 31, 2004, management reviewed the license upgrade agreement and services agreement and determined that the agreements were separable and that each reflected the fair value of each element of these agreements. Subsequently, in January, our Audit Committee reviewed with management and with our independent auditors the revenue recognition treatment of the license upgrade agreement for the quarter ended December 31, 2004. Based on this review, we recognized \$846,000 of revenue related to this agreement, which was reflected in our operating results for its fourth fiscal quarter and fiscal year ended December 31, 2004 set forth in the press release previously furnished by us on a Form 8-K dated February 2, 2005. In connection with our independent auditors' final review of the audited financial statements to be included in this Annual Report on Form 10-K for the fiscal year ended December 31, 2004, our independent auditors informed us on March 9, 2005 that they were further reviewing the revenue recognition treatment of this license upgrade agreement.

The audited financial statements included in this Annual Report on Form 10-K reflect the deferral of all of the revenues to be derived from the license upgrade agreement to future periods. As a result, we are reporting revenues for our fiscal year ended December 31, 2004 of \$37.7 million instead of the \$38.5 million previously set forth in our press release furnished on the Form 8-K dated February 2, 2005. In addition we are reporting net income of \$1.7 million instead of the \$2.1 million previously set forth in our press release furnished on the Form 8-K dated February 2, 2005. This has resulted in a decrease in our reported net income per share to \$0.09 from \$0.11 previously set forth in our press release furnished on the Form 8-K dated February 2, 2005.

For our fourth fiscal quarter ended December 31, 2004, we had revenues of \$9.2 million instead of the \$10.0 million previously set forth in our press release furnished on the Form 8-K dated February 2, 2005. In addition we had net income of \$0.2 million for our fourth fiscal quarter ended December 31, 2004 instead of the \$0.7 million previously set forth in our press release furnished on the Form 8-K dated February 2, 2005. This has resulted in a decrease in our net income per share to \$0.01 for our fourth fiscal quarter from \$0.03 previously set forth in our press release furnished on the Form 8-K dated February 2, 2005.



### **PART III**

#### **ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information regarding our directors required by this item is incorporated herein by reference to the 2005 Proxy Statement. Information regarding the members of the Audit Committee, our code of business conduct and ethics, the identification of the Audit Committee Financial Expert, shareholder nominations of directors and compliance with Section 16(a) of the Securities Exchange Act of 1934 is also incorporated herein by reference to the 2005 Proxy Statement.

The information regarding our executive officers required by this item is contained in Part I of this annual report.

#### **ITEM 11. EXECUTIVE COMPENSATION**

The information required by this item is incorporated herein by reference to the 2005 Proxy Statement.

#### **ITEM 12.**

#### **SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCK HOLDER MATTERS**

The information required by this item is incorporated herein by reference to the 2005 Proxy Statement.

#### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information required by this item is incorporated herein by reference to the 2005 Proxy Statement.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by this items is incorporated herein by reference to the 2005 Proxy Statement.

**PART IV**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES**

(a) *The following documents are filed as part of or are included in this Annual Report on Form 10-K:*

1. Financial Statements:

Consolidated Balance Sheets as of December 31, 2004 and 2003.

Consolidated Statements of Operations for the Years Ended December 31, 2004, 2003 and 2002.

Statements of Changes in Stockholders' Equity and Related Company Investment for the Years Ended December 31, 2004, 2003 and 2002.

Consolidated Statements of Cash Flows for the Years Ended December 31, 2004, 2003 and 2002.

Notes to Consolidated Financial Statements.

2. Financial Statement Schedules:

Schedule II: Valuation of Qualifying Accounts and Reserves

Other financial statement schedules have been omitted since they are either not required or the information is otherwise included.

3. Exhibits:

The Exhibits filed as part of this Annual Report on Form 10-K are listed on the Exhibit Index immediately preceding such Exhibits, which Exhibit Index is incorporated herein by reference. Some of these documents have previously been filed as exhibits with the Securities and Exchange Commission and are being incorporated herein by reference to such earlier filings. CEVA's file number under the Securities Exchange Act of 1934 is 000-49842.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**CEVA, INC. AND ITS SUBSIDIARIES**

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Report of Independent Registered Public Accounting Firm (Kost Forer Gabbay & Kassierer)	F-3
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of CEVA, INC.

We have audited the accompanying consolidated balance sheets of CEVA, Inc. and its subsidiaries (the Company) as of December 31, 2004 and 2003, and the related consolidated statements of operations, changes in stockholders' equity and Related Company investment, and cash flows for each of the two years in the period ended December 31, 2004. Our audits also included the financial statement schedule listed in the Index at Item 15(a) 2. These consolidated financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of CEVA, Inc. and its subsidiaries as of December 31, 2004 and 2003, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ ERNST & YOUNG

Dublin, Ireland

March 29, 2005



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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Shareholders of CEVA, Inc. (formerly ParthusCeva, Inc.)

We have audited the accompanying consolidated statements of operations, changes in stockholders' equity and Related Company investment and cash flows of CEVA, Inc. and its subsidiaries (the Company) for the year ended December 31, 2002. Our audit also included the financial statements schedule listed in the Index at Item 15(a)2. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated results of operations and cash flows of the Company for the year ended December 31, 2002, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ KOST FORER GABBAY & KASSIERER  
KOST FORER GABBAY & KASSIERER

(Formerly Kost Forer & Gabbay)  
A Member of Ernst & Young Global

Tel-Aviv, Israel

January 21, 2003

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**CEVA, INC. AND ITS SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

(U.S. dollars in thousands, except share and per share data)

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 59,130	\$ 28,844
Marketable securities (note 2)		30,794
Trade receivables (net of allowance for doubtful accounts of \$ 795 in 2003 and \$813 in 2004)	10,226	10,835
Deferred tax assets		125
Prepaid expenses (note 5)	1,277	703
Other accounts receivable (note 5)	668	647
Total current assets	71,301	71,948
Long-term investments:		
Severance pay fund	1,487	1,713
Deferred tax assets		70
Property and equipment, net (note 3)	4,792	4,471
Goodwill (note 4)	38,398	38,398
Other intangible assets, net (note 4)	3,455	2,563
	48,132	47,215
Total assets	\$ 119,433	\$ 119,163
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Trade payables	\$3,030	\$1,714
Accrued expenses and other payables (note 6)	12,876	9,816
Taxes payable	891	707
Deferred revenues	1,064	1,751
Total current liabilities	17,861	13,988

Long term liabilities:		
Accrued severance pay	1,510	1,844
Accrued liabilities (note 6)	1,583	782
Total long term liabilities	3,093	2,626
Stockholders' equity:		
Preferred Stock:		
\$0.001 par value: 5,000,000 shares authorized at December 31, 2003 and 2004; none issued and outstanding		
Common Stock:		
\$0.001 par value: 100,000,000 shares authorized at December 31, 2003, and 2004; 18,167,332 and 18,557,818 shares issued and outstanding at December 31, 2003 and 2004, respectively		
	18	19
Additional paid-in capital	134,449	136,868
Accumulated deficit	(35,988 )	(34,338 )
Total stockholders' equity	98,479	102,549
Total liabilities and stockholders' equity	\$ 119,433	\$ 119,163

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

**CEVA, INC. AND ITS SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(U.S. dollars in thousands, except share and per share data)**

	<b>Year Ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Revenues:			
Licensing and royalties	\$ 14,739	\$ 29,795	\$ 32,271
Other revenue	4,457	7,041	5,402
Total revenues	19,196	36,836	37,673
Cost of revenues	2,168	6,061	5,178
Gross profit	17,028	30,775	32,495
Operating expenses:			
Research and development, net	8,414	17,382	17,276
Selling and marketing	3,356	6,058	6,965
General and administrative	3,557	6,109	5,863
Amortization of intangible assets	189	1,127	892
In-process research and development	15,771		
Reorganization, restructuring and severance charge	6,442	8,620	
Impairment of assets		3,233	
Total operating expenses	37,729	42,529	30,996
Operating income (loss)	(20,701 )	(11,754 )	1,499
Other income (expense), net	(207 )	63	796
Income (loss) before taxes on income	(20,908 )	(11,691 )	2,295
Taxes on income (loss)	1,014	300	645
Net income (loss)	\$ (21,922 )	\$ (11,991 )	\$ 1,650
Basic net income (loss) per share	\$ (2.15 )	\$ (0.66 )	\$ 0.09
Diluted net income (loss) per share	\$ (2.15 )	\$ (0.66 )	\$ 0.09
Weighted average number of shares of Common Stock used in computation of net income (loss) per share (in thousands)			

Basic	10,177	18,106	18,421
Diluted	10,177	18,106	19,016

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

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**CEVA, INC. AND ITS SUBSIDIARIES**  
**STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY AND**  
**RELATED COMPANY INVESTMENT**

(U.S. dollars in thousands, except share data)

	Common Stock		Additional paid in capital	Related Company investment	Accumulated deficit	Total stockholders equity and Related Company investment
	Shares	Amount				
<b>Balance as of January 1, 2002</b>	20,000,000	\$ 20	\$	\$ 4,325	\$	\$ 4,345
Capital contribution from Related Company upon separation	1,000	(*)	45,607			45,607
Non-cash contribution from Related Company upon separation			2,073			2,073
Issuance of Common Stock in consideration of the acquisition of Parthus	8,998,887	9	86,304			86,313
Retirement of Common Stock upon separation	(10,959,149 )	(11 )		11		
Amortization of deferred stock compensation			37			37
Issuance of Common Stock	12,769		30			30



upon exercise of employee stock options							
Net loss					(21,922 )		(21,922 )
Capital return to Related Company					(4,336 )	(2,075 )	(6,411 )
<b>Balance as of December 31, 2002</b>	18,053,507	18	134,051			(23,997 )	110,072
Issuance of Common Stock upon exercise of employee stock options (a)	15,647	(*)	43				43
Issuance of Common Stock under employee stock purchase plan (a)	98,178	(*)	355				355
Net loss					(11,991 )		(11,991 )
<b>Balance as of December 31, 2003</b>	18,167,332	18	134,449			(35,988 )	98,479
Issuance of Common Stock upon exercise of employee stock options (a)	193,886	(*)	1,417				1,417
Issuance of Common Stock under employee stock purchase plan (a)	196,600	1 (*)	773				774
Stock-based compensation			229				229
Net income						1,650	1,650
<b>Balance as of December 31, 2004</b>	18,557,818	\$ 19	\$ 136,868	\$	\$	(34,338 )	\$ 102,549

(\*) Amount less than \$ 1.

(a) See Note 7 to these consolidated financial statements

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

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**CEVA, INC. AND ITS SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(U.S. dollars in thousands)

	Year Ended December 31,		
	2002	2003	2004
Cash flows from operating activities:			
Net income (loss)	\$ (21,922 )	\$ (11,991 )	\$ 1,650
Adjustments required to reconcile net income (loss) to net cash used in operating activities:			
Depreciation	2,360	3,710	2,523
Impairment of tangible assets		910	
Amortization of intangible assets	189	1,127	892
Redundant asset write down		464	
Impairment of intangible assets		973	
Impairment of investment		1,350	
Stock-based compensation	37		229
Loss (gain) on disposal of fixed assets		39	(9 )
Unrealized gain on investments			(50 )
Unrealized foreign exchange loss (gain)		221	(72 )
In-process research and development	15,771		
Marketable securities			(30,744 )
Changes in operating assets and liabilities:			
Trade receivables	6,843	(3,736 )	(569 )
Other accounts receivable and prepaid expenses	2,132	(41 )	612
Deferred income taxes	240		(195 )
Inventories	239	168	
Trade payables	(1,057 )	(524 )	(404 )
Deferred revenues	(1,786 )	(51 )	687
Accrued expenses and other payables	(1,470 )	(4,983 )	(4,233 )
Taxes payable	(3,516 )	(400 )	(184 )

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Accrued severance pay, net	39	(56 )	108
Net cash used in operating activities	(1,901 )	(12,820 )	(29,759 )
Cash flows from investing activities:			
Purchase of property and equipment	(860 )	(2,691 )	(3,125 )
Proceeds from sale of property and equipment	124	142	54
Proceeds from long-term lease deposits	190		
Purchase of technology	(1,593 )	(72 )	(115 )
Proceeds from acquisition of Parthus (a)	42,145		
Net cash provided by (used in) investing activities	40,006	(2,621 )	(3,186 )
Cash flows from financing activities:			
Capital return to Related Company	(4,325 )		
Capital contribution from Related Company upon Separation	40,000		
Proceeds from issuance of Common Stock upon exercise of employee options	30	43	1,417
Proceeds from issuance of Common Stock under employee stock purchase plan		355	774
Net cash provided by financing activities	35,705	398	2,191
Effect of exchange rate movements on cash		363	468
Increase (decrease) in cash and cash equivalents	73,810	(14,680 )	(30,286 )
Cash and cash equivalents at the beginning of the year		73,810	59,130
Cash and cash equivalents at the end of the year	\$ 73,810	\$ 59,130	\$ 28,844

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

**CEVA, INC. AND ITS SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)****(U.S. dollars in thousands)**

	<b>Year Ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
(a) Proceeds from acquisition of a consolidated subsidiary, Parthus, estimated fair values of assets acquired and liabilities assumed at the date of acquisition:			
Working capital deficiency, excluding cash and cash equivalents	\$ 14,877	\$	\$
Property and equipment	(6,018 )		
Investments in other company	(1,350 )		
Parthus name	(610 )		
Patent portfolio	(2,247 )		
Current technology and customer backlog	(2,824 )		
In-process research and development	(14,178 )		
Transaction costs	973		
Transaction costs incurred by Related Company prior to separation	5,607		
Goodwill	(38,398 )		
Less amount acquired by issuance of shares	86,313		
	\$ 42,145	\$	\$
Supplemental information of cash-flows activities:			
Cash paid during the year for:			
Income taxes	\$ 32	\$ 450	\$ 842
Supplemental disclosure of non-cash investing and financing activities:			
Transaction costs	\$ 973	\$	\$
Contribution of property, equipment and inventory from related company upon separation	\$ 2,073	\$	\$

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

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**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1: ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

*Organization:*

CEVA, Inc. ( CEVA or the Company ) was a wholly owned subsidiary of DSP Group, Inc. ( DSPG or the Related Company ) until November 1, 2002. On November 1, 2002, DSPG, the Company and Parthus Technologies plc ( Parthus ) completed a combination of their businesses pursuant to a combination agreement dated April 4, 2002. DSPG contributed the DSP cores licensing business and operations and the related assets and liabilities of such business and operations to the Company; DSPG then spun-off the Company to the existing stockholders of DSPG (the separation ); and Parthus was acquired by the Company from the existing shareholders of Parthus. The combined company was initially named ParthusCeva, Inc., and was renamed CEVA, Inc. in December 2003.

The Company was incorporated in Delaware on November 22, 1999. The Company had no business or operations prior to the transfer of the DSP cores licensing business and operations from DSPG.

These financial statements give effect to the transfer by DSPG of the DSP cores licensing business and operations and the related assets and liabilities of such businesses to the Company for all periods presented and include the results of Parthus subsequent to the Combination on November 1, 2002.

CEVA licenses to semiconductor companies and electronic equipment manufacturers (also known as original equipment manufacturers, or OEMs) digital signal processor (DSP) cores and related intellectual property (IP) solutions that enable a wide variety of electronic devices. The Company's programmable DSP cores and application-level IP solutions power wireless devices, handheld devices, consumer electronics products, global positioning system (GPS) devices, consumer audio products and automotive applications.

*a. Use of estimates:*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

*b. Basis of presentation and principles of consolidation:*

The consolidated financial statements have been prepared according to United States Generally Accepted Accounting Principles ( U.S. GAAP ).

The consolidated financial statements incorporate the financial statements of the Company and all of its subsidiaries. All significant inter-company balances and transactions have been eliminated on consolidation.

For periods prior to November 1, 2002, the Company's financial statements present the financial position, results of operations and cash flows of the licensing business and operations of DSPG, which have been carved out from the financial statements of DSPG using the historical results of operations and historical bases of the assets and liabilities of the DSPG business that it comprises. The consolidated financial statements reflect the assets, liabilities, results of operations, changes in stockholders' equity and Related Company investment, and cash flows (the Company's Business ) as if the Company and its subsidiaries had been a separate entity for all periods presented.

Changes in Related Company investment represent DSPG's contribution of its net investment after giving effect to the net income of the Company plus net cash transfers to or from DSPG. DSPG and the Company jointly agreed the balance of the net investment account as of November 1, 2002.

The Company began accumulating its retained earnings on November 1, 2002, the date on which DSPG transferred to the Company all of the assets and liabilities relating to the Company's Business.

The transfer of assets, liabilities and operations of the Company's Business from DSPG is a reorganization of entities under common control and has been accounted for in a manner similar to a pooling of interests.



**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Accordingly, the financial statements of the Company have been restated to include the Company's Business as if it had always been operated as a separate entity.

*c. Financial statements in U.S. dollars:*

A majority of the revenue of the Company and its subsidiaries is generated in U.S. dollars (dollars). In addition, a substantial portion of the Company and its subsidiaries' costs are incurred in U.S. dollars. The Company's management believes that the U.S. dollar is the primary currency of the economic environment in which the Company and its subsidiaries principally operate. Thus, the functional and reporting currency of the Company and its subsidiaries is the U.S. dollar.

Accordingly, monetary accounts maintained in currencies other than the U.S. dollar are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standards (SFAS) No. 52, Foreign Currency Translation. All transaction gains and losses from remeasurement of monetary balance sheet items are reflected in the Consolidated Statements of Operations as financial income or expenses as appropriate, which is included in Other income (expense). The Company recorded a foreign exchange gain of \$37 in 2004 and foreign exchange losses of approximately \$690,000 in 2003 and \$484,000 in 2002. The foreign exchange losses arose principally on euro liabilities as a result of the appreciation of the euro against the U.S. dollar. The Company reviews their monthly expected non-US dollar denominated expenditure and look to hold equivalent non-U.S. dollar cash balances to mitigate currency fluctuations and this has resulted in a neutral foreign exchange impact in 2004.

*d. Cash equivalents:*

Cash equivalents are short-term highly liquid investments that are readily convertible to cash with maturities of three months or less from the date acquired.

*e. Marketable securities:*

Marketable securities consist of certificates of deposits and U.S. government and agency securities. Marketable securities are stated at market value, and by policy, the Company invests in high grade marketable securities. All marketable securities are defined as trading securities under the provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and unrealized holding gains and losses are reflected in the Consolidated Statements of Operations.

*f. Property and equipment:*

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, at the following annual rates:

	%
Computers, software and equipment	25-33
Office furniture and equipment	7-25
Plant and equipment	20-33
Motor vehicles	15
Leasehold improvements	10-25

(being shorter of  
lease term or  
useful economic  
life)

The Company and its subsidiaries long-lived assets and certain identifiable intangibles are reviewed for impairment in accordance with SFAS Standard No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Recoverability of the carrying amount of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs.

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*g. Investment in a company:*

Investments in privately held companies in which the Company does not have the ability to exercise significant influence over operating and financial policy are presented at cost. The carrying value is periodically reviewed by management for impairment. If this review indicates that the cost is not recoverable, the carrying value is reduced to its estimated fair value. As part of the combination with Parthus, CEVA acquired a minority investment in a private company ( the Portfolio Company ). CEVA has no influence or control over the Portfolio Company or any board representation. In December 2003, the Portfolio Company commenced a round of private funding at a significantly reduced valuation to CEVA's original investment. CEVA assessed the carrying value of the investment taking into consideration an assessment of discounted projected future cash flows, the valuation derived from the most recent proposed private placement, the liquidity of the investment and the general market conditions in which the Portfolio Company operates, and recognized an impairment charge of \$1,350 during 2003 reducing its estimated fair value to \$0.

*h. Goodwill:*

Goodwill represents the excess of purchase price over the fair value of the net assets of businesses acquired. Under SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill acquired in a business combination on or after July 1, 2001, is not amortized. As a result of the Parthus acquisition in November 2002, the Company recorded goodwill in the amount of \$38,398 and one-time non-cash in-process research and development charges of \$14.2 million arising in connection with the combination with Parthus and \$1.6 million relating to certain wireless design technology which had not reached technological feasibility and had no alternative future use.

SFAS No. 142 requires goodwill to be tested for impairment on adoption and at least annually thereafter or between annual tests in certain circumstances, and written down when impaired, rather than being amortized as previous accounting standards required.

The Company completes its annual test of impairment for goodwill in October of each year. In addition the Company tests for impairment periodically whenever events or circumstances occur subsequent to its annual impairment test that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Indicators the Company considers important which could trigger an impairment include, but are not limited to, significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of the acquired assets or the strategy for the Company's overall business, significant negative industry or economic trends, a significant decline in the Company's stock price for a sustained period and the Company's market capitalization relative to net book value.

The goodwill impairment test, which is based on fair value, is performed on a reporting unit level. A reporting unit is defined by SFAS No. 131, *Disclosure About Segments of an Enterprise and Related Information*, as an operating segment or one level lower. The Company markets its products and services in one segment and thus allocates

goodwill to one reporting unit. Therefore, impairment is tested at the enterprise level using the Company's market capitalization as fair value. Accordingly, in conducting the first step of this impairment test, the Company compares the carrying value of its assets and liabilities to its market capitalization. If the carrying value exceeds the fair value, the goodwill is potentially impaired and the Company then completes the second step in order to measure the impairment loss. If the fair value exceeds the carrying value, the second step in order to measure the impairment loss is not required.

In the second step of the impairment test, the fair value of all the unit's balance sheet assets and liabilities, as well as the Company's identifiable intangible assets, excluding goodwill, must be determined at the valuation date. The Company estimates the future cash flows to determine the fair value of these assets and liabilities. These cash flows are then discounted at rates reflecting the respective specific industry's cost of capital. The discounted cash flows are then compared to the carrying amount of the Company's assets and liabilities to determine if an impairment exists. If, upon review, the fair value is less than the carrying value, the carrying value is written down to estimated fair value.

Should the Company's market capitalization decline, in assessing the recoverability of goodwill, the Company may be required to make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. This process is subjective and requires judgment at many points throughout the analysis. If the Company's estimates or their related assumptions change in subsequent periods or if

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

actual cash flows are below their estimates, an impairment charge may be required for these assets not previously recorded.

In October 2004, the Company completed its annual impairment test and assessed the carrying value of goodwill as required by SFAS 142. The goodwill impairment test compared the carrying value of the Company (the reporting unit ) with the fair value at that date. Because the market capitalization exceeded the carrying value significantly, no impairment arose. No indicators of impairment were identified between the date of the annual impairment test and year end.

*i. Other intangible assets:*

Intangible assets acquired in a business combination should be amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS No. 144, *Accounting for Impairment of Long-Lived Assets* . The costs of technology have been capitalized and are amortized to the Consolidated Statements of Operations over the period during which benefits are expected to accrue, currently estimated at five years.

The Company is required to test their other intangible assets for impairment whenever events or circumstances indicate that the value of the assets may be impaired. Factors the Company consider important, which could trigger impairment include:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of the Company's use of the acquired assets or the strategy for the Company's overall business;

significant negative industry or economic trends;

significant decline in the Company's stock price for a sustained period; and

significant decline in the Company's market capitalization relative to net book value.

Where events or circumstances are present which indicate that the carrying amount of an intangible asset may not be recoverable, the Company will recognize an impairment loss. Such impairment loss is measured by comparing the fair value of the assets with their carrying value. The determination of the value of such intangible assets requires the Company to make assumptions regarding future business conditions and operating results in order to estimate future cash flows and other factors to determine the fair value of the respective assets. The Company incurred an impairment loss of US\$973 and an asset write down charge of \$164 in 2003. Further details are contained in Note 4.

*j. Revenue recognition:*

The Company generates its revenues from (1) licensing intellectual property, which in certain circumstances is modified to customer-specific requirements, (2) royalty income and (3) other income, which includes design and consulting services and maintenance for licensees. The Company licenses its IP to semiconductor companies throughout the world. These semiconductor companies then manufacture, market and sell custom-designed chips to original equipment manufacturers of a variety of electronic products. The Company also licenses its technology directly to OEMs, which are considered end users.

The Company accounts for its IP license revenues in accordance with Statement of Position 97-2, "Software Revenue Recognition", as amended by SOP 98-4 and SOP 98-9 issued by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants and related interpretations (collectively, "SOP 97-2"). Under the terms of SOP 97-2, revenues are recognized when: (1) collectability is probable; (2) delivery has occurred; (3) the vendor's fee is fixed or determinable; and (4) persuasive evidence of an arrangement exists. SOP 97-2 generally requires revenue earned on licensing arrangements involving multiple elements to be allocated to each element based on the relative vendor specific objective evidence of fair value (VSOE) of the elements. The Company has also adopted SOP 98-9, "Modification of SOP 97-2, Software

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Revenue Recognition with Respect to Certain Transactions, for multiple element transactions entered into after January 1, 2000. SOP 98-9 requires that revenue be recognized under the residual method when VSOE of fair value exists for all undelivered elements and VSOE does not exist for one of the delivered elements. The VSOE of fair value of the undelivered elements (support and maintenance, upgrades, training, etc) is determined based on the price charged for the undelivered element when sold separately. If an undelivered element is not currently sold separately we determine VSOE in accordance with SOP 97-2 based on the price established by Management having the authority to do so.

SOP 97-2 specifies that extended payment terms in a licensing arrangement may indicate that the license fees are not deemed to be fixed or determinable. If the fee is not fixed or determinable, or if collection is not considered probable, revenue is recognized as payments become due from the customer, provided that all other revenue recognition criteria have been met. SOP 97-2 specifies that if a company has a standard business practice of using extended payment terms in licensing arrangements and has a history of successfully collecting the license fees under the original terms of the licensing arrangement without making concessions, the company should recognize the license fees when all other SOP 97-2 revenue recognition criteria are met. The Company has concluded that certain arrangements with extended payment terms of up to a maximum of eighteen months meet these criteria.

Under certain circumstances revenue consists of license fees received under the terms of license agreements pursuant to which the Company modifies its IP to that customer's specific requirements. The Company's IP consists of software and related documentation that enable a customer to produce integrated circuits and related technology and software. In general the time between the signing of such a license and final customer acceptance is between three and twelve months. Fees are payable upon completion of agreed upon milestones, such as delivery of specifications and technical documentation. Each license is designed to meet the specific requirements of the particular customer and can vary from rights to incorporate Company technology into a customer's own application specific product to the complete design of a system on a chip. No upgrades or modifications to the licensed IP are provided. Following customer acceptance, the Company has no further obligations under the license agreement (other than pursuant to a separate service and maintenance agreement).

Revenues from license fees that involve customization of the Company's IP to customer specific specifications are recognized in accordance with the principles set out in Statement of Position 81-1, Accounting for Performance of Construction Type and Certain Production Type Contracts, (SOP 81-1) using contract accounting on a percentage of completion method, over the period from signing of the license through to customer acceptance in accordance with the Input Method. The amount of revenue recognized is based on the total license fees under the license agreement and

the percentage of completion achieved. The percentage of completion is measured by monitoring progress using records of actual time incurred to date in the project compared to the total estimated project requirements, which corresponds to the costs related to earned revenues. Estimates of total project requirements are based on prior experience of customization, delivery and acceptance of the same or similar technology and are reviewed and updated regularly by management. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2004, no such estimated losses were identified. The amount of revenue recognized under SOP 81-1 that was unbilled due to milestone related invoicing was \$1,489 at December 31, 2004 and \$822 at December 31, 2003.

Estimated gross profit or loss from long-term contracts may change due to changes in estimates resulting from differences between actual performance and original forecasts. Such changes in estimated gross profit are recorded in results of operations when they are reasonably determinable by management, on a cumulative catch-up basis.

The Company believes that the use of the percentage of completion method is appropriate as the Company has the ability to make reasonably dependable estimates of the extent of progress towards completion, contract revenues and contract costs. In addition, contracts executed include provisions that clearly specify the enforceable rights regarding services to be provided and received by the parties to the contracts, the consideration to be exchanged and the manner and terms of settlement. In all cases the Company expects to perform its contractual obligations and its licensees are expected to satisfy their obligations under the contract.



**CEVA, INC. AND ITS SUBSIDIARIES****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Royalties from licensing the right to use the Company's IP are recognized when the related sales are made. The Company determines such sales by receiving confirmation of sales subject to royalties from licensees. Non-refundable payments on account of future royalties are recognized upon payment, provided that no future obligation exists. Prepaid royalties are recognized under the licensing revenue line.

Revenues from licensing sales are composed as follows:

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Licensing and royalties revenues:			
Licensing	\$ 12,302	\$ 25,738	\$ 26,240
Royalties	2,437	4,057	6,031
	<b>\$ 14,739</b>	<b>\$ 29,795</b>	<b>\$ 32,271</b>

In addition to license fees, contracts with customers generally contain an agreement to provide support and maintenance, which consists of an identified customer contact at the Company and telephone or e-mail support. Fees for post contract support, which take place after customer acceptance, are specified in the contract and are generally mandatory for the first year. After the mandatory period, the customer may extend the support and maintenance agreement on similar terms on an annual basis. The Company recognizes revenue for post contract support on a straight-line basis over the period for which technical support and maintenance and training are contractually agreed with the licensee.

Design and consulting services entail the development and design of integrated circuits for specific customers. Revenues from design services comprise revenues arising from fees for service contracts based on time and materials. Revenue from these services is recognized when the service has been provided and all obligations to the customer under the contract have been fulfilled.

Hard IP is the incorporation of intellectual property into reference designs (either as silicon chips or printed circuit boards). Revenues from Hard IP are recognized when reference designs are complete, delivery has occurred and all obligations to the customer are fulfilled. In the fourth quarter of 2003, the Company ceased producing and selling chips embodying its technology, which is referred to as Hard IP.

Revenues from design and consulting services, support and maintenance and Hard IP are included under other revenue.

The Company does not grant rights of return.

When a sale of the Company's IP is made to a third party who also supplies the Company with goods or services under separate agreements, the Company evaluates each of the agreements to determine whether they are clearly separable, and independent of one another and that reliable fair value exists for either the sales or purchase element in order to determine the appropriate revenue recognition.

Deferred revenues include unearned amounts received under license agreements, unearned technical support and maintenance and amounts billed to customers not yet recognized as revenues.

*k. Cost of Revenue:*

Cost of revenue includes the costs of products and services. Cost of product revenue includes shipping, handling, materials (such as diskettes, packaging and documentation) and the portion of development costs associated with product development arrangements. Cost of service revenue includes the salary costs for personnel engaged in consultancy, training and customer support, and telephone and other support costs.

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*l. Income taxes:*

The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

Deferred tax assets and liabilities are determined using enacted tax rates for the effects of net operating losses and temporary differences between the book and tax bases of assets and liabilities. The Company has provided a valuation allowance on the majority of their net deferred tax assets, which includes federal and foreign net operating loss carryforwards, because of the uncertainty regarding their realization. Accounting for deferred taxes under SFAS 109, involves the evaluation of a number of factors concerning the realizability of the Company's deferred tax assets. In concluding that a valuation allowance was required, the Company primarily considered such factors as their history of operating losses and expected future losses in certain jurisdictions and the nature of their deferred tax assets. The Company provides valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. Management currently believes that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses will not be realized in the foreseeable future. In the event that the Company was to determine that it would not be able to realize all or part of its deferred tax assets in the future, an adjustment to the deferred tax assets would be charged to earnings in the period in which it makes such determination. Likewise, if the Company later determines that it is more likely than not that the net deferred tax assets would be realized, the Company would reverse the applicable portion of the previously provided valuation allowance. In order for the Company to realize its deferred tax assets it must be able to generate sufficient taxable income in the tax jurisdictions in which the deferred tax assets are located.

The Company does not provide for US Federal Income taxes on the undistributed earnings of its international subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be re-invested indefinitely. In addition, the Company operates within multiple taxing jurisdictions involving complex issues and it provides for tax liabilities on investment activity as appropriate.

*m. Research and development:*

SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a working model. The Company and its subsidiaries do not incur material costs between the completion of the working model and the point at which the product is ready for general release. Therefore, research and development costs are charged to the Consolidated Statements of Operations as incurred.

*n. Government grants:*

Government grants received relating to capital expenditure are offset against the cost of the related property and equipment.

Grants relating to categories of operating expenditures are credited in the period in which the expenditure to which they relate is charged.

Non-royalty-bearing grants from the Government of Israel for funding certain approved research and development projects are recognized at the time when the Company is entitled to such grants, on the basis of the related costs incurred, and included as a deduction from research and development costs.

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company and its subsidiaries recorded grants in the amounts of \$869, \$1,994 and \$346 for the years ended December 31, 2002, 2003 and 2004, respectively.

*o. Pension costs:*

The Company contributes to defined contribution plans covering all eligible employees. The Company contributes to these plans based upon various fixed percentages of employee compensation, and such contributions are expensed as incurred.

*p. Accrued severance pay:*

CEVA's Israeli subsidiary's liability for severance pay is calculated pursuant to Israeli severance pay laws for all employees, based on the most recent salary of each employee multiplied by the number of years of employment for that employee as of the balance sheet date. The Israeli subsidiary's liability is fully provided by monthly deposits with severance pay funds, insurance policies and by an accrual.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israeli severance pay laws or labor agreements. The value of these policies is recorded as an asset in the Company's balance sheet.

Severance pay expenses, net of related income for the years ended December 31, 2002, 2003 and 2004, were approximately \$332, \$416 and \$488, respectively.

*q. Accounting for stock-based compensation:*

The Company has elected to follow Accounting Principles Board Statement No. 25, *Accounting for Stock Options Issued to Employees* (APB No. 25), and related interpretations (collectively, APB No. 25) in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of an employee stock option is less than the market price of the underlying stock on the date of grant, compensation expense is recognized.

Under SFAS No. 123, *Accounting for Stock Based Compensation*, pro forma information regarding net income (loss) per share is required, and has been determined as if CEVA had accounted for its employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a

Black-Scholes option pricing model with the following weighted-average assumptions:

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Dividend yield	0%	0%	0%
Expected volatility	80%	80%	45-80%
Risk-free interest rate	2%	2%	2%
Expected life of up to	4 years	4 years	3-4 years

Weighted-average fair value of the options granted to the employees of the Company whose exercise price is equal to the market price of the shares of the Company at the date of grant are as follows:

	<b>Weighted-average fair value of option grants at an exercise price</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Equal to fair value at dates of grant	\$ 12.46	\$ 8.15	\$ 8.10

## CEVA, INC. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following pro forma information includes the effect of the options granted to the Company's employees to purchase shares. For purposes of pro forma disclosures, the estimated fair value of the options is amortized over the options' vesting period.

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Net income (loss) as reported	\$ (21,992 )	\$ (11,991 )	\$ 1,650
Add: Total stock-based employee compensation expense determined under the fair value based method of SFAS 123 for all awards, net of related tax effects	(8,722 )	(9,116 )	(10,462 )
Pro forma net loss:	\$ (30,714 )	\$ (21,107 )	\$ (8,812 )
Net income (loss) per share:			
Basic and diluted as reported	\$ (2.15 )	\$ (0.66 )	\$ 0.09
Basic and diluted pro-forma	\$ (3.02 )	\$ (1.17 )	\$ (0.48 )

As allowed under SFAS No. 123 and related pronouncements, the pro forma stock-based compensation expense presented above has been calculated using the accelerated method specified in SFAS No.28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans .

*r. Fair value of financial instruments:*

The carrying amount of cash, cash equivalents, trade receivables, other accounts receivable, unbilled revenue, and trade payables and other accounts payable approximates fair value due to the short-term maturities of these instruments. The fair value of marketable securities (classified as trading) are based on quoted market prices at year end.

*s. Concentration of credit risk:*

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash, cash equivalents and trade receivables. The Company invests its surplus cash in cash deposits in financial institutions with strong credit ratings and has established guidelines relating to the diversification and maturities that maintain safety and liquidity. The Company performs ongoing credit evaluations of their customers and to date have not experienced any material losses. The Company makes judgments on its ability to collect outstanding receivables and provide allowances for the portion of receivables for which collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding receivables. In determining the provision, the Company considers

the historical collection experience and current economic trends.

The Company invests cash in high grade certificates of deposits and U.S. government and agency securities. Cash held by foreign subsidiaries is generally held in short-term time deposits denominated in the local currency.

Net interest income was \$759,000 in 2004, \$750,000 in 2003 and \$277,000 in 2002. The Company is exposed primarily to fluctuations in the level of U.S. and EMU interest rates. To the extent that interest rates rise, fixed interest investments may be adversely impacted, whereas a decline in interest rates may decrease the anticipated interest income for variable rate investments.

The Company is exposed to financial market risks, including changes in interest rates. The company typically does not attempt to reduce or eliminate its market exposures on its investment securities because the majority of its investments are short-term. The Company does not have any derivative instruments.

The Company has no off-balance-sheet concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

*t. Advertising expenses:*

Advertising expenses are charged to the Consolidated Statements of Operations as incurred. Advertising expenses for the years ended December 31, 2002, 2003 and 2004 were, \$304 , \$154 and \$52, respectively.



## CEVA, INC. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

*u. Net income ( loss) per share of Common Stock:*

Basic net income (loss) per share is computed based on the weighted-average number of shares of Common Stock outstanding during each year. Diluted net income per share is computed based on the weighted-average number of shares of Common Stock outstanding during each year, plus dilutive potential shares of Common Stock considered outstanding during the year, in accordance with SFAS No. 128, Earnings Per Share .

(in thousands except per share data)

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
<b>Numerator:</b>			
Numerator for basic and diluted net income (loss) per share	\$ (21,992 )	\$ (11,991 )	\$ 1,650
<b>Denominator:</b>			
Denominator for basic net income (loss) per share	10,177	18,106	18,421
Effect of employee stock options			595
Denominator for diluted net income (loss) per share	10,177	18,106	19,016
Net income (loss) per share:			
Basic net income (loss) per share	\$ (2.15 )	\$ (0.66 )	\$ 0.09
Diluted net income (loss) per share	\$ (2.15 )	\$ (0.66 )	\$ 0.09

*v. Impact of recently issued accounting standards:*

FASB Staff Position ( FSP ) No. 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 ( FSP 109-2 ), provides guidance under SFAS Statement No. 109, Accounting for Income Taxes, with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the Jobs Act ) on enterprises' income tax expense and deferred tax liability. Foreign earnings are currently required for continued investment in the local jurisdiction. Accordingly, as provided for in FSP 109-2, the Company has not adjusted its tax expense or deferred tax liability to reflect the repatriation provisions of the Jobs Act.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ), which replaces SFAS No. 123, Accounting for Stock-Based Compensation, ( SFAS 123 ) and supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values and is effective for public companies at the beginning of the first interim or annual period beginning after June 15, 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. The Company is required to adopt SFAS 123R in the third quarter of fiscal 2005, beginning July 1, 2005. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The Company is evaluating the requirements of SFAS 123R and expects that the adoption of SFAS 123R will have a material impact on the Company's Consolidated Statements of Operations and net income (loss) per share. The Company has not yet determined the method of adoption or the effect of adopting SFAS 123R, and it has not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

The adoption or future adoption of the following recent accounting pronouncements have not or are not expected to have a material impact on the Company's results of operations and financial condition:

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

SFAS No. 153, Exchanges of Nonmonetary Assets An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions ( SFAS 153 ). SFAS 153 is effective for the fiscal periods beginning after June 15, 2005;

FASB Interpretation No. 46(R) ( FIN 46R ), Consolidation of Variable Interest Entities An Interpretation of ARB No. 51 ;

FASB issued revised SFAS No. 132 (R) (revised 2003), Employer s Disclosures about Pensions and Other Post-Retirement Benefits An Amendment of FASB Statements No. 87, 88, and 106 ;

EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments ; and

EITF Issue No. 03-5, Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software.

**NOTE 2: MARKETABLE SECURITIES**

Marketable securities consist of certificates of deposits and U.S. government and agency securities. Marketable securities are stated at market value, and by policy, CEVA invests in high grade marketable securities to reduce risk of loss. All marketable securities are defined as trading securities under the provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities , and unrealized holding gains and losses are reflected in the Consolidated Statements of Operations.

**As at December 31, 2004**

	<b>Cost</b>	<b>Unrealized Gain (Loss)</b>	<b>Market Value</b>
Certificates of deposits	\$ 5,280	\$ (3 )	\$ 5,277
U.S. government and agency securities	25,464	53	25,517
	\$ 30,744	\$ 50	\$ 30,794

Marketable securities were purchased in 2004 and the unrealized gain (loss) has been included in net income. There were no marketable securities at December 31, 2003.

### **NOTE 3: PROPERTY AND EQUIPMENT, NET**

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
Cost:		
Computers, software and equipment	\$ 9,364	\$ 10,716
Office furniture and equipment	574	1,328
Plant and equipment	69	
Leasehold improvements	710	897
Motor vehicles	154	22
	10,871	12,963
Accumulated depreciation	6,079	8,492
Total property and equipment, net	\$ 4,792	\$ 4,471

The Company recorded in 2003 a non-cash impairment charge of \$910 in connection with non-performing assets following the realignment of business structures and a non-cash restructuring charge of \$300 following the decision to cease the Company's Hard IP manufacturing product line and certain non-strategic technology areas. Depreciation expense was \$2,360, \$3,710 and \$2,523 for the years ended December 31, 2002, 2003 and 2004, respectively.

## CEVA, INC. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## NOTE 4: GOODWILL AND OTHER INTANGIBLE ASSETS, NET

	December 31, 2003				December 31, 2004			
	Gross Carrying Amount	Impairment Loss/Asset write down	Accumulated Amortization	Net	Gross Carrying Amount	Impairment Loss/Asset write down	Accumulated Amortization	Net
Goodwill	\$ 38,398	\$	\$	\$ 38,398	\$ 38,398	\$	\$	\$ 38,398
Other intangible assets amortizable:								
Parthus name	610	478	132		610	478	132	
Patent portfolio	2,247		524	1,723	2,247		972	1,275
Current technology and customer backlog	2,824	659	645	1,520	2,824	659	1,043	1,122
Purchased technology	227		15	212	227		61	166
	5,908	1,137	1,316	3,455	5,908	1,137	2,208	2,563
Total identifiable intangible assets	\$ 44,306	\$ 1,137	\$ 1,316	\$ 41,853	\$ 44,306	\$ 1,137	\$ 2,208	\$ 40,961

Intangible assets primarily represent the acquisition of certain intellectual property together with the value of patents acquired on the purchase of Parthus.

Future estimated annual amortization charges are as follows:

2005	\$ 892
2006	892
2007	751
2008	28
	\$ 2,563

The Company recorded in 2003 a non-cash impairment charge of \$973 arising in respect of certain technology acquired and the Parthus name following the rebranding and realignment of business structures and a \$164 restructuring charge following the decision to cease the Company's Hard IP manufacturing product line and certain non-strategic technology areas. Amortization expense was \$189, \$1,127 and \$892 for the years ended December 31, 2002, 2003 and 2004, respectively.

**NOTE 5: PREPAID EXPENSES AND OTHER ACCOUNTS RECEIVABLE**

**PREPAID EXPENSES**

**December 31,  
2003      2004**

Current:

Prepaid leased design tools	\$ 562	\$ 317
Prepaid directors and officers insurance	406	188
Other prepaid expenses	309	198
	\$ 1,277	\$ 703

**OTHER ACCOUNTS RECEIVABLE**

**December 31,  
2003      2004**

Current:

Indirect taxes	\$ 434	\$ 307
Rental deposits	20	120
Other accounts receivable	214	220
	\$ 668	\$ 647

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 6: ACCRUED EXPENSES AND OTHER PAYABLES**

	<b>December 31,</b>	
	<b>2003</b>	<b>2004</b>
Current:		
Accrued compensation and benefits	\$ 3,569	\$ 3,993
Acquired liabilities	401	
Restructuring accruals	3,374	2,284
Engineering accruals	838	521
Professional fees	953	971
Other accruals	3,741	2,047
	\$ 12,876	\$ 9,816
Non-current Restructuring accruals	\$ 1,583	\$ 782

**NOTE 7: STOCKHOLDERS EQUITY**

*a. Common Stock:*

Holders of the Company's Common Stock are entitled to one vote per share on all matters to be voted upon by the Company's stockholders. In the event of liquidation, dissolution or winding up, holders of the Common Stock are entitled to share ratably in all of the Company's assets. The Board of Directors may declare a dividend out of funds legally available therefor and the holders of Common Stock are entitled to receive ratably any such dividends. Holders of Common Stock have no preemptive rights or other subscription rights to convert their shares into any other securities.

Prior to the Combination with Parthus on November 1, 2002, the Company had 20,000,000 shares of Common Stock outstanding. A separation agreement with DSPG provided for the transfer to CEVA of assets and liabilities from DSPG related to the DSP cores licensing business in exchange for the issuance by CEVA to DSPG of 1,000 shares of CEVA common stock on the Separation date.

In connection with the separation of the assets related to the DSP cores licensing business discussed in Note 1, DSPG surrendered 10,959,149 shares of CEVA's common stock it held to CEVA without consideration, to adjust the number

of shares of CEVA's common stock held by DSPG, and then distributed the remaining shares of CEVA's common stock it held to the DSPG stockholders on the basis of one share of CEVA common stock for every three shares of DSPG Common Stock held by such stockholders on the record date for the distribution, resulting in the issuance of 9,041,851 shares of CEVA Common Stock. As a result of this adjustment the Company retired the remaining 10,959,149 shares of Common Stock immediately after Separation.

As part of the assets contributed to CEVA in the separation, DSPG also contributed upon issuance of CEVA shares a total sum of \$40,000 as initial working capital, plus transaction costs of \$5,607 incurred and paid by DSPG, and property, equipment and inventory in the amount of approximately \$2,073. In addition, under the separation agreement, the Company has recorded a return of capital in the amount of \$2,075 related to the net income earned in the period prior to the separation.

On November 1, 2002, the Company issued 8,998,887 shares of Common Stock with a fair market value of \$86,313 to Parthus shareholders in exchange for all of the outstanding Parthus shares.

*b. Preferred Stock:*

The Company is authorized to issue up to 5,000,000 shares of blank check Preferred Stock, par value \$0.001 per share. Such Preferred Stock may be issued by the Board of Directors from time to time in one or more series, with such designations, preferences and relative, participating, optional or other special rights of such series, and any qualifications, limitations or restrictions thereof; including the dividend rights, dividend rates, conversion rights, exchange rights, voting rights, rights and terms of redemption (including sinking and purchase fund provisions), the redemption price or prices, the dissolution preferences and the rights in respect of any distribution of



**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

assets of any wholly unissued series of Preferred Stock and the number of shares constituting any such series, and the designation thereof.

*c. Related company investment:*

The identification of the assets and liabilities transferred to the Company in the separation was agreed upon between the Company and DSPG. The net equity balance for each year prior to the separation includes additional financing received from DSPG. The net income of the Company was recorded as a return of capital to DSPG. Based on the agreements between DSPG and the Company, upon the separation, DSPG and the Company jointly agreed the net balance of the investment account on November 1, 2002, and DSPG paid the Company a net amount of \$ 796.

Prior to November 1, 2002, DSPG handled virtually all of the cash transactions of the Company's Business, as well as collecting related receivables and settling accounts with related suppliers and other creditors.

*d. Employee stock plans:*

The Company issues stock options to its employees, directors and certain consultants and provides the right to purchase stock pursuant to approved stock option and employee stock purchase programs. The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Options Issued to Employees ( APB No. 25 ), and related interpretations in accounting for its stock option plans. Under APB No. 25, when the exercise price of an employee stock option is less than the market price of the underlying stock on the date of grant, compensation expense is recognized. All options granted under these plans had an exercise price equal to the fair market value of the underlying Common Stock on the date of grant.

Certain stock options issued to non-employee consultants are accounted for under SFAS 123 using the fair value method. A stock compensation charge of \$229 in respect of 96,000 fully vested options granted to non-employee consultants is reflected in the Consolidated Statements of Operations for the year ended December 31, 2004. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions: risk-free interest rate of 2%; dividend yield of 0%; volatility factor of 80%; and a weighted-average expected life of the options of four years. No options were exercised during 2004 and options to purchase 96,000 shares were outstanding as of December 31, 2004.

During 2004, the Company granted options to purchase 1,851,055 shares of Common Stock, at exercise prices ranging from \$7.06 to \$11.75 per share, and the Company issued 390,486 shares of Common Stock under its stock option and purchase programs for consideration of \$2,191. Options to purchase 5,897,634 shares were outstanding at December 31, 2004. During 2003 the Company granted options to purchase 3.7 million shares (including options to purchase 1.6 million shares pursuant to the exchange offer described below), at exercise prices ranging from \$3.36 to \$9.82, per share and the Company issued 113,825 shares of Common Stock under its stock option and purchase programs for consideration of \$398.

In May 2003, the Company made an offer to its employees (including executive officers) and directors to exchange their outstanding options to purchase shares of Common Stock that had an exercise price of more than \$5.50 per share. In exchange for eligible options, participants received a commitment for new stock options to be granted on or after December 19, 2003. Only those participants in the option exchange who were employees or directors of the Company on the date the new options were granted were eligible to receive the new grant. In deciding to make this offer, the Company's Board of Directors and management considered the need to motivate and retain employees. At the time, all then-outstanding options had exercise prices significantly in excess of the trading price of the Company's common stock, which substantially eroded the incentive value of those options. In addition, the exercise price for the substantial majority of the then-outstanding options had been fixed prior to the separation of the Company and its combination with Parthus, based upon a third party's estimated valuation, which included assumptions which proved unrealistic in the ensuing economic environment. As a consequence, the exercise prices of then-outstanding options never reflected actual trading values of the Company's common stock. Options accepted for exchange under the offer were cancelled as of June 18, 2003. The Company granted new options, to purchase 1,569,870 shares, on December 19, 2003. The new options have an exercise price per share of \$9.82, which was the closing price on the NASDAQ National Market on the date the new options were granted.

## CEVA, INC. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of activity of options granted to purchase the Company's Common Stock under the Company's stock option plans is as follows:

	2002		Year ended December 31, 2003		2004	
	Number of options	Weighted-average exercise price	Number of options	Weighted-average exercise price	Number of options	Weighted-average exercise price
Outstanding at the beginning of the year	1,169,126	\$ 12.17	3,316,050	\$ 14.29	5,010,707	\$ 9.66
Granted(1)	2,387,448	15.31	3,696,090	8.15	1,851,055	8.10
Exercised	(12,769 )	2.32	(15,647 )	2.79	(193,886 )	7.31
Forfeited	(227,755 )	14.79	(1,985,786 )	14.43	(770,242 )	11.01
Outstanding at the end of the year	3,316,050	\$ 14.29	5,010,707	\$ 9.66	5,897,634	\$ 8.84
Number of options exercisable as of December 31,	1,568,407	\$ 13.21	2,362,578	\$ 11.81	2,788,677	\$ 10.06

(1) Includes 709,854 options granted in 2002 to CEVA employees who previously held DSPG options. On the distribution date, each DSPG option was converted into two options: an option to purchase the same number of shares of DSPG Common Stock and an option to purchase one share of CEVA's Common Stock for every three shares of DSPG's Common Stock. As a result of the separation, the exercise price of options was reduced and number of shares increased.

This transaction was determined to be an equity restructuring. The Company has accounted for this transaction under FIN 44. According to FIN 44, at the time of an equity restructuring transaction, the exercise price of an option may be reduced and the number of shares under the award increased, to offset the decrease in the per-share price of the stock underlying the award. There is no accounting consequence for changes made to the exercise price and the number of

shares of an outstanding fixed award as a result of an equity restructuring since both of the following criteria were met:

- a. The aggregate intrinsic value of the award immediately after the change is not greater than the aggregate intrinsic value of the award immediately before the change.
- b. The ratio of the exercise price per share to the market value per share is not reduced.

The options granted to the employees and directors of the Company which are outstanding as of December 31, 2004 have been classified into a range of exercise prices as follows:

<b>Exercise price (range) \$</b>	<b>Options outstanding as of December 31, 2004</b>	<b>Weighted-average remaining contractual life (in years)</b>	<b>Weighted-average exercise price</b>	<b>Options exercisable as of December 31, 2004</b>	<b>Weighted-average exercise price of options exercisable</b>
1.5-2.25	6,745	0.6	\$ 2.12	6,745	\$ 2.12
2.26-3.38	15,000	8.3	3.36	8,124	3.36
3.39-5.10	368,891	8.3	4.23	117,148	4.25
5.11-7.6	2,457,467	6.9	7.06	548,742	6.47
7.7-11.40	2,466,234	4.9	9.59	1,624,567	9.75
11.41-15.0	380,840	3.6	13.42	291,351	13.47
15.01-20.0	49,290	3.5	17.70	38,833	17.72
20.01-30.0	153,167	2.0	22.97	153,167	22.97
	5,897,634	5.8	\$ 8.84	2,788,677	\$ 10.06

**CEVA, INC. AND ITS SUBSIDIARIES****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The total number of shares related to the outstanding options excluded from the calculations of diluted net loss per share were 3,316,050, 5,010,707 and 5,301,854 for the years ended December 31, 2002, 2003 and 2004, respectively. The number of shares reserved at December 31, 2004 for future issuance under the equity compensation plans are as follows:

Ceva 2003 Director Stock Option Plan	700,000
Ceva 2002 Stock Incentive Plan	3,222,656
Ceva 2000 Stock Incentive Plan	2,706,768
Ceva 2002 Employee Stock Purchase Plan	705,222

***2003 Director Stock Option Plan***

The Company's 2003 Director Stock Option Plan (the "Director Plan") was adopted by the Board of Directors in April 2003 and by the stockholders in June 2003. Up to 700,000 shares of Common Stock, subject to adjustment in the event of stock splits and other similar events, are reserved for issuance under the Director Plan, which became effective on June 18, 2003. In 2003, options to purchase 293,000 shares, with a weighted-average exercise price of \$7.45 per share, were granted under the Director Plan and options to purchase 51,000 shares were cancelled. In 2004, options to purchase 181,000 shares, with a weighted-average exercise price of \$8.29 per share, were granted under the Director Plan and options to purchase 423,000 shares were outstanding as of December 31, 2004; and no shares had been issued pursuant to the exercise of options under the Director Plan.

The Director Plan provides for the grant of nonqualified stock options to non-employee directors. Options must be granted at an exercise price equal to the fair market value of the Common Stock on the date of grant. Options may not be granted for a term in excess of ten years. The Director Plan permits the following forms of payment of the exercise price of options: (i) payment by cash or certified or bank check or (ii) delivery to the Company of an irrevocable undertaking by a broker to deliver sufficient funds or delivery to the Company of irrevocable instructions to a broker to deliver sufficient funds.

On June 18, 2003, each non-employee director on the Company's board of directors was granted an option to purchase 38,000 shares of common stock. Any person who subsequently becomes a non-employee director of the Company will automatically be granted an option to purchase 38,000 shares of common stock. Each option will vest as to 25% of the shares underlying the option on each anniversary of the option grant.

On June 18, 2003, each non-employee director who had served on the Company's Board of Directors was granted an additional option to purchase 13,000 shares of common stock. Also on that date, any non-employee director who had

served as a chairperson of a committee of the Company's Board of Directors was granted an option to purchase 13,000 shares of common stock. Under the terms of the Director Plan, on June 30 of each year, beginning in 2004, each non-employee director who has served on the Company's Board of Directors as of such date will automatically be granted an option to purchase 13,000 shares of common stock, and each non-employee director shall receive an option to purchase 13,000 shares of Common Stock for each committee on which he or she shall have served as chairperson at such date.

The Company's Board of Directors may grant additional options to purchase a number of shares and with a vesting schedule determined by the Board of Directors in recognition of services provided by a non-employee director in his or her capacity as a director.

The Company's Board of Directors has authority to administer the Director Plan. The Company's Board of Directors has the authority to adopt, amend and repeal the administrative rules, guidelines and practices relating to the Director Plan and to interpret its provisions.

### ***2002 Stock Incentive Plan***

The Company's 2002 Stock Incentive Plan (the "2002 Plan") was adopted by the Board of Directors and sole stockholder in July 2002. Up to 3,300,000 shares of Common Stock, subject to adjustment in the event of stock splits and other similar events, are reserved for issuance under the 2002 Plan. In 2002 and 2003 the Company granted options to purchase 54,235 shares of Common Stock, with a weighted average exercise price of \$4.47 and

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

options to purchase 1,741,720 shares of Common Stock, with a weighted average exercise price of \$6.70 per share, respectively. In 2004 the Company granted options to purchase 1,298,055 shares of Common Stock, with a weighted average exercise price of \$7.48 per share and options to purchase 2,767,866 shares were outstanding as of December 31, 2004. In 2004, the Company issued 77,344 shares of Common Stock upon exercise of options under the 2002 Plan for consideration of \$322.

The 2002 Plan provides for the grant of incentive stock options intended to qualify under Section 422 of the Internal Revenue Code, nonqualified stock options and restricted stock awards. Officers, employees, directors, outside consultants and advisors of the Company and those of the Company's present and future parent and subsidiary corporations are eligible to receive awards under the 2002 Plan. Under current law, incentive stock options may only be granted to employees.

Optionees receive the right to purchase a specified number of shares of the Company's Common Stock at a specified option price, subject to the terms and conditions of the option grant. The Company may grant options at an exercise price less than, equal to or greater than the fair market value of the Company's Common Stock on the date of the grant. Under current law, incentive stock options and options intended to qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code may not be granted at an exercise price less than the fair market value of the Common Stock on the date of grant, or less than 110% of the fair market value in the case of incentive stock options granted to optionees holding more than 10% of the voting power of the Company's securities. The 2002 Plan permits the Board of Directors to determine how optionees may pay the exercise price of their options, including by cash, check or in connection with a cashless exercise through a broker, by surrender of shares of Common Stock, or by any combination of the permitted forms of payment.

The Company's Board of Directors and its compensation committee have authority to administer the 2002 Plan. The Company's Board of Directors or its compensation committee has the authority to adopt, amend and repeal the administrative rules, guidelines and practices relating to the 2002 Plan and to interpret its provisions.

***2000 Stock Incentive Plan***

In July 2000, the Company adopted the 2000 Stock Incentive Plan (the 2000 Plan ). As of December 31, 2004, there were options to purchase 2,706,768 shares of Common Stock outstanding under the 2000 Stock Incentive Plan, with a weighted average exercise price of \$10.92 per share. In 2003, the Company granted options to purchase 1,661,370 shares (including options to purchase 1,569,870 shares issued under the exchange offer described above), with a weighted average exercise price of \$9.79, under the 2000 Plan. In 2003, the Company issued 15,647 shares of Common Stock upon exercise of options under the 2000 Plan for consideration of \$43. During 2004, the Company granted options to purchase 372,000 shares with a weighted average exercise price of \$10.17, under the 2000 Plan and issued 116,542 shares of Common Stock upon exercise of options under the 2000 Plan for consideration of \$1,095.

Generally, options granted under our Stock Incentive Plans vest at rates of 25% to 50% of the shares underlying the option after one year and the remaining shares vest in equal portions over the following 4 to 12 quarters, such that all shares are vested after two to four years.

### ***2002 Employee Stock Purchase Plan***

The Company's 2002 Employee Stock Purchase Plan (the ESPP ) was adopted by the Company's Board of Directors and sole stockholder in July 2002. The plan is intended to qualify as an Employee Stock Purchase Plan under Section 423 of the U.S. Internal Revenue Code and is intended to provide the Company's employees with an opportunity to purchase Common Stock through payroll deductions. An aggregate of 1,000,000 shares of Common Stock (subject to adjustment in the event of future stock splits, future stock dividends or other similar changes in the Company's Common Stock or the Company's capital structure) have been reserved for issuance and are available for purchase under the ESPP. In 2003 and 2004, the Company issued 98,178 and 196,600 shares of Common Stock to employees under the ESPP for consideration of \$355 and \$773, respectively.



**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

All of the Company's employees who are regularly employed for more than five months in any calendar year and work 20 hours or more per week are eligible to participate in the ESPP. Non-employee directors, consultants, and employees subject to the rules or laws of a foreign jurisdiction that prohibit or make impractical their participation in an employee stock purchase plan are not eligible to participate in the ESPP.

The plan designates offer periods, purchase periods and exercise dates. Offer periods will generally be overlapping periods of 24 months. Purchase periods will generally be six-month periods. Exercise dates are the last day of each purchase period. In the event the Company merges with or into another corporation, sells all or substantially all of the Company's assets, or enters into other transactions in which all of the Company's stockholders before the transaction own less than 50% of the total combined voting power of the Company's outstanding securities following the transaction, the Company's Board of Directors or a committee designated by the board may elect to shorten the offer period then in progress.

The price per share at which shares of Common Stock are to be purchased under the ESPP during any purchase period is the lesser of:

85% of the fair market value of the Company's Common Stock on the date of the grant of the option, which is the commencement of the offer period; or

85% of the fair market value of the Company's Common Stock on the exercise date, which is the last day of a purchase period.

The participant's purchase right is exercised in this manner on each exercise date arising in the offer period unless, on the first day of any purchase period, the fair market value of the Company's Common Stock is lower than the fair market value of the Company's Common Stock on the first day of the offer period. If so, the participant's participation in the original offer period will be terminated, and the participant will automatically be enrolled in the new offer period effective the same date.

The ESPP is administered by the Board of Directors or a committee designated by the Company's board, which will have the authority to terminate or amend the plan, subject to specified restrictions, and otherwise to administer and resolve all questions relating to the administration of the plan.

*g. Dividend policy:*

The Company has never declared or paid any cash dividends on its capital stock and does not anticipate paying any cash dividends in the foreseeable future. In the event that cash dividends are declared in the future, such dividends will be paid in dollars subject to statutory limitations.

**NOTE 8: GEOGRAPHIC INFORMATION AND MAJOR CUSTOMER DATA**

*a. Summary information about geographic areas:*

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, established standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The Company manages its business on a basis of one industry segment: the licensing of intellectual property to semiconductor companies and electronic equipment manufacturers (see Note 1 for a brief description of the Company's business). The following is a summary of operations within geographic areas:

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Revenues based on customer location:			
United States	\$ 7,224	\$ 17,369	\$ 11,104
Europe, Middle East and Africa	7,554	11,426	16,628
Asia (1)	4,418	8,041	9,941
	\$ 19,196	\$ 36,836	\$ 37,673
(1) Japan	\$ 1,413	\$ 4,048	\$ 5,498

## CEVA, INC. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Year ended December 31,		
	2002	2003	2004
Long-lived assets by geographic region:			
United States	\$ 43,890	\$ 41,883	\$ 41,169
Ireland	4,587	2,438	2,005
Israel	2,006	2,324	2,064
Other			264
	\$ 50,483	\$ 46,645	\$ 45,502

	December 31,		
	2002	2003	2004
Net assets by geographic region:			
United States	\$ 79,489	\$ 74,095	\$ 74,978
Ireland	19,070	7,585	6,870
Israel	43	4,017	7,864
Other	11,470	12,782	12,837
	\$ 110,072	\$ 98,479	\$ 102,549

*b. Major customer data as a percentage of total revenues:*

The following table sets forth the customers that represented 10% or more of the Company's net revenue in each of the periods set forth below.

	Year ended December 31,		
	2002	2003	2004
Customer A			12.1 %
Customer B		10.0 %	

Customer C	12.6 %
Customer D	10.6 %

**NOTE 9: TAXES ON INCOME**

A number of the Company's operating subsidiaries are taxed at rates lower than US rates. The Irish operating subsidiary currently qualifies for a 10% tax rate, which under current legislation will remain in force until December 31, 2010. Two other Irish subsidiaries qualify for an exemption from income tax as their revenue source is license fees from qualifying patents within the meaning of Section 234 of the Irish Taxes Consolidation Act 1997.

CEVA's Israeli subsidiary's production facilities have been granted Approved Enterprise status under Israeli law in connection with six separate investment plans. According to the provisions of such Israeli law, CEVA's Israeli subsidiary has elected to enjoy Alternative plan benefits, which is a waiver of grants in return for tax exemption. Accordingly, this company's income from an Approved Enterprise is tax-exempt for a period of two or four years and is subject to a reduced corporate tax rate of 10% - 25% (based on percentage of foreign ownership) for an additional period of six or eight years. The tax benefits under these investment plans are scheduled to gradually expire starting from 2006 through 2013. The period of tax benefits, as detailed above, expires the earlier of 12 years from commencement of production, or 14 years from receipt of approval.

CEVA's Israeli subsidiary's first, second, third, fourth, fifth and sixth plans, commenced operations in 1996, 1998, 1999, 2001, 2002 and 2004, respectively. The first plan is tax exempt for four years and the other plans are tax exempt for two years from the first year they have taxable income and are entitled to a reduced corporate tax rate of 10% - 25% (based on the percentage of foreign ownership) for an additional period of up to ten years.

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The sixth plan commenced operation in 2004. It entitles this company to a corporate tax exemption for a period of two years and to a reduced corporate tax rate of 10% - 25% (based on percentage of foreign ownership) for an additional period of eight years.

Under Israeli law, CEVA's Israeli subsidiary is entitled to claim accelerated rates of depreciation on equipment used by an Approved Enterprise during the first five tax years from the beginning of such use.

The entitlement to the above benefits is conditional upon the company's fulfilling the conditions stipulated by the above law, regulations published thereunder and the instruments of approval for the specific investments in Approved Enterprises. In the event of failure to comply with these conditions, the benefits may be canceled and the company may be required to refund the amount of the benefits, in whole or in part, including interest.

The tax-exempt income attributable to the Approved Enterprise can be distributed to shareholders without subjecting the subsidiary to taxes only upon the complete liquidation of the company. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of the subsidiary they would be taxed at the corporate tax rate applicable to such profits as if the company had not elected the alternative system of benefits, currently between 10%-25% for an Approved Enterprise. As of December 31, 2004 the accumulated deficit of the Company does not include tax-exempt profits earned by the subsidiary's Approved Enterprise.

Should CEVA's Israeli subsidiary derive income from sources other than the Approved Enterprise during the period of benefits, such income will be taxable at the regular corporate tax rate of 35% in 2004.

*a. The provision for income taxes is as follows:*

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Domestic taxes:			
Current	\$ 673	\$	\$ 5
Deferred	240		
	913		5
Foreign taxes:			
Current	101	300	835
Deferred			(195 )
Taxes on income	\$ 1,014	\$ 300	\$ 645
Income (loss) before taxes on income:			
Domestic	\$ (14,887 )	\$ (2,775 )	\$ (783 )

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Foreign	(6,021 )	(8,916 )	3,078
	\$ (20,908 )	\$ (11,691 )	\$ 2,295

Prior to November 1,2002 (the date of the Combination), the results of the Company s Business were included in the consolidated income tax returns filed by DSPG. Income tax expense in the Company s consolidated financial statements has been calculated on a separate tax return basis. These calculations reflect DSPG s tax strategy, and are not necessarily reflective of the tax strategies that the Company would have followed or will follow as a stand-alone company.

*b. A reconciliation between the Company s effective tax rate and the U.S. statutory rate:*

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Income (loss) before taxes on income	\$ (20,908 )	\$ (11,691 )	\$ 2,295
Tax at U.S. statutory rate-35%	(7,318 )	(4,092 )	803
Foreign income taxes at rates other than U.S. rate	(324 )	1,720	(1,420 )
Rate differential-intercompany recharge			(887 )
In-process research and development	5,586		
Restructuring and impairment cost	2,254	1,773	
Non-deductible/non-taxable items			(89 )
Valuation allowance	80	1,175	2,490
Other	736	(276 )	(252 )
Taxes on income	\$ 1,014	\$ 300	\$ 645

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*c. Deferred taxes on income:*

Deferred taxes on income reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets are as follows:

	<b>Year ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
Operating loss carryforward	\$ 5,553	\$ 6,728	\$ 8,438
Accrued expenses			850
Other			125
Valuation allowance	(5,553 )	(6,728 )	(9,218 )
Balance at the end of the year	\$	\$	\$ 195

The Company and its subsidiaries provided valuation allowances in respect of deferred tax assets resulting principally from the carryforward of tax losses. Management currently believes that it is more likely than not that the deferred tax regarding the carryforward of losses and certain accrued expenses will not be realized in the foreseeable future. The change in valuation allowance as of December 31, 2004 was \$2,490. The company does not provide for US Federal Income taxes on the undistributed earnings of its international subsidiaries because such earnings are re-invested and, in the opinion of management, will continue to be re-invested indefinitely.

*d. Separation from DSPG:*

DSPG obtained a tax ruling for the tax-exempt split plan pursuant to section 105A(a) to the Israeli Income Tax Ordinance ( section 105 ). Under section 105 and according to the ruling, the majority of the assets that were transferred to CEVA's Israeli subsidiary and the majority of the assets that remained in DSPG cannot be sold for a two-year period (ending November 1, 2004) and subject to other requirements determined by law. In addition, according to the ruling provisions, CEVA's Israeli subsidiary is restricted to a minimum investment in Israel, of 50% of total capital. Undistributed earnings of \$5,359 from international subsidiaries are considered permanently invested in accordance with the provisions of APB 23. The determination of the potential US taxes that would be payable in the event these earnings were repatriated is not practicable to calculate.

*e. Tax loss carryforwards:*

As of December 31, 2004, CEVA and its subsidiaries had net operating loss carryforwards for federal income tax purposes of approximately \$4,016, which are available to offset future US taxable income and begin to expire in 2023. As of December 31, 2004, CEVA and its subsidiaries had foreign operating losses which carryforward indefinitely for tax purposes of approximately \$67,781 principally in Ireland, which are available to offset future taxable income.

**NOTE 10: REORGANIZATION, RESTRUCTURING AND SEVERANCE CHARGE**

The Company's management and Board of Directors approved reorganization and restructuring plans in 2003, which resulted in a total charge of \$8,620.

In the first, third and fourth quarters of 2003, the Company recorded reorganization, restructuring and severance charges of \$1,380, \$1,402 and \$5,838, respectively. The charges arose in connection with the implementation of the Company's strategic initiative to strengthen its headquarters function in the U.S., including the hiring of a new chief executive officer and a new chief financial officer, and the related resignations of the Company's Ireland-based chief executive officer and chief financial officer and the resignations of the Company's Chairman and Vice-Chairman from their executive management positions. Also included are severance charges for 39 employees, underutilized building operating lease and commitment charges and a charge for non-performing assets arising from a reduction in headcount and facility requirements. The reduction in headcount and facility requirements is a result of the realignment of the business structures focusing on DSP cores and integrated application technologies and the decision to exit the Company's Hard IP manufacturing product line and certain non-strategic technology areas. The Company provided in the restructuring charge for grants received that may become repayable due to the reduction in headcount numbers.



**CEVA, INC. AND ITS SUBSIDIARIES****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In the fourth quarter of 2002, the Company recorded restructuring and other non-recurring charges of \$6,442. The strategic initiatives included Parthus rationalizing certain product lines to enhance strategic focus and to further reduce costs. This principally resulted in severance costs following a headcount reduction of 46 employees and onerous lease commitments arising from a reduction in the facility and design tool requirements.

Management are required to make and review certain estimates and assumptions in assessing the underutilized building operating lease charges arising from the reduction in facility requirements. The underutilized building operating lease charge at December 31, 2003 was calculated by taking into consideration (1) the committed annual rental charge associated with the vacant square footage, (2) an assessment of the sublet rents that could be achieved based on current market conditions, vacancy rates and future outlook, (3) the estimated periods that facilities would be empty before being sublet, (4) an assessment of the percentage increases in the primary lease rent and the sublease rent at each five-year rent review, and (5) the application of a discount rate of 4.75% over the remaining period of the lease.

The Company revised their assumptions at December 31, 2004 in respect of future vacancy rates and sublet rents in light of current market conditions and their discount rate based on projected interest rates applicable.

The major components of the restructuring and other charges are as follows:

	<b>Severance and related costs</b>	<b>Underutilized building operating lease obligations</b>	<b>Legal and professional fees</b>	<b>Non-performing assets</b>	<b>Total</b>
Balance as of November 1, 2002	\$	\$	\$	\$	\$
Charge	2,210	3,942	239	51	6,442
Cash outlays	(2,085 )	(1,044 )	(8 )	(51 )	(3,188 )

Balance as of December 31, 2002	125	2,898	231		3,254
Charge	6,455	1,431	250	484	8,620
Cash outlays	(4,876 )	(1,176 )	(381 )	(484 )	(6,917 )
Balance as of December 31, 2003	1,704	3,153	100		4,957
Charge					
Reallocation		50	(50 )		
Cash outlays	(849 )	(992 )	(50 )		(1,891 )
Balance as of December 31, 2004	\$ 855	\$ 2,211	\$	\$	\$ 3,066

**NOTE 11: EMPLOYEE BENEFITS**

Certain of the Company's employees are eligible to participate in a defined contribution pension plan (the "plan"). Participants in the plan may elect to defer a portion of their pre-tax earnings into the plan, which is run by an independent party. The Company makes pension contributions at rates varying up to 10% of the participant's pensionable salary. Contributions to this plan are recorded as an expense in the Consolidated Statements of Operations.

The Company's US operations maintain a retirement plan (the "U.S. Plan") that qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Participants in the U.S. Plan may elect to defer a portion of their pre-tax earnings, up to the Internal Revenue Service annual contribution limit. The Company matches 100% of each participant's contributions up to a maximum of 6% of employee's base pay. Each participant may contribute up to 15% of base remuneration. Contributions to this plan are recorded in the year contributed as an expense in the Consolidated Statements of Operations.

Total contributions for the years ended December 31, 2002, 2003 and 2004 were \$156, \$1,570 and \$850, respectively.

**CEVA, INC. AND ITS SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 12: RELATED PARTY TRANSACTIONS**

a. The Company trades in the normal course of business with DSPG, which was the parent company of CEVA until November 1, 2002 (see Note 1). Ceva and DSPG have common directors.

Until November 30, 2003, CEVA's Israeli subsidiary occupied and utilized portions of DSPG Ltd.'s facilities. CEVA's Israeli subsidiary was obligated to pay an agreed amount to DSPG Ltd. for its pro rata share of occupying and operating these facilities. The amount charged to CEVA's Israeli subsidiary for these services between November 1, 2002 and December 31, 2002, was \$ 60 and \$332 for the period between January 1 and November 30, 2003. Non-moveable fixtures and fittings with a net book value of \$140 were sold to DSPG prior to exiting the premises for proceeds of \$100.

Revenue generated from DSPG from licensing, royalty and support agreements during the years ended December 31, 2002, 2003 and 2004 was \$108, \$383 and \$540, respectively. The accounts receivable balances with DSPG at December 31, 2002, 2003 and 2004 were \$50, \$178 and \$47 respectively.

b. Directors who are not employees of CEVA receive an annual retainer of \$40 to \$50, payable in quarterly installments of \$10 to \$12.5 each. The retainer contemplates attendance at four board meetings per year. Additional board meetings of a face-to-face nature are compensated at the rate of \$1 per meeting. In addition, committee meetings of a face-to-face nature and on a telephonic basis are compensated at the rate of \$1 per meeting. All directors are reimbursed for expenses incurred in connection with attending board and committee meetings. Directors are eligible to participate in the Company's stock plans.

c. On July 1, 1996 one of CEVA's Irish subsidiaries entered into a property lease agreement with Veton Properties Limited to lease office space in Dublin, Ireland. The lease term is 25 years from July 1, 1996 and the current annual rent charge is €762 (\$1,039). Brian Long and Peter McManamon, directors of the Company, are minority shareholders of Veton Properties Limited.

d. One of the Company's directors, Bruce Mann, is a partner of Morrison & Foerster LLP, one of the Company's legal counsel for intellectual property matters. Fees paid to Morrison & Foerster LLP during the years ended December 31, 2002, 2003 and 2004 was \$0, \$282 and \$67, respectively. The accounts receivable balances with Morrison & Foerster LLP at December 31, 2002, 2003 and 2004 were \$0, \$57 and \$17 respectively.

**NOTE 13: COMMITMENTS AND CONTINGENCIES**

a. The Company is not party to any litigation or other legal proceedings that the Company believes could reasonably be expected to have a material adverse effect on the Company's business, results of operations and financial condition.

b. The Company and its subsidiaries have several non-cancelable operating leases, primarily for equipment and for vehicles. These leases generally contain renewal options and require the Company and its subsidiaries to pay all executory costs such as maintenance and insurance.

The Company and its subsidiaries paid \$323, \$2,344 and \$2,555 in rental expense for the fiscal years ended December 31, 2002, 2003 and 2004, respectively.

Future purchase obligations and minimum rental commitments for leasehold properties and operating leases with non-cancelable terms in excess of one year are as follows:

	<b>Minimum rental payments</b>
2005	\$ 3,606
2006	2,832
2007	1,953
2008	1,802
2009	1,752
Thereafter	21,705
	\$ 33,650

## CEVA, INC. AND ITS SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Under the terms of certain foreign subsidiary grant agreements, amounts received may become repayable in full should certain circumstances specified within the grant agreements occur. The Company provides where appropriate for grants received that may become repayable.

## NOTE 14: QUARTERLY FINANCIAL INFORMATION (Unaudited)

	Three months ended							
	March 31,	June 30,	September 30,	December 31,	March 31,	June 30,	September 30,	December 31,
	2003				2004			
Revenues:								
Licensing and royalties	\$ 6,981	\$ 7,170	\$ 7,651	\$ 7,993	\$ 7,769	\$ 8,180	\$ 8,482	\$ 7,840
Other revenue	1,862	1,917	1,651	1,611	1,445	1,396	1,232	1,329
Total revenues	8,843	9,087	9,302	9,604	9,214	9,576	9,714	9,169
Cost of revenues	1,638	1,601	1,415	1,407	1,510	1,451	1,199	1,018
Gross profit	7,205	7,486	7,887	8,197	7,704	8,125	8,515	8,151
Operating expenses:								
Research and development, net	4,049	4,052	4,490	4,791	4,009	4,222	4,384	4,661
Sales and marketing	1,373	1,449	1,436	1,800	1,673	1,718	1,768	1,806
General and administrative	1,478	1,485	1,455	1,691	1,459	1,495	1,555	1,354
Amortization of other intangible assets	284	284	288	271	223	223	223	223
	1,380		1,402	5,838				

Reorganization, restructuring and severance charge									
Impairment of assets				3,233					
Total operating expenses	8,564	7,270	9,071	17,624	7,364	7,658	7,930	8,044	
Operating income (loss)	(1,359 )	216	(1,184 )	(9,427 )	340	467	585	107	
Other income (expense), net	41	(184 )	150	56	189	162	145	300	
Income before taxes on income (loss)	(1,318 )	32	(1,034 )	(9,371 )	529	629	730	407	
Taxes on income (loss)			100	200	120	135	170	220	
Net income (loss)	\$ (1,318 )	\$ 32	\$ (1,134 )	\$ (9,571 )	\$ 409	\$ 494	\$ 560	\$ 187	
Basic net income (loss) per share	\$ (0.07 )	\$ 0.002	\$ (0.06 )	\$ (0.53 )	\$ 0.02	\$ 0.03	\$ 0.03	\$ 0.01	
Diluted net income (loss) per share	\$ (0.07 )	\$ 0.002	\$ (0.06 )	\$ (0.53 )	\$ 0.02	\$ 0.03	\$ 0.03	\$ 0.01	
Weighted average number of shares of Common Stock used in computation of net income (loss) per share (in thousands):									
Basic	18,070	18,079	18,108	18,167	18,326	18,380	18,453	18,522	
Diluted	18,070	18,149	18,108	18,167	19,257	18,909	18,793	19,106	

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

**CEVA, INC.**

By: /s/ CHESTER J. SILVESTRI  
Chester J. Silvestri  
Chairman, President and Chief  
Executive Officer

March 30, 2005

Pursuant to the requirements of the Securities Exchange Act of 1934, this report on Form 10-K has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ CHESTER J. SILVESTRI</u> Chester J. Silvestri	Chairman, President and Chief Executive Officer (Principal Executive Officer)	March 30, 2005
<u>/s/ CHRISTINE RUSSELL</u> Christine Russell	Chief Financial Officer and Treasurer (Principal Financial Officer and Principal Accounting Officer)	March 30, 2005
<u>/s/ ELIYAHU AYALON</u> Eliyahu Ayalon	Director	March 30, 2005
<u>/s/ BRIAN LONG</u>	Director	March 30, 2005

Brian Long

/s/ ZVI LIMON

Director

March 30, 2005

Zvi Limon

/s/ BRUCE MANN

Director

March 30, 2005

Bruce Mann

/s/ PETER McMANAMON

Director

March 30, 2005

Peter McManamon

/s/ SVEN-CHRISTER-NILSSON

Director

March 30, 2005

Sven-Christer Nilsson

/s/ LOUIS SILVER

Director

March 30, 2005

Louis Silver

/s/ DAN TOCATLY

Director

March 30, 2005

Dan Tocatly



## CEVA, INC.

## SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

	<b>Balance at beginning of period</b>	<b>Additions</b>	<b>Deduction (1)</b>	<b>Balance at end of period</b>
Year ended December 31, 2004				
Allowance for doubtful accounts	\$ 795	\$ 478	\$ 460	\$ 813
Year ended December 31, 2003				
Allowance for doubtful accounts	\$ 250	\$ 545	\$	\$ 795
Year ended December 31, 2002				
Allowance for doubtful accounts	\$	\$ 250	\$	\$ 250

(1) Actual write-offs of uncollectible accounts receivables

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description</b>
2.1(1)	Combination Agreement, dated as of April 4, 2002, among DSP Group, Inc., the Registrant and CEVA Technologies Limited (formerly Parthus Technologies plc)
2.2(2)	Amendment No. 1 to Combination Agreement, dated as of August 29, 2002, among DSP Group, Inc., the Registrant and CEVA Technologies Limited (formerly Parthus Technologies plc)
3.1(1)	Amended and Restated Certificate of Incorporation of the Registrant
3.2(3)	Certificate of Ownership and Merger (merging CEVA, Inc. into ParthusCeva, Inc.)
3.3(8)	Second Amended and Restated Bylaws of the Registrant
3.4(9)	Bylaws Amendment to the Second Amended and Restated Bylaws of the Registrant
3.5(10)	Bylaws Amendment to the Second Amended and Restated Bylaws of the Registrant
4.1(2)	Specimen of Common Stock Certificate
10.1(4)	Separation Agreement among DSP Group, Inc., DSP Group, Ltd., the Registrant, CEVA Technologies, Inc. (formerly DSP Ceva, Inc.) and Ceva D.S.P. Ltd. (formerly Corage, Ltd.) dated as of November 1, 2002
10.2(4)	Tax Indemnification and Allocation Agreement between DSP Group, Inc. and the Registrant dated as of November 1, 2002
10.3(4)	Technology Transfer Agreement between DSP Group, Inc. and the Registrant dated as of November 1, 2002
10.4(4)	Technology Transfer Agreement between DSP Group, Ltd. and Ceva D.S.P. Ltd. (formerly Corage, Ltd.) dated as of November 1, 2002
10.5(4)	Technology Transfer Agreement between CEVA Technologies, Inc. (formerly DSP Ceva, Inc.) and the Registrant dated as of November 1, 2002
10.6(2)	CEVA, Inc. 2000 Stock Incentive Plan
10.7(2)	CEVA, Inc. 2002 Stock Incentive Plan
10.8(2)	CEVA, Inc. 2002 Employee Stock Purchase Plan
10.9(5)	CEVA, Inc. 2003 Director Stock Option Plan
10.10(6)	Parthus 2000 Share Option Plan
10.13(1)	Form of Indemnification Agreement executed between the Registrant and each of Eliyahu Ayalon, Brian Long, Bruce Mann, Sven-Christer Nilsson, Issachar Ohana, Bat-Sheva Ovadia, Christine Russell, Louis Silver, Chester J. Silvestri and Gideon Wertheizer
10.17(4)	Employment Agreement between the Registrant and Gideon Wertheizer dated as of November 1, 2002

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- 10.18(4) Employment Agreement between the Registrant and Issachar Ohana dated as of November 1, 2002
- 10.21(5) Letter Agreement between CEVA, Inc. and Chester J. Silvestri dated as of June 2, 2003
- 10.22(7) Letter Agreement between CEVA, Inc. and Christine Russell dated as of September 5, 2003
- 10.23(8) Lease dated November 8, 1996 with Veton Properties Limited, as amended by an Assignment dated May 16, 2003 and Memorandum of Rent Review dated as of May 23, 2003.
- 21.1\* Subsidiaries of the Registrant
- 23.1\* Consent of Ernst & Young, Chartered Accountants
- 23.2\* Consent of Kost Forer Gabbay & Kassierer
- 31.1\* Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2\* Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
- 32\* Section 1350 Certification of Chief Executive Officer and Chief Financial Officer

(1)

Filed as an exhibit to CEVA's registration statement on Form 10, as amended, initially filed with the Commission on June 3, 2002 (registration number 000-49842), and incorporated herein by reference.

(2)

Filed as an exhibit to CEVA's registration statement on Form S-1, as amended, initially filed with the Commission on July 30, 2002 (registration number 333-97353), and incorporated herein by reference.

(3)

Filed as an exhibit to CEVA's Report on Form 8-K, filed with the Commission on December 8, 2003, and incorporated hereby by reference.

(4)

Filed as an exhibit to CEVA's 2002 Annual Report on Form 10-K, filed with the Commission on March 28, 2003, and incorporated hereby by reference.

(5)

Filed as an exhibit to CEVA's Quarterly Report on Form 10-Q/A, filed with the Commission on August 12, 2003, and incorporated hereby by reference.

(6)

Filed as an exhibit to the registration statement on Form S-8 of Parthus Technologies plc, filed with the Commission on June 6, 2000 (registration number 333-12090), and incorporated herein by reference.

(7)

Filed as an exhibit to CEVA's Quarterly Report on Form 10-Q, filed with the Commission on November 13, 2003, and incorporated hereby by reference.

(8)

Filed as an exhibit to CEVA's 2003 Annual Report on Form 10-K, filed with the Commission on March 12, 2004, and incorporated hereby by reference.

(9)

Filed as an exhibit to CEVA's Quarterly Report on Form 10-Q, filed with the Commission on May 7, 2004, and incorporated hereby by reference.

(10)

Filed as an exhibit to CEVA's Report on Form 8-K, filed with the Commission on January 31, 2005, and incorporated hereby by reference.

Management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 15(c) of Form 10-K.

\*

Filed herewith.