SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**

For the quarterly period ended June 27, 2004

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**

For the transition period from to

Commission File Number: 0-15930

SOUTHWALL TECHNOLOGIES INC.
(Exact name of registrant as specified in its charter)

DELAWARE	**94_2551470**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
3975 East Bayshore Road, Palo Alto, California	**94303**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(650) 962-9111**

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 x No ¨

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

As of August 2, 2004 there were 12,549,992 shares of the Registrant's Common Stock outstanding.

SOUTHWALL TECHNOLOGIES INC.

INDEX

PART I FINANCIAL INFORMATION

Item 1 Financial Statements:

SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	June 27, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,424	$ 1,152
Restricted cash	557	739
Accounts receivable, net of allowance for bad debt of $511 at June 27, 2004 and $778 at December 31, 2003	5,715	7,096
Inventories, net	6,671	6,830
Other current assets	3,420	2,617
Total current assets	17,787	18,434
Property, plant & equipment, net	19,988	21,787
Restricted cash loans	1,024	1,066
Other assets	1,240	434
Total assets	$ 40,039	$ 41,721
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long term debt and capital leases	$ 1,235	$ 2,042
Line of credit	4,549	6,844
Accounts payable	3,509	6,315
Accrued compensation	1,007	1,392
Other accrued liabilities	6,902	6,051
Total current liabilities	17,202	22,644
Term debt and capital leases	11,625	13,658
Convertible promissory notes	3,303	--
Government grants advanced	558	614
Other long term liabilities	12,729	3,084
Total liabilities	45,417	40,000
Contingencies (See note 10)	-	-
Stockholders equity (deficit):		
Preferred stock, $1.00 stated value, authorized 5,000; issued and outstanding	-	-
Common stock, $0.001 par value per share; 20,000 shares authorized, and 12,550 and 12,548 shares outstanding at June 27, 2004 and December 31, 2003, respectively	13	13
Capital in excess of par value	69,795	70,861
Accumulated other comprehensive income:		
Translation gain on subsidiary	2,711	3,240

Accumulated deficit		(77,897)		(72,393)
Total stockholders equity (deficit)		(5,378)		1,721
Total liabilities and stockholders equity	$	40,039	$	41,721

See accompanying notes to condensed consolidated financial statements.

3

SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three months ended				Six months ended			
		June 27, 2004		June 29, 2003		June 27, 2004		June 29, 2003
Net revenues	$	14,548	$	15,328	$	25,615	$	30,549
Cost of sales		8,936		12,405		17,402		24,588
Gross profit		5,612		2,923		8,213		5,961
Operating expenses:								
Research and development		771		1,517		1,581		3,185
Selling, general and administrative		2,520		3,000		5,583		5,876
Restructuring expenses		-		-		-		(65)
Impairment recoveries for long-lived assets		(1,428)		-		(1,428)		-
Total operating expenses		1,863		4,517		5,736		8,996
Income (loss) from operations		3,749		(1,594)		2,477		(3,035)
Interest expense		(635)		(217)		(1,240)		(509)
Cost of warrants issued		(1,473)		-		(6,291)		-
Other income (loss), net		(112)		274		248		363
Income (loss) before provision for income taxes		1,529		(1,537)		(4,806)		(3,181)
Provision for income taxes		343		176		698		191
Net income (loss)	$	1,186	$	(1,713)	$	(5,504)	$	(3,372)
Net income (loss) per share:								

Basic	$ 0.09	$ (0.14)	$ (0.44)	$ (0.27)
Diluted	$ 0.04	$ (0.14)	$ (0.44)	$ (0.27)
Weighted average shares of common stock and dilutive potential common stock:				
Shares used in computation, basic and diluted				
Basic	12,548	12,532	12,548	12,530
Diluted	31,416	12,532	12,548	12,530

See accompanying notes to condensed consolidated financial statements.

SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Six months ended June 27, 2004	June 29, 2003
Cash flows provided from operating activities:		
Net income (loss)	$ (5,504)	$ (3,372)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,218	3,307
Charges related to warrants issued to investors and creditors	6,291	-
Amortization of debt issuance costs	59	-
Unamortized debt discount	116	-
(Loss) from impairment recoveries from long-lived assets	(1,428)	133
Stock compensation charge	-	33
Interest on note receivable	-	(4)
Officer loan forgiveness	-	131
Change in assets and liabilities:		
Accounts receivable, net	1,381	1,587
Inventories, net	159	2,313
Other current and non current assets	(1,316)	969
Accounts payable and accrued liabilities	(2,556)	(3,313)
Cash (used) provided by operating activities	(1,580)	1,784
Cash flows used in investing activities:		
Restricted cash	147	(77)

Proceeds from sale of fixed assets		1,180		-
Expenditures for property, plant and equipment and other assets		(512)		(2,247)
Net cash provided (used) in investing activities		815		(2,324)
Cash flows provided by financing activities:				
Principal payment on borrowings		(1,600)		(1,944)
Borrowings (payments) on line of credit		(2,295)		3,003
Proceeds from sale of convertible promissory notes		4,500		-
Proceeds from stock options and employee stock purchase plan exercises		-		18
Net cash provided by financing activities		605		1,077
Effect on cash of foreign exchange rate charges on cash		433		(132)
Net increase in cash and cash equivalents		273		405
Cash and cash equivalents, beginning of year		1,152		1,998
Cash and cash equivalents, end of period	$	1,425	$	2,403
Supplemental cash flow disclosures:				
Cash paid for interest	$	630	$	555
Cash paid for income taxes	$	117	$	150

See accompanying notes to condensed consolidated financial statements.

SOUTHWALL TECHNOLOGIES INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Interim Period Reporting:

While the information presented in the accompanying condensed consolidated financial statements is unaudited, it includes all adjustments (consisting only of normal recurring adjustments) which, in the opinion of management, are necessary to present fairly the Company's financial position, results of operations and changes in financial position as of the dates and for the periods indicated.

Certain information and footnote disclosures normally contained in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. The Company suggests that these consolidated financial statements be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Form 10-K for the year ended December 31, 2003 filed with the Securities and Exchange Commission on April 14, 2004 (as amended by the Company's Form 10-K/A filed on May 7, 2004 and the Company s Form 10-K/A filed on August 10, 2004). The results of operations for the interim periods presented are not necessarily indicative of the operating results of the full year.

Due to the structure of the transactions resulting from the investment agreement with Needham & Company, or Needham, and certain of Needham s affiliates, and Dolphin Direct Equity Partners, LP, which was entered into by the Company on December 18, 2003, and later amended and restated on February 20, 2004, the Company was not in compliance with certain NASDAQ listing requirements. On March 26, 2004, the Company voluntarily delisted from the Nasdaq National Market and on May 6, 2004, began trading on the Over-the-Counter Bulletin Board. Management believed that a voluntary delisting from Nasdaq and a move to the Over-the-Counter Bulletin Board provided the best option to the Company s shareholders by retaining liquidity in the Company s common stock.

On April 29, 2004, the Company amended its credit agreements with its senior lender, Pacific Business Funding, or PBF, to extend the facilities maturity date to May 5, 2005. The amended agreements provide for a maximum borrowing capacity of $9.0 million for the Company. The credit facilities consist of a $3.0 million revolving line of credit facility, which is guaranteed by Needham & Company, and a $6.0 million receivables factoring line of credit. The $3.0 million revolving line of credit facility bears an annual rate of 2% above PBF s Base Rate (which was 4.0% at June 27, 2004), and is calculated based on the borrowings outstanding under the line. The $6.0 million facility bears an annual rate of 7% above PBF s Base Rate and the annual interest is calculated based on the average daily accounts receivable against which the Company has borrowed. Availability under the $6.0 million line is limited to 75% of the value of accounts receivables acceptable to PBF. PBF continues to reserve the right to reduce the percentage of eligible accounts receivable against which the Company may borrow under this facility or to terminate the facility at any time. The amendments also deleted the requirements that the Company maintain a listing on the NASDAQ National Market and maintain minimum net tangible net worth of $33.0 million, a current ratio of assets to liabilities of at least 0.70, and revenues equal to or greater than 80% of revenues projected.

Cumulative operating losses, negative working capital, negative cash flows, and the Company s limited current cash balance raise substantial doubt about the Company s ability to continue as a going concern. The Company incurred a net loss and negative cash flows from operations in 2003 and the first quarter of 2004. As of December 31, 2003 and June 27, 2004, the Company s cash and cash equivalents and restricted cash were $1.9 million and $2.0 million, respectively. If the Company is unable to maintain our existing financing sources, or procure new sources of financing, the Company may be unable to satisfactorily meet all of the cash commitments required to fund our operations or to continue as a going concern.

The Company uses a 52_week fiscal year ending on December 31. The quarters ended June 27, 2004 and June 29, 2003 each included 13 weeks.

Note 2 Balance Sheet:

Restricted cash

Restricted cash consists of the unexpended portion of grants received from the Saxony government in Germany to co-finance the costs of the construction of the Company s Dresden facility. In the event the Company fails to meet certain conditions related to the grants, the Saxony government has the right to demand repayment of the grants (see Note 7 - Government Grant and Investment Allowances).

Inventories, net

Inventories are stated at the lower of cost (determined by the first-in, first-out method) or market. Cost includes materials, labor and manufacturing overhead. The Company establishes provisions for excess and obsolete inventories to reduce such inventories to their estimated net realizable value. Such provisions are charged to cost of sales. At June 27, 2004 and December 31, 2003, inventoriesconsisted of the following (in thousands):

	June 27, 2004	December 31, 2003
Raw materials	$ 4,103	$ 2,677
Work-in-process	1,618	3,148
Finished goods	950	1,005
	$ 6,671	$ 6,830

Government grants advanced and investment allowances

Government grants advanced and investment allowances consist of monies received by the Company from the Saxony government in Germany. Upon approval and receipt of the grants and investment allowances from the Saxony government, the funds are applied as a reduction of the costs of the Dresden facility. In the event the Company fails to meet certain conditions related to the grants and investment allowances, the Saxony government has the right to reclaim the grants and allowances. (see Note 7 - Government Grant and Investment Allowances.)

Other long-term liabilities

Other long-term liabilities consisted of the following at June 27, 2004 and December 31, 2003 (in thousands):

	June 27, 2004	December 31 2003
Warrants	$ 7,627	$ -
Liabilities associated with Settlement Agreement (Note 5)	2,354	1,591
Deferred tax liability	1,342	1,177
Embedded derivative (Note 9)	973	-
Long-term restructuring costs (Note 12)	259	293
Other	174	22
	$ 12,729	$ 3,084

Other long-term liabilities consist of warrants issued costs in connection with the Investment Agreement (see Note 9 - Warrants and Other Financial Instruments), liabilities associated with a settlement agreement (see Note 5 - Term Debt), deferred tax liabilities, embedded derivatives (See Note 9) and accrued restructuring costs (see Note 12 - Restructuring).

Note 3 Net Income (Loss) Per Share:

Basic net income (loss) per share is computed by dividing income available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. Diluted net income (loss) per share gives effect to all dilutive common shares potentially outstanding during the period. The computation of diluted earnings (loss) per share uses the average of the closing prices of the common stock during the period. At June 27, 2004, there were 12,548,192 shares outstanding which were used for the basic earnings per share and 31,416,237 shares used for the diluted earnings per share. The total amount of the difference in the basic and diluted weighted average shares of common stock and common stock equivalents represents the dilutive effect of the 18,868,245 warrant shares outstanding. Options outstanding of 2,972,571 were not included in the calculation as the exercise prices of the options were higher than the price of the common stock of at June 27, 2004 and were considered anti-dilutive. For purposes of the fully diluted earnings per share calculation, net income after tax was adjusted by the interest expense associated with the convertible promissory notes of $147,000, as the shares issuable on conversion of the promissory notes were included in the denominator.

In net loss periods, the basic and diluted weighted average shares of common stock and common stock equivalents are the same because inclusion of stock options would not be dilutive. Accordingly, for the three-month period ended June 29, 2003 and six-month periods ended June 27, 2004, and June 29, 2003, there was no difference between the denominators used for the calculation of basic and diluted net income (loss) per share, and the number of shares used in the calculation were 12,532,000, 12,548,000 and 12,530,000, respectively.

Note 4 Line of Credit:

On May 16, 2003, the Company entered into credit agreements for a $10.0 million receivables financing line of credit (which were amended on June 16, 2003, December 18, 2003 and April 29, 2004) with a financial institution, Pacific Business Funding, or PBF, that were due to expired on May 5, 2004, subject to automatic one-year renewals unless terminated at any time by either party. Borrowings under the line of credit bear an annual interest rate of 7% above the financial institution s Base Rate (which was 4.0% at June 27, 2004), and was calculated based on the average daily accounts receivable against which the Company has borrowed. Half of the $10.0 million line of credit was represented by a $5.0 million credit line, guaranteed by the United States Export-Import Bank ("EXIM"). Availability under the EXIM line was limited to 80% of eligible foreign receivables acceptable to the lender. The remaining $5.0 million portion of the $10.0 million credit line was supported by domestic receivables. Availability under the domestic line of credit was limited to 70% of eligible domestic receivable acceptable to the lender. PBF reserved the right to lower the 70% and 80% of eligible receivable standards for borrowings under the credit agreements. In connection with the line of credit, the Company granted to the bank a lien upon and security interest in, and right of set off with respect to all of the Company s right, title and interest in all personal property and other assets, other than certain of the Company s Germany property or assets. The borrowing arrangements required the Company to comply with financial covenants to maintain minimum tangible net worth of $33.0 million, a current ratio of assets to liabilities of at least 0.70, and revenues equal to or greater than 80% of revenues projected. As part of the agreements, the Company incurred and paid a one-time commitment fee of $0.1 million in the second quarter of 2003, which will be amortized over the term of the agreements.

As a result of the impairment charge recorded at the end of the third quarter and a deterioration in our working capital position during the fourth quarter of 2003, the Company was in violation of the minimum tangible net worth covenant and current ratio covenant set forth in each of the credit agreements, and, therefore, in default thereunder. On December 18, 2003, the Company entered into a Forbearance Agreement with PBF to forbear from exercising the rights and remedies available to it owing to the default condition. Concurrent with the Forbearance Agreement, the credit agreement was amended to reduce the facility to $7.0 million, subject to the same restrictions in borrowing capacity. The amendment to the credit facility was made following an agreement reached with Needham to guarantee an additional $3.0 million facility with PBF. The guarantee was provided in two separate allotments of $2.25 million on December 18, 2003 and $0.75 million on January 15, 2004. In exchange for the guarantees, the Company issued two separate allotments of warrants for 941,115 shares of common stock each to Needham. (See Note 9 - Warrants and Other Financial Instruments). In connection with the forbearance and amended credit facility, the Company also issued warrants exercisable for 360,000 shares of common stock to PBF.

On April 29, 2004, the Company amended its credit agreements with its senior lender, Pacific Business Funding, or PBF, to extend the facilities maturity date to May 5, 2005. The amended agreements provide for a maximum borrowing capacity of $9.0 million for the Company. The credit facilities consist of a $3.0 million revolving line of credit facility, which is guaranteed by Needham & Company, and a $6.0 million receivables factoring line of credit. The $3.0 million revolving line of credit facility bears an annual rate of 2% above PBF s Base Rate (which was 4.0%

at June 27, 2004), and is calculated based on the borrowings outstanding under the line. The $6.0 million facility bears an annual rate of 7% above PBF s Base Rate and the annual interest is calculated based on the average daily accounts receivable against which the Company has borrowed. Availability under the $6.0 million line is limited to 75% of the value of accounts receivables acceptable to PBF. PBF continues to reserve the right to reduce the percentage of eligible accounts receivable against which the Company may borrow under this facility or to terminate the facility at any time. The amendments also deleted the requirements that the Company maintain a listing on the NASDAQ National Market and maintain minimum net tangible net worth of $33.0 million, a current ratio of assets to liabilities of at least 0.70, and revenues equal to or greater than 80% of revenues projected.

As of June 27, 2004, the Company had approximately $4.5 million of borrowings outstanding and $1.6 million availability to borrow under the credit agreements.

Note 5 Term Debt:

The Company's term debt and capital leases consisted of the following at June 27, 2004 (dollars in thousands):

Description	Rate	Balance at June 27, 2004	Remaining Principal Due in 2004
Term debt:			
Teijin loan dated January 19, 2004	0.00%	$ 709	-
German bank loan dated May 12, 1999	6.13% (1)	2,276	$ 207
German bank loan dated May 28, 1999	7.10% (2)	3,035	-
German bank loan dated May 28, 1999	3.75%	866	173
German bank loan dated July 25, 2000	7.15% (3)	1,789	143
German bank loan dated			
August 14, 1999 (due June 30, 2009)	5.75%	2,048	-
German bank loan dated December 18, 2000	7.50%	45	45
German bank loan dated December 19, 2000	8.0%	52	52
Settlement agreement dated February 20, 2004	(4)	2,000	-
Total term debt		$ 12,820	$ 620
Capital leases			
Other equity financings			
Total capital leases		41	41
Total term debt and capital leases		$ 12,861	$ 661
Less: current portion		1,236	
Term debt, non-current		$ 11,625	

(1) Interest rate will remain fixed until December 31, 2004 and will be reset to the then prevailing market rate.
(2) Interest rate will be reset to the then prevailing market rate in 2009.
(3) Interest rate will be reset to the then prevailing market rate in 2005.
(4) Stepped interest rate starting at 3% for 2004, which will increase by one percentage point per year until 2010.

Teijin loan

The Teijin loan represents the unpaid principal and accrued interest owed by the Company on a loan with a Japanese bank, dated May 6, 1997, which had been guaranteed by Teijin Limited (Teijin), a Japanese company. Teijin is a stockholder of and supplier of substrate materials to the Company. The Teijin guarantee was collateralized by certain equipment located in Southwall's Tempe manufacturing facility and inventory, to the extent necessary to provide 120% net book value coverage of the outstanding loan balance. The Company was also subject to certain financial covenants under the guarantee. The Company paid Teijin semi-annually a loan guarantee service fee equal to 0.5625% of the outstanding balance. The loan required semi-annual payments of interest only during the first four years, followed by semi-annual principal installments plus interest, beginning in May 2001, for the remaining three and one half year term. The Company had made each of its scheduled principal and interest payments to the Japanese bank through May 2003, representing principal payments of $8.8 million. However, the Company did not make the scheduled payment of $1.25 million due on November 5, 2003, thereby defaulting on the debt. Teijin honored its guarantee by satisfying the obligation. Under the terms of Teijin s guarantee, the Company was obligated to immediately repay the amounts paid by Teijin. As part of the restructuring plan implemented by the Company in the fourth quarter of 2003, the Company entered into a guaranteed Loan Agreement with Teijin on January 19, 2004 to satisfy Teijin s claim. The agreement includes a payment schedule that spreads the aggregate payments of $1.25 million over a period of four years through 2008. The obligations owed to Teijin will not accrue interest if paid according to the payment schedule. The Company s obligations to Teijin are guaranteed by its subsidiary, Southwall Europe GmbH.

In June 2004, the January 19, 2004 agreement was amended as the Company was able to sell one of its machines to a third party. The amendment to the agreement provided that the Company would pay to Teijin the proceeds from the sale of the equipment. In June 2004, the Company paid $560,000 to Teijin from the proceeds of the disposal of a fixed asset. The remaining balance due to Teijin under the agreement ($690,000 at June 27, 2004) will be paid in accordance with the agreement, as amended.

The Company performed an assessment under SFAS No.15, Accounting by Debtors and Creditors for Troubled Debt Restructurings and EITF 02-04, Debtors Accounting for a Modification or an Exchange of Debt Instruments in accordance with SFAS 15, to assess whether the debt restructuring constituted a troubled debt restructuring. The Company concluded that the debt restructuring was in fact a troubled debt restructuring as the Company was in financial difficulty and Teijin had granted a concession to the Company, under the definitions of such conditions in the EITF 02-04 guidance. The concession resulted from the non-interest bearing nature of the debt. As the carrying value of the original debt approximates to the new debt and bears no interest, SFAS 15, requires no accounting as of the date of the restructuring. The carrying value of the debt will be reduced as payments are made.

Settlement agreement

During 1999, Southwall entered into a master equipment sale-leaseback agreement with a leasing company, Matrix Funding Corporation ("lessor"). The Company was in dispute with the lessor over interpretation of certain terms of the lease agreement and withheld lease payments due from March 2001 until February 2004. The lessor notified the Company that it considered the Company to be in default and in January 2002 drew down on a letter of credit in the amount of $0.5 million that collateralized the Company's obligations. In May 2002, a suit was filed against the Company by an agent of the successor to the lease demanding payment of unpaid lease payments and alleged residual values. (See Note 10- Contingencies.) In February 2004, the Company entered into a settlement agreement with the agents pursuant to which the Company agreed to pay an aggregate of $2.0 million bearing interest at a stepped rate. The settlement requires the Company to make an interest payment in 2004, and beginning in 2005, to make quarterly principal and interest payments until 2010. At June 27, 2004, the carrying value of the liability was $4.4 million ($2.0 million of principal, plus $2.4 million of accrued interest and tax). As a result of the settlement the Company is obligated to pay a lesser amount of $2.0 million over five years at a stepped rate of interest. The agreement included a confession of judgment, whereby the Company acknowledges that it would owe damages of $5.9 million in the event of payment defaults under the settlement agreement.

The Company performed an assessment under SFAS 15 and EITF 02-04 to assess whether this debt restructuring constituted a troubled debt restructuring. The Company concluded that the debt restructuring was in fact a troubled debt restructuring as the Company was in financial difficulty and the lessors had granted a concession to the Company, under the definitions of such conditions as set forth in EITF 02-04. The reduction in the amount of the debt indicated that a concession had been granted. SFAS 15, requires an assessment of the total future cash payments specified by the new terms of the debt, including, principal, interest and contingent payments. If the payments are less than the carrying amount of the payable, the Company should reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and should recognize a gain on restructuring of payables equal to the amount of the reduction. In its assessment, management factored in the $5.9 million confession of judgment as a contingent payment, thereby eliminating any potential gain on restructuring. The carrying value of the debt remains on the balance sheet and the liability will be reduced as payments are made, with a potential gain to be recorded at the date of the final payment and the expiry of the confession of judgment. Based on a SFAS 5 determination, at the time the Company considers default probable, the liability would be increased to the $5.9 million confession of judgment value. The excess of the carrying value over the $2.0 million is recorded in Other Long-Term Liabilities on the balance sheet.

Loans from German banks

On May 12, 1999, the Company entered into a loan agreement with a German bank that provides for borrowings up to 3.1 million ($3.7 million). Under the terms of this agreement, the funds were used solely for the purpose of capital investment by Southwall's German subsidiary. The term of the loan is for a period of 10 years and the principal is repayable in euros after the end of one year in 36 quarterly payments. The loan bears interest at 6.125% per annum until December 31, 2004, after which it will be revised to the prevailing rate. Of the borrowings outstanding of $2.3 million under this bank loan at June 27, 2004, $1.7 million was classified as noncurrent in the accompanying balance sheet**.**

On May 28, 1999, the Company entered into a general loan agreement with a German bank. Under the terms of the loan agreement, funds were made available in three tranches, and were used solely for the purpose of capital investment by the Company's German subsidiary. The agreement contains various covenants with which the Company was in compliance at June 27, 2004; the Company is current with respect to all principal and interest payments due under the loan agreement. Under the first tranche, the Company borrowed 2.5 million ($3.0 million) for a term of twenty years beginning on May 28, 1999. The principal is repayable in euros beginning after ten years in ten equal, semi-annual payments. The loan bears fixed interest of 7.1% per annum for the first ten years, after which time the rate will be adjusted to a current prevailing rate. All $3.0 million of borrowings outstanding under this tranche at June 27, 2004, were classified as noncurrent in the accompanying balance sheet. Under the second tranche, the Company borrowed 1.7 million ($2.1 million) for a term of seven years beginning May 28, 1999 and the principal is repayable beginning after one year in twelve equal, semi-annual payments. The loan bears fixed interest at 3.75% per annum. At June 27, 2004, the amount due under this second tranche was $0.9 million, and $0.5 million was classified as a noncurrent liability. Under the third tranche, the Company borrowed 2.1 million ($2.5 million) for a term of ten years beginning on July 25, 2000, and the principal is repayable beginning after one year, in thirty-six equal quarterly payments. The loan bears fixed interest of 7.15% per annum for the first five years, after which time the rate will be adjusted to a current prevailing market rate. At June 27, 2004, the amount due was $1.8 million; of this amount, $1.5 million was classified as noncurrent.

On August 14, 1999, the Company entered into a loan agreement with a German bank that provides for borrowings up to 1.7 million ($2.1 million). As required by this agreement, the funds were used solely for the purpose of capital investment by the Company's German subsidiary. The principal balance is due in a single payment on June 30, 2009 and bears interest at a rate of 5.75% per annum. The interest is payable quarterly in euros. Fifty percent of the loan proceeds are restricted in an escrow account for the duration of the loan period and are classified as non-current "Restricted loan proceeds." The amount due under this bank loan at June 27, 2004 was $2.0 million, which was classified as noncurrent.

On December 18, 2000, the Company entered into a loan agreement with a German bank that provides for borrowings up to 0.2 million ($0.2 million). As required by this agreement, the funds were used solely for the purpose of capital investment by the Company's German subsidiary. The principal balance is repayable in nine quarterly payments beginning March 2002 and bears interest at a rate of 7.5% per annum. The interest is payable quarterly in euros. At June 27, 2004, the amount outstanding under this bank loan was minimal and was classified as current.

On December 19, 2000, the Company entered into a loan agreement with a German bank that provides for borrowings up to 0.3 million ($0.4 million). As required by this agreement, the funds were used solely for the purpose of capital investment by the Company's German subsidiary. The principal balance is repayable in 12 quarterly payments beginning March 2002 and bears interest at a rate of 7.5% per annum. At June 27, 2004, the amount outstanding under this bank loan was $0.1 million and was classified as current.

The preceding German bank loans are collateralized by the production equipment, building and land owned by the Company's German subsidiary. The dollar equivalent value for the preceding German bank loans has been calculated using the euro exchange rate as of June 27, 2004.

Other term debt consists of capitalized leases related primarily to certain computer equipment used by the Company.

Scheduled repayments
Scheduled principal reductions of term debt as of June 27, 2004 for the balance of 2004, and for the next four years and thereafter, are as follows (in thousands):

		Amount
Balance of 2004	$	661
2005		1,221
2006		1,558
2007		1,211
2008		1,211
Thereafter		6,998
Total	$	12,860

The Company incurred total interest expense of $0.6 million and $0.2 million in the second quarters of 2004 and 2003, respectively. The Company incurred total interest expense of $1.2 million and $0.5 million in the first six months of 2004 and 2003, respectively.

Note 6 - Convertible Promissory Notes:

The Company s convertible promissory notes as of June 27, 2004 consist of the following (in thousands):

Description		Balance at June 27, 2004
Needham Capital Partners and affiliates	$	3,000
Dolphin Direct Equity Partners		1,500
Total face value of convertible promissory notes	$	4,500
Less:		
Unamortized debt discount		(1,197)
Total convertible promissory note	$	3,303

On February 20, 2004, the Company entered into an agreement with Needham & Company, Inc., certain of its affiliates, and Dolphin Direct Equity Partners, LP (the "Holders") and issued $3.0 million and $1.5 million of convertible notes to them, respectively. The notes are convertible, at the Holders option, into the Company s Series A preferred stock at a conversion price of $1.00 per share (subject to adjustment). The notes accrue interest at an annual rate of 10%, compounded daily, which interest is payable each December 31st. The notes are secured by a pledge of a portion of the stock of Southwall Europe GmbH. The notes are due and payable on the earlier of: i) 45 days after failure of the stockholders to approve the increase in the number of the Company s authorized shares, or ii) February 20, 2009. In addition, so long as any of the convertible notes are outstanding, the approval of the Holders of a majority of the convertible notes will be required to effect certain corporate actions. In connection with the issuance of the convertible notes the Company issued warrants for 1,694,007 shares of common stock. In addition, the Company bifurcated the conversion feature of the notes and recorded an embedded derivative. (See Note 9 - Warrants and Other Financial Instruments.)

Note 7 Government Grant and Investment Allowances:

The Company has an agreement to receive cash grant awards (the "Grant"), which was approved by the Saxony government in May 1999. As of June 27, 2004, the Company had received an aggregate of approximately 5.6 million ($6.8 million) under this Grant since May 1999 and accounted for the Grant by applying the proceeds received to reduce the cost of fixed assets of the Dresden manufacturing facility. Additionally, as of June 27, 2004, the Company has a balance remaining from the government grants received in May 1999 of 0.5 million ($0.6 million) which has been recorded as an advance and held as restricted cash until the Company receives approval from the Saxony government to apply the funds to reduce its capital expenditures.

Giving effect to an amendment of the terms of the Grant in 2002, the Grant is subject to the following requirements:

a) The Grant was earmarked to co-finance the costs of the construction of a facility to manufacture XIR® film for the automotive glass industry;

b) The construction period for the project is from March 15, 1999 to June 30, 2006;

c) The total investment during the construction period should be at least 47.0 million ($56.8 million); and

d) The project must create at least 143 permanent jobs and 7 apprenticeships by June 30, 2006.

If the Company fails to meet the above requirements, the Saxony government has the right to demand repayment of the Grant.

In addition to the Grant, the Company is eligible for cash investment allowances from the Saxony government calculated based on the total projected capital investment by the Company in its Dresden facility of 47.0 million ($56.8 million). The investment allowances are also subject to European Union regulatory approval. During 2000, 2001, 2002 and 2003, the Company received 1.2 million ($1.5 million), 2.5 million ($3.0 million), 1.2 million ($1.5 million), and 1.3 million ($1.6 million), respectively, in investment allowances from the Saxony government, and those proceeds were applied to reduce the capitalized construction cost of the Dresden facility. We have not received any investment allowance from the Saxony government to date in 2004. The investment allowances are subject to the following requirements:

a) The movable and immovable assets, the acquisition costs of which are taken into account in determining the investment allowance, shall be employed within the subsidized territory for a period of at least five years following the acquisition or production.

b) The movable assets, the acquisition costs of which are taken into account in determining the increased investment allowance, shall remain in a business that is engaged in the processing industry, or in a similar production industry, for a period of at least five years following the acquisition or production.

If the Company fails to meet the above requirements, the Saxony government has the right to demand repayment of the allowances.

The Grant and investment allowances, if any, that the Company is entitled to seek from the Saxony government varies from year to year based upon the amount of capital expenditures that meet the above requirements. Generally, Southwall is not eligible to seek total investment grants for any year in excess of 33% of its eligible capital expenditures for that year. The Company cannot guarantee that it will be eligible for or receive additional grants or allowances in the future.

Note 8 Segment Reporting:

Southwall reports segment information using the management approach to determine segment information. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the source of its reportable segments. The Company is organized on the basis of products and services. The total net revenues for the automotive glass, electronic display, window film and architectural product lines for the three and six month periods ended June 27, 2004 and June 29, 2003 were as follows (in thousands):

	Three months ended		Six months ended	
	June 27, 2004	June 29, 2003	June 27, 2004	June 29, 2003
Automotive glass	$ 5,627	6,556	$ 10,028	$ 11,765
Electronic display	5,796	6,092	9,215	12,694
Window film	1,805	1,315	3,649	3,325
Architectural	1,320	1,365	2,723	2,765
Total net revenues	$ 14,548	$ 15,328	25,615	30,549

The following is a summary of net revenues by geographic area (based on the location of the Company s customers) for the second quarter and the first six months of 2004 and 2003, respectively (in thousands):

	Three months ended		Six months ended	
	June 27,	June 29,	June 27,	June 29,

	2004	2003	2004	2003
United States	$ 2,966	$ 1,256	$ 4,447	$ 2,770
Japan	5,285	5,783	8,259	11,606
France	2,471	2,199	4,719	5,274
Pacific Rim	1,520	1,090	3,190	3,226
Rest of the world	833	2,658	2,104	4,205
Germany	1,473	2,342	2,896	4,205
Total net revenues	$ 14,548	$ 15,328	$ 25,615	$ 30,549

Note 9 Warrants and Other Financial Instruments:

The warrants described below are for common stock at an exercise price of $0.01. With the exception of the warrants issued in connection with the letter of intent, the term of the warrants is five years from the date of issuance. As a result of the nominal exercise price of the warrants, the warrant value is based on the value of the common stock on the date of issuance.

The quoted market price of the Company s common stock was not regarded as an appropriate basis for warrant values, on account of the dilution of the stock and the thin trading of the stock. The fair value of the common stock was based on a Company valuation performed by management using accepted valuation methodologies.

Balance sheet classification of warrants:

EITF 00-19 identifies conditions necessary for equity classification for warrants. One condition is that a sufficient number of authorized and unissued shares exist at the classification assessment date to control settlement by delivering shares. In that evaluation, a company must compare (a) the number of currently authorized but unissued shares, less the maximum number of shares that could be required to be delivered during the contract period under existing commitments with (b) the maximum number of shares that could be required to be delivered under share settlement (either net-share or physical) of the contract. If the amount in (b) exceeds the amount in (a), share settlement is not within the control of the company and asset or liability classification is required.

As of December 31, 2003, the Company satisfied the conditions necessary for equity classification of its warrants, including the availability of sufficient authorized and unissued shares to satisfy existing commitments.

On January 19, 2004, in addition to issuing warrants to PBF, the Company obligated itself to issue 1,597,000 of warrants to Needham and Dolphin, the Investors, as a result of entering into a debt agreement with Teijin, as detailed below. As a result, as of January 19, 2004, the Company had insufficient authorized and unissued shares to satisfy existing commitments had all outstanding warrants been exercised on that date, thereby triggering liability classification for all outstanding warrants.

The Company was required to re-measure all outstanding warrants as of January 19, 2004 and to transfer the fair value warrant value to liabilities with the difference between the equity carrying value and the re-measured fair value of the liability recorded as non-operating expense. The charge recorded on January 19, 2004 totaled $151,000.

The warrants will continue to be classified as liabilities until shareholder approval for the increase in authorized shares occurs, at which point they will be re-measured and reclassified to equity, assuming all other conditions for equity classification are satisfied. The warrants were re-measured as of the end of the first quarter, resulting in a charge of

$23,000, which was recorded as non-operating expense. The warrants were again re-measured as of the end of the second quarter, resulting in a charge of $1,282,000, which was recorded as non-operating expense.

Warrants issued in connection with the Letter of Intent:

In connection with the November 11, 2003 Letter of Intent signed between Needham and the Company outlining the proposed debt guarantee and equity financing the Company issued warrants for 1,254,000 shares of common stock, representing 10% of the outstanding common stock of the Company, with an exercise price of $0.01 per share. The warrants were to expire on November 11, 2008 or execution of definitive investment agreements, whichever was earlier. The warrants expired on December 18, 2003, the date of the signing of the definitive investment agreements.

The warrants included anti-dilution protection whereby the number of warrants would be increased to 10% of the fully diluted number of shares of the Company in the event that the Company entered into a financing agreement with an alternate investor before the end of the first quarter of 2004.

Needham did not seek exclusive negotiations with the Company and the warrants were considered as compensation for Needham investing time in negotiating and structuring the potential transaction.

The warrants were valued by the Company at $100,000 and that value reflected the relative probabilities of an agreement being reached and the anti-dilution feature being triggered. The fair value of the warrant was recorded as a non-operating expense in the fourth quarter of 2003.

Warrants issued in connection with the investment agreement:

In accordance with the investment agreement, warrants were to be issued to the Investors on the closing of each guarantee and equity tranche. However, the investment agreement provided that the Investors were entitled to receive warrants to purchase 753,000 shares of common stock associated with the second tranche of equity regardless of whether the second equity closing occurred. This term was included in the agreements as further incentive for the Investors to enter into definitive agreements. As the Company had an enforceable obligation to issue the warrants and as the terms of the warrants were known as of the date of the investor agreement, the warrants were considered issued for accounting purposes as of December 18, 2003.

As the warrants were issued as an incentive to enter into definitive agreements for transactions that the Investors were not necessarily committed to consummate, the Company determined that the value of the warrants should be recorded as a non-operating expense, which was recorded in the fourth quarter of 2003. The Company considered that the Investors were not necessarily committed to the contemplated transactions because of the arguably subjective nature of determining whether certain conditions to closing were satisfied. Management determined the value of the warrants to be $309,000.

The investment agreement also included terms that required the Company to issue additional warrants to the Investors if, as part of its restructuring plan, the Company issued any equity instruments, notes or other debt instruments to any creditor, landlord, employee, director, agent or consultant.

Following the issuance of equity instruments as part of its restructuring plans the Company is required to issue to each of the Investors warrants in such amounts as would allow the Investors to maintain their aggregate ownership percentage (on a fully-diluted basis) as if such issuance had not occurred. Such warrants represent anti-dilution protection for the investor and are therefore not valued as stand-alone instruments.

Following note or debt issuances to creditors as part of its restructuring plan the Company is required to issue additional warrants to each of the Investors representing the right to purchase that number of shares of common stock equal to the product of (x) 1.25 and (y) the original principal amount of such note or debt instrument. Such warrants represent protection for the investors for the Company failing to eliminate obligations to creditors, and are regarded as issued for accounting purposes as of the date of the agreement triggering legal entitlement.

In December 2003, the issuance to the Investors of additional warrants exercisable for 409,000 shares of common stock was required by note or debt issuances under the restructuring plan. The Company determined the value of the warrants to be $168,000. The fair value of the warrants was recorded as non-operating expense in the fourth quarter of 2003. In the first quarter of 2004, the Company issued 9,849,000 additional warrants to the Investors as a result of note or debt issuances under the restructuring plan. The Company determined the fair value of the warrants to be $4,277,000, which was recorded as a non-operating expense in the first quarter of 2004.

Warrants issued in connection with the guarantee from Needham and line of credit from PBF:

In connection with the first guarantee from Needham and as additional incentive to complete the financing closings, as contemplated in the investment agreement, the Company issued warrants for 941,000 shares of common stock in the fourth quarter of 2003. Management determined the value of the guarantee and warrants at $98,000 and $386,000, respectively.

The Company recorded the amount of the warrant value equal to the fair value of the guarantee, $98,000 as debt issuance costs to be amortized over the life of the line of credit. The residual value of the warrants, $288,000 was recorded as a non-operating expense in the fourth quarter of 2003, as representing an incentive to enter into definitive agreements for transactions to which Needham was not committed.

In connection with the second guarantee from Needham and as additional incentive to complete the financing closings, as contemplated in the investment agreement, the Company issued warrants for 941,000 shares of common stock in the first quarter of 2004. Management determined the value of the guarantee and warrants at $33,000 and $367,000 respectively.

The Company recorded the amount of the warrant value equal to the fair value of the guarantee, $33,000 as debt issuance costs to be amortized over the life of the line of credit. The residual value of the warrants, $334,000 was recorded as a non-operating expense in the first quarter of 2004, as representing an incentive to enter into definitive agreements for transactions to which Needham was not committed.

In November 2003, the Company defaulted under its Factoring Agreements with PBF. On account of the default, PBF was entitled to demand immediate repayment of all outstanding obligations, or to foreclose its security interest in the Company s collateral. In consideration of PBF s forbearance from exercising its rights and as incentive to provide $3.0 million of borrowings under the line credit, the Company agreed to issue warrants for 250,000 shares of the Company s common stock. In addition, the Company paid a forbearance fee of $70,000 and reimbursed PBF for $31,000 of legal fees. The Company determined that the fair value of the warrants was $103,000. The Company has recorded the fair value of the warrants and the fees to debt issuance costs and is amortizing the amount over the life of the line of credit.

On January 19, 2004, the Company issued 75,000 warrants to PBF in consideration of PBF s consent to the execution by Southwall Europe GmbH ("Southwall Europe") of a written Guaranty Agreement in favor of Teijin Limited ("Teijin"). The Guaranty by Southwall Europe was to guarantee the Company s obligations to pay Teijin $1.3 million in full settlement of the Company s debts and obligations to Teijin stemmed from the Company s default on a Japanese bank loan for which Teijin was the guarantor. The Company determined the fair value of the warrants was $34,000 and has recorded the cost as a non-operating expense in the first quarter of 2004.

On January 30, 2004, the Company issued 35,000 warrants to PBF in exchange for PBF granting a two-week extension of its forbearance to enable the Company to execute the investment agreement. The Company determined the fair value of the warrants to be $15,000. The Company recorded the fair value of the warrants to debt issuance costs and is amortizing the amount over the life of the line of credit.

Issuance Of Warrants In Connection With The Convertible Debt:

In connection with the issuance of the convertible notes the Company issued warrants for 1,694,000 shares of common stock to the investors on February 20, 2004.

As discussed above, the terms of the original investment agreement was such that the Investors were entitled to receive the 753,000 warrants associated with the second tranche of equity regardless of whether the second equity closing occurred. As the Company had an enforceable obligation to issue the warrants and because the terms of the warrants were known as of the date of the investor agreement, the warrants were considered issued for accounting purposes as of December 18, 2003. As discussed above, the Company valued the 753,000 warrants at $309,000 and recorded the amount as non-operating expense in the fourth quarter of 2003. As a result, the number of warrants issued for accounting purposes on February 20, 2004, in connection with the issuance of convertible debt was 941,000 (that is, 1,694,000 shares underlying the warrants actually issued less the 753,000 shares underlying the warrants deemed previously issued on December 18, 2003).

The fair value of the 941,000 warrants was determined by management to be $414,000 and is recorded as discount on the convertible notes in the final quarter of 2004 and is being expensed as interest expense over the life of the debt instrument using the effective interest rate method.

Embedded Derivatives:

The features of the Convertible Notes include the right to convert the Notes into Series A preferred stock ("Conversion Right"). This right was evaluated by the Company to determine if it gave rise to an embedded derivative instrument that would need to be accounted for separately in accordance with SFAS 133 and EITF 00-19.

The Company concluded that the Conversion Right qualified as an embedded derivative and did not meet the SFAS 133 scope exceptions. Therefore, the Company bifurcated and fair valued the conversion feature. The fair value of the Conversion Right was determined by management to be $820,000 and was recorded as a discount on the convertible notes and will be amortized as interest expense over the life of the debt instrument using the effective interest rate method.

The embedded derivative was classified as a liability and was re-measured at the end of the first quarter and second quarter of 2004. The warrants will be re-measured at subsequent period ends until shareholder approval for the increase in authorized shares occurs, at which point the Company will cease accounting for the Conversion Right at fair value separate from the debt. The re-measurement at the end of the second quarter resulted in a loss of $192,000 for the three-month period then-ended and a net loss of $153,000 for the six-month period ended June 27, 2004.

The following table summarizes the carrying value of the warrants issued as of June 27, 2004 (in thousands):

Description	Number of Shares Issued Under Warrant		Value of Warrants Issued
Warrants issued in connection with investment agreement	11,010	$	4,754
Warrants issued for Needham loan guarantees	1,882		720
Warrants associated with discount on promissory note	941		414
Warrants issued to PBF	360		152
Warrants issued in association with letter of intent	-		100
Discount associated with embedded derivative	-		820
Re-measurement of financial instruments in the first six months	-		1,640
Total	14,193	$	8,600

15

Note 10 Contingencies:

The Company was a defendant in an action entitled "Portfolio Financial Servicing Company v. Southwall Technologies Inc.," which was filed in state court in Utah on May 22, 2002. This action arose out of sale-leaseback agreements, which the Company entered into with an entity formerly known as Matrix Funding Corporation, or Matrix, in 1999 in connection with the acquisition of two of the Company s production machines. Matrix thereafter filed bankruptcy proceedings. Plaintiffs in the action were Bank of America, which alleged that it was the successor in interest to Matrix, and Portfolio Financial Servicing Company, which claimed to be an agent of the successor to Matrix. The plaintiffs demanded payment of $6.5 million, which they alleged constituted unpaid lease payments, plus the alleged residual value of the equipment, less monies that Matrix owed to Southwall. The Company asserted that Matrix violated certain material terms of the lease. The Company entered into a settlement agreement on February 20, 2004. Pursuant to the settlement agreement, the Company agreed to pay the plaintiffs a total of $2.0 million plus interest over a period of 6 years from December 31, 2004 until December 31, 2010. The Company also agreed to return to the plaintiffs the equipment in question. If the Company fails to make the required payments, the plaintiffs may enter a confession of judgment against it in the amount of $5.9 million.

The insurance carriers in some of the litigation related to alleged product failures and defects in window products manufactured by others in which the Company was a defendant in the past paid the defense and settlement costs related to such litigation. Those insurance carriers reserved their rights to recover a portion or all of such payments from the Company. As a result, those insurance carriers could seek from the Company up to an aggregate of $12.9 million plus defense costs, although any such recovery would be restricted to claims that were not covered by the Company s insurance policies. The Company intends to vigorously defend any attempts by these insurance carriers to seek reimbursement. The Company is not able to estimate the likelihood that these insurance carriers will seek to recover any such payments, the amount, if any, they might seek, or the outcome of such attempts.

In addition, the Company is involved, from time to time, in certain other legal actions arising in the ordinary course of business. The Company believes, however, that none of these actions, either individually or in the aggregate, will have a material adverse effect on its business, its consolidated financial position, results of operations or cash flows.

Note 11 Stock-Based Compensation:

SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an Amendment of FASB Statement No. 123" amends the disclosure requirements of SFAS No. 123, "Accounting for Stock-Based Compensation," to require more prominent disclosures in both annual and interim financial standards regarding the method of accounting for stock-based employee compensation and the effect of the method used on reported results.

The Company accounts for stock-based employee compensation arrangements in accordance with provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. Under APB 25, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of the Company s stock and the exercise price.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 and SFAS 148 to stock-based employee compensation (in thousands, except per share amounts):

	Three months ended		Six months ended	
	June 27, 2004	June 29, 2003	June 27, 2004	June 29, 2003
Net income (loss)				
As reported	$ 1,186	$ (1,713)	$ (5,504)	$ (3,372)
Add: Stock-based employee compensation in reported net income (loss), net of related tax effects	-	-	-	-
Deduct: Total stock-based employee compensation determined under fair value based method for all awards, net of related tax effects	(194)	(262)	(202)	(499)
Pro forma	$ 992	(1,975)	$ (5,706)	$ (3,871)
As reported - basic	$ 0.09	$ (0.14)	$ (0.44)	$ (0.27)
Pro forma - basic	$ 0.08	$ (0.16)	$ (0.46)	$ (0.31)
As reported - diluted	$ 0.04	$ (0.14)	$ (0.44)	$ (0.27)
Pro forma - diluted	$ 0.04	$ (0.16)	$ (0.46)	$ (0.31)

For the stock option plans, the fair value of each option grant is estimated on the date of grant using the Black_Scholes option pricing model, for the multiple option approach, with the following weighted average assumptions used for grants in the second quarters of 2004 and 2003, respectively: expected volatility of 99%, and 96%; risk-free interest rate of 3.8% and 2.1%; and expected lives from vesting date of 2.89 and 3.04 years. Southwall did not pay dividends during these periods and assumed no dividend yield. The weighted average fair value of stock options granted in the second quarters of 2004 and 2003 was $1.81 and $0.58 per share, respectively. The Company granted no options and 95,000 options during the second quarters of 2004 and 2003, respectively.

Note 12 - Restructuring:

The Company implemented a reduction in force at its Palo Alto location in December 2002, and elected to vacate certain buildings in Palo Alto. As result of these actions, the Company incurred a restructuring charge of $2.6 million in 2002 relating to employee severance packages and the remaining rents due on excess facilities in Palo Alto no longer occupied. As part of the restructuring plan commenced in the fourth quarter of 2003, the Company implemented a reduction in force at its Palo Alto facility and closed its Tempe facility. However, there were no restructuring charges incurred, or to be incurred as a result of these actions.

The following tables set forth the beginning and ending liability balances relating to the above described restructuring activities as well as activity during the periods ended June 29, 2003 and June 27, 2004 (in thousands):

	Workforce Reduction	Excess Facilities	Total
Balance at January 1, 2003	$ 125	$ 2,281	$ 2,406
Provisions	-	-	-
Adjustment to reserve	(65)	-	(65)
Cash payments	(41)	-	(41)
Balance at June 29, 2003	$ 19	$ 2,281	$ 2,300

	Workforce Reduction	Excess Facilities	Total
Balance at January 1, 2004	$ -	$ 1,569	$ 1,569
Provisions	-	-	-
Adjustment to reserve	-	(144)	(144)
Cash payments	-	(569)	(659)
Balance at June 27, 2004	$ -	$ 856	$ 856

Note 13 - Guarantees:

The Company establishes a reserve for warranties and sales returns for specifically identified, as well as anticipated warranty claims based on warranty experience. The reserve for warranty and sales returns at June 27, 2004 and June 29, 2003 were as follows (in thousands):

	Balance at December 31, 2003	Provision	Utilized	Balance at June 27, 2004
Accrued warranty	$ 1,850	$ 578	$ (434)	$ 1,994

	Balance at December 31, 2002	Provision	Utilized	Balance at June 29, 2003
Accrued warranty	$ 2,069	$ 570	$ (586)	$ 2,053

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and notes thereto appearing elsewhere in this report. This discussion and analysis contains forward_looking statements that involve risks and uncertainties, including those discussed below under "Forward_Looking Statements" and "Risk Factors" and in our Annual Report on Form 10-K/A, as amended, for the year ended December 31, 2003. You should not place undue reliance on these forward_looking statements. Actual results may differ materially from those anticipated in the forward_looking statements. These forward_looking statements represent our judgment as of the date of the filing of this Form 10-Q.

Overview

We are a global developer, manufacturer and marketer of thin film coatings on flexible substrates for the automotive glass, electronic display, window film, and architectural glass markets. We have developed a variety of products that control sunlight in automotive glass, reduce light reflection, reduce electromagnetic radiation and improve image quality in electronic display products and conserve energy in architectural products. Our products consist of transparent solar_control films for automotive glass; anti-reflective films for computer screens, including flat panel displays, plasma displays, and transparent conductive films for use in touch screen and liquid crystal displays; energy control films for architectural glass; and various other coatings.

We have experienced a significant reduction in our annual revenues since 2000, and we anticipate a further decline in our revenues in 2004. Demand for our customers' products has changed rapidly from time to time in the past and may do so in the future. For example, as a result of changing demand in the personal computer industry from 1999 through 2003, our electronic display revenues rose from $16.0 million in 1999 to $47.7 million in 2000 then declined to $29.6 million, $26.6 million and $19.0 million in 2001, 2002, and 2003, respectively. Similarly, our revenues from our automotive segment rose from $20.2 million in 2000, to $37.4 million in 2001, and declined to $25.7 million and $23.2 million in 2002 and 2003, respectively, because of competition from alternative technology solutions. Demand for our products can also be affected when the markets for the products in which our films are used evolve to new technologies, such as the evolution from cathode ray tubes, or CRTs, to flat panel displays.

Cumulative operating losses, negative working capital, negative cash flows, and defaults with respect to our debt obligations, and our current cash balance raise substantial doubt about our ability to continue as a going concern. We incurred a net loss and negative cash flows from operations in 2003 and the first quarter of 2004. We generated an operating profit and positive cash flow for the quarter ended June 27, 2004. Based on our current financial outlook we believe it is likely we will remain profitable and maintain positive cash flow in the second half of 2004. As of December 31, 2003 and June 27, 2004, our cash and cash equivalents were $1.2 million and $1.4 million, respectively, and our restricted cash was $0.7 million and $0.6 million, respectively. If we are unable to maintain our existing financing sources, generate positive cash flow from operations, or procure new sources of financing we may be unable to satisfactorily meet all of the cash commitments required to fund our operations or to continue as a going concern. In addition, if we do not obtain stockholders approval of a proposed amendment to increase the number of shares that we are authorized to issue under our charter, the $4.5 million of our convertible notes held by investors will accelerate and we may be unable to meet our obligations to issue shares of capital stock under the investment agreement. If we were required to repay the convertible notes, we would likely become insolvent and be required to file for bankruptcy protection. We expect to hold an annual meeting of our stockholders in September 2004 to seek approval of the charter amendment. There can be no assurance that such approval will be obtained.

Recent Development:

On April 29, 2004, we entered into an amendment to our receivables financing line of credit with Pacific Business Funding, or PBF, that was due to expire on May 5, 2004. The amendment waived the events of default set forth in the Forbearance Agreement between PBF and us and terminated the portion of the line of credit guaranteed by the United

States Export-Import Bank. The remaining portion of the line of credit, which is supported by domestic receivables, was increased to $6.0 million and the maturity date was extended until May 5, 2005. Availability under the domestic line of credit is limited to 75% of the value of eligible domestic receivables acceptable to PBF. PBF continues to reserve the right to lower the 75% of the value of eligible receivables standard for borrowings under the credit agreement or to terminate the credit agreement at any time. The amendment also deleted the requirements that we maintain a listing on the Nasdaq National Market and comply with financial covenants to maintain minimum net tangible net worth of $33.0 million, a current ratio of assets to liabilities of at least 0.70, and revenues equal to or greater than 80% of revenues projected. On April 29, 2004, we also entered into an amendment to our $3.0 million credit facility with PBF that is guaranteed by Needham to extend the maturity date until May 5, 2005.

Effective March 26, 2004, we voluntarily de-listed from the Nasdaq National Market and on March 29, 2004, our common stock began trading on the Pink Sheets. On May 6, 2004, our common stock began trading on the Over-the-Counter Bulletin Board under the symbol SWTX.OB.

Recent Financing and Related Transactions

Overview. On December 18, 2003, in order to raise cash to continue operations, we entered into an investment agreement with Needham & Company, Inc., Needham Capital Partners II, L.P., Needham Capital Partners II (Bermuda), L.P., Needham Capital Partners III, L.P., Needham Capital Partners IIIA, L.P., Needham Capital Partners III (Bermuda), L.P., and Dolphin Direct Equity Partners, LP, collectively, the Investors. On February 20, 2004, we amended and restated that agreement. Under the terms of the amended and restated agreement, we agreed to issue and sell $4.5 million of Secured Convertible Promissory Notes that are convertible into our Series A 10% Cumulative Convertible Preferred Stock, par value $.001 per share, or the Series A shares, at a conversion price of $1.00 per share, together with warrants initially exercisable for 13,881,500 shares of our common stock. If, as of June 27, 2004, the Investors were to exercise all warrants and convert all Series A shares issuable to them pursuant to the terms of the investment agreement, if our senior lender, Pacific Business Funding, or PBF, were to exercise all warrants issued to it, and if our option holders were to exercise all options outstanding, we would have 34,388,808 shares of common stock outstanding at June 27, 2004. We currently have 20,000,000 shares of common stock authorized under our certificate of incorporation. At our shareholders meeting expected to be held in September 2004, we will seek approval of an amendment to our certificate of incorporation increasing the number of authorized shares available for issuance to a number that would allow us to meet fully our obligations to issue shares of capital stock under the investment agreement. If an amendment to our certificate of incorporation is not approved, the amounts due under the convertible notes will accelerate 45 days after the shareholder vote, and we will not be able meet our obligations under the investment agreement. The resulting lack of capital will prevent us from funding our operations and continuing as a going concern. The form of the amended and restated Certificate of Designation describing the preferences and rights of the Series A shares and the Amended and Restated Investment Agreement and related documents were filled with the SEC on Form 8-K/A on March 3, 2004.

Background. As described above, during 2003, we experienced a significant decline in sales which led to a significant deterioration in our working capital position, which raised concerns about our ability to fund our operations and continue as a going concern in the short term and our ability to meet obligations coming due over the next few years.

In the third quarter of 2003, we determined that due to reduced demand for our products, anticipated revenues through the remainder of 2003 and 2004 would be substantially below historical levels. As our U.S. operations have a higher operating cash breakeven point compared to our Dresden operations, we believed that the lower than anticipated revenues indicated that an impairment analysis of the long-lived assets of our U.S. operations was necessary at

September 28, 2003.

Subsequently, in the fourth quarter of 2003, as a result of a further erosion of estimated future revenues, management decided to close the Tempe manufacturing operation. This decision caused us to conclude that a further impairment analysis of the long-lived assets of the U.S. operation were necessary at December 31, 2003.

In summary, our evaluation concluded that impairment charges were required to write down the carrying value of our long-lived assets to their fair market values during the third and fourth quarters of fiscal 2003. The amounts of these impairment charges were $19.4 million and $8.6 million for the periods ended September 28, 2003 and December 31, 2003, respectively. Approximately $21 million of the $28 million cumulative impairment charge was associated with manufacturing machines, software and equipment housed in the Tempe facility, which was planned to be closed during the fourth quarter 2003.

We performed an evaluation of the recoverability of long-lived assets related to our U.S. business in accordance with the Statement of Financial Standards No. 144, "Accounting for the Impairment of Disposal of Long-Lived Assets," or SFAS 144. We made our evaluation of the impairment of our long-lived assets based in the following three categories as required by applicable accounting guidelines:

1. *Long-lived assets to be held and used* those assets that we intended to retain and continue to use.
2. *Long-lived asserts to be abandoned* those assets that we did not intend to use in the future.
3. *Long-lived assets to be disposed of by sale* those assets that we did not intend to use in the future but intended to put up for sale and for which we expect some value to be recovered.

Below is a summary of our impairment charges by category (in thousands):

		September 28, 2003		December 31, 2003
Held for Use	$	15,000(1)	$	3,000
Abandoned		4,400(2)		3,600(3)
Disposed by Sale		-		2,000(4)
Total Impairment	$	19,000	$	8,600

19

1) Includes $10.4 million for our Production Machines 1,2, and 4, located in Palo Alto, and our Production Machines 5 and 6, located in Tempe.
2) Represents amounts for our Production Machine 7, located in Tempe.
3) Includes $3.6 million for the balance of our Production Machines 6 and 7.
4) Includes $1.7 million for the balance of our Production Machine 5.

Details on the assumptions and calculations we used in determining these impairment charges are described more fully below.

To determine the amount of the impairment charge in accordance with the SFAS 144, we estimated the discounted future cash flows associated with the equipment in each of the three categories. To generate the appropriate cash flow estimates, we determined the appropriate variables were relevant to our business conditions, including an estimate of future revenues and costs and certain other assumptions specific to our situation, including assumptions with respect to:

1. Our weighted average cost of capital, calculated with reference to

   a. The desired return on equity, which was based on information received from our investment banker.
   b. The desired return on debt, which was based on the average interest rate for tour term debt.
   c. Total debt amount, which consisted of the outstanding balance on our line of credit and term debt at September 28, 2003 and December 31, 2003.
   d. Equity, which consisted of common stock, additional paid in capital and net deficit at September 28, 2003 and December 31, 2003.
   e. Projected revenue, which was only for display products, which will be the only products we continue to produce in the U.S.

2. Our cost of goods sold, which was derived by historical and projected manufacturing costs.
3. Our operating expenses, which were determined using our 2004 budget.
4. Our cash flows, which included days sale outstanding assumptions based on historical results and days paymentsoutstanding based on our historical payment schedule.
5. The net present value, which was calculated based on the net present value of the projected cash outflows subtracted from cash inflows from the first quarter of 2004 through the first quarter of 2005. Our U.S. based liabilities, which were measured at September 28, 2003 and December 31, 2003 and represents total liabilities, less current and long-term portion of term debt.
6. During the third quarter 2003 analysis we had assumed that we return to profitability by the second half of 2004.
7. During the fourth quarter analysis we had assumed that we return to profitability by the second half of 2005.

We possessed six Production Machines in the U.S., namely Production Machines 1, 2 and, 4, located in our Palo Alto manufacturing facility, and Production Machines 5, 6 and 7, located in our Tempe facility. The revised business plan assumed that the
Palo Alto machines would be only operated part time.

Assumptions supporting the impairment charges associated with long-lived assets to be held and used:

As a result of our analysis, an impairment charge of $15.0 million was recorded at September 28, 2003 for long-lived assets to be held and used, and it was charged to our operating results at September 28, 2003. These items included a portion of Production Machines 1, 2, 4, 5 and 6 and other manufacturing software and hardware that, at the time, we assumed would be used on a part time basis for the remaining portion of 2003 and beyond.

At December 31, 2003, based on a deteriorating business outlook and a downwardly revised forecast of our future discounted cash flows associated with certain long-lived assets to be held and used, we determined that the net book value of those long-lived assets exceeded the future discounted cash flows to be derived from these long-lived assets by an additional $3.0 million. As a result of our analysis, an impairment charge of $3.0 million was recorded at December 31, 2003 for U.S. long-lived assets to be held and used.

Long-lived assets to be abandoned:

At September 28, 2003, we made the determination that one of our production machines located in our Tempe facility was not capable of profitably manufacturing commercial products that would meet our future product specifications. As a result of our assessment, a portion of Production Machine 7 was recorded as a long-lived asset to be abandoned, and we recorded a charge of $4.4 million against our operating results at September 28, 2003.

We decided, during the fourth quarter of 2003, that we would discontinue our Tempe operations as of December 31, 2003. At December 31, 2003, we recorded an additional impairment charge of $3.6 million covering the remaining portion of Production Machines 6 and 7 as long-lived assets to be abandoned, both of which were located in our Tempe facility. We determined that the age and specialized function of these long-lived assets made it unlikely we would be able to find a buyer for these assets.

Long-lived assets to be disposed of by sale:

When we decided to close our Tempe facility, we determined that we might be able to find buyers for certain long-lived assets, primarily Production Machine 5 and certain manufacturing and computer equipment, located at that facility. We committed to a plan to sell these assets, the assets were available for immediate sale at December 31, 2003, an active program to locate buyers was initiated, and it was unlikely that significant changes to the plan would be made, or that the plan would be withdrawn. As a result of our assessment, these long-lived assets were recorded as a long-lived asset to be disposed of by sale at December 31, 2003, and we recorded a charge to operating results of $2.0 million, which was equivalent to the net book value of these long-lived assets, minus their estimated salvage value. The majority of the $2.0m write down was associated with Production Machine 5.

. On October 8, 2003, our management reviewed the revenue forecast for the fourth quarter of 2003 and determined the anticipated sales for the quarter would not generate enough cash flow to continue operations through the end of the quarter. Management presented its findings to our Board of Directors on October 10, 2003 and the directors instructed our management team to develop an emergency restructuring plan to improve our cash flow and to obtain new financing.

The primary elements of management s restructuring plan included:

· Shutting down a majority of our domestic manufacturing and transferring that production to our Dresden, Germany facility;

· Undertaking a series of staggered layoffs;

· Arranging new payment terms with all major creditors and vendors to extend or reduce our payment obligations;

· Accelerating our cash collections;

· Reducing our operating expenses and inventory levels;

· Minimizing our capital expenditures; and

· Seeking new sources of financing.

We also began to solicit and receive proposals from potential investors and lenders. We evaluated a variety of public and private market alternatives to raise additional capital, as well as alternatives to restructure our upcoming payment obligations without raising additional capital. Our access to the traditional capital markets was, and continues to be, constrained, however, by a number of factors, including the risks described in our filings with the SEC. As a result, we concluded that a private equity investment was the most attractive alternative to continue as a going concern.

We received and evaluated three financing proposals, which were presented to our Board of Directors. After reviewing and seeking to negotiate revisions to all of the proposals submitted, the Board unanimously determined on November 10, 2003 to proceed with the Needham & Company, Inc. offer, which is described in further detail below. The Needham offer was chosen primarily because the Board believed that the amount of cash we would have received under each of the two other proposals would have been insufficient to meet our short-term operational cash flow requirements. We entered into a non-binding letter of intent with Needham on November 11, 2003 to sell $3.0 million of Series A shares at a price of $1.00 per share. Needham also agreed to guarantee up to $2.0 million of additional borrowing under our existing Domestic Factoring Agreement with our senior lender, PBF. In connection with the guarantee and the sale of the Series A shares, we agreed to issue warrants to Needham exercisable for a number of shares of our common stock equal to 10% of the total shares outstanding, at a nominal exercise price, which warrants terminated by their terms upon the execution of the investment agreement described below. During the negotiations of the investment agreement, the parties agreed to increase the aggregate number of Series A shares to be sold to 4.5 million. The parties also increased the guarantee to $3.0 million and determined that it would apply to a new line of credit facility with PBF.

On December 18, 2003, we entered into the investment agreement with the Investors. Under the terms of the investment agreement, Needham agreed to issue the guarantees of our new line of credit facility in two separate tranches of $2.25 million and $0.75 million, respectively, and the Investors agreed to purchase the Series A shares in two separate tranches of $1.5 million and $3.0 million, respectively. The new borrowings and the purchase of each equity tranche were subject to certain conditions, including, among other things, the receipt of concessions by us from creditors and landlords, the completion by us of certain restructuring actions and the achievement of cash flow break-even at quarterly revenue levels below those of the third quarter 2003. Needham executed a guarantee of up to $2.25 million under the new line of credit facility on December 18, 2003, and received a warrant to purchase 941,115 shares of our common stock, approximately 7.5% of our total shares currently outstanding at an exercise price of $0.01 per share. On January 15, 2004, Needham executed a guarantee with respect to an additional $0.75 million under the new line of credit and received an additional warrant to purchase 941,115 shares of common stock at an exercise price of $0.01 per share. A further description of the terms of all warrants is set forth below.

On February 20, 2004, the parties amended and restated the investment agreement to provide that we would issue and sell to the Investors an aggregate of $4.5 million of our convertible notes in one tranche instead of Series A shares in two separate tranches. A further description of the convertible notes is set forth below. Under the investment agreement, and as further described in the "Anti-Dilution Protection" section below, we were also required to issue additional common stock warrants to the Investors as anti-dilution protection for the issuance of debt and equity by us as part of the restructuring of our obligations to creditors. In connection with the sale of the convertible notes and honoring the Investors anti-dilution protection, on February 20, 2004 we issued warrants to the Investors to purchase a total of 9,913,614 shares of our common stock, at an exercise price of $0.01 per share, approximately 82% of our total shares currently outstanding.

Summary of Current Ownership by Investors. Following completion of the financing, based on securities outstanding as of June 27, 2004, the following convertible securities and warrants are held by the Investors:

· if Needham and its affiliated entities were to exercise all of their warrants and convert all of their Series A shares (issuable upon conversion of its convertible notes), while maintaining their current ownership of approximately 2,200,067 shares of common stock, then Needham and its affiliated entities would own approximately 15,081,834 shares of our common stock, or about 59.3% of the total shares outstanding, including such issuances to Needham and its affiliates but excluding outstanding warrants and Series A shares held by other Investors.

· if Dolphin Direct Equity Partners, LP were to exercise all warrants and convert all of its Series A shares (issuable upon conversion of its convertible notes), then Dolphin would own approximately 5,499,769 shares of our common stock, or about 30.5% of the total shares outstanding, including such issuances to Dolphin but excluding outstanding warrants and Series A shares held by other Investors.

In addition, the convertible notes held by the Investors accrue interest at 10% per year, compounded daily, payable each December 31st, which interest is also convertible into Series A shares, and the Series A shares are entitled to a cumulative dividend of 10% per year, accruing daily, payable at the discretion of the Board, which dividends are convertible into common stock.

Material Terms of the Secured Convertible Promissory Notes

In connection with the investment agreement, we issued convertible notes in an aggregate principal amount of $4.5 million to the Investors. The convertible notes:

- are convertible, at each holder s option, into our Series A shares at a conversion price of $1.00 per share;
- accrue interest at an annual rate of 10%, compounded daily, payable each December 31, which interest if accrued but unpaid is also convertible into Series A shares;
- are secured by a pledge of a portion of the stock of our subsidiary, Southwall Europe GmbH; and
- are due and payable on February 20, 2009 or earlier under certain circumstances. For instance, the failure of our stockholders to approve Proposal 1 (the amendment of our charter) will result in the acceleration of the convertible notes.

In addition, so long as any of the convertible notes are outstanding, the approval of the holders of a majority of the convertible notes will be required to effect the corporate actions set forth below under " Material Terms of the Series A Shares General Voting Rights" of the Series A shares. The convertible notes are subordinate to the credit facilities with our senior lender, PBF.

Material Terms of the Series A Shares

22

Dividends on Series A Shares. Each of the Series A shares will have a stated value of $1.00 and will be entitled to a cumulative dividend of 10% per year, payable at the discretion of the Board of Directors. Dividends on the Series A shares shall accrue daily commencing on the date of issuance and shall be deemed to accrue whether or not earned or declared and whether or not there are profits, surplus or other funds legally available for the payment of dividends. Accumulated dividends, when and if declared by the Board, will be paid in cash.

Restrictions. As long as any Series A shares are outstanding, unless all accrued dividends on all Series A shares have been paid, we are prohibited from:

- redeeming or purchasing any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference), except the repurchase of shares of common stock held by officers, directors or employees, upon death, disability, or termination of employment;
- paying or declaring any cash dividend or making any cash distribution upon any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference); and
- setting aside any monies for the purchase or redemption of any shares of our common stock (or any other capital stock ranking junior to the Series A shares in respect of dividends or liquidation preference), except as described above.

General Voting Rights. Except as described below or as otherwise provided by law, the holders of Series A shares have no voting rights. The approval of the holders of a majority of the Series A shares voting separately as a class will be required to effect certain corporate actions, including:

- the authorization or issuance of shares of any class or series of stock having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;
- the reclassification of any shares of capital stock into shares having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;
- the authorization or issuance of any debt or other obligations convertible into or exchangeable for any shares of stock having any preference or priority as to dividends or redemption rights, liquidation preferences, conversion rights, or voting rights, superior to or on a parity with any rights of the Series A shares;
- declaring or paying dividends on or making any distributions with respect to our common stock;
- increasing or decreasing the authorized number of Series A shares;
- amending or repealing any provision of, or adding any provision to, our certificate of incorporation or bylaws if such action would alter or change the preferences, rights, privileges or powers of, or the restrictions provided for the benefit of, any Series A shares;
- increasing the number of shares of common stock reserved for issuance under our stock option plans, other than the annual increase currently provided in such plans and other than a further increase of not more than 1,000,000 shares;
- engaging in any transaction or series of related transactions constituting a liquidation or dissolution of Southwall, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity; or
- making any material change to our line of business.

Liquidation Preference. Upon a liquidation or dissolution of Southwall, the holders of Series A shares are entitled to be paid a liquidation preference out of assets legally available for distribution to our stockholders before any payment may be made to the holders of common stock. The liquidation preference is equal to the stated value of the Series A shares, which is $1.00 per share, plus any accumulated but unpaid dividends. Mergers, the sale of all or substantially all of our assets, or the acquisition of Southwall by another entity and certain other similar transactions may be deemed to be liquidation events for these purposes.

Conversion. Each of the Series A shares is convertible into common stock at any time at the option of the holder. Each of the Series A shares is convertible into a number of shares of common stock equal to the sum of its stated value plus any accumulated but unpaid dividends, divided by the conversion price of the Series A shares. The conversion price of the Series A shares is $1.00 per share and is subject to adjustment in the event of any stock dividend, stock split, reverse stock split or combination affecting such shares. The Series A shares also have anti-dilution protection that adjusts the conversion price downwards using a weighted-average calculation in the event we issue certain additional securities at a price per share less than the closing price per share of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed. Each Series A share is initially convertible into one share of common stock.

If the closing price of our common stock on the Nasdaq National Market or any other stock exchange on which our common stock is listed is $4.00 or more per share (subject to appropriate adjustment if a stock split, reverse split or similar transaction is effected) for 30 consecutive days, all outstanding Series A shares shall automatically be converted. The closing price of our common stock on the Over-the-Counter Bulletin Board on August 2, 2004, was $0.56 per share.

Redemption. The Series A shares are not redeemable.

Material Terms of the Warrants.

Investor Warrants. In connection with the investment agreement, we issued warrants to the Investors that may be exercised to acquire up to 14,366,245 shares of common stock (including warrants issued to the Investors as anti-dilution protection for the issuance of debt and equity by us as part of the restructuring of our obligations to creditors) at an initial exercise price of $0.01 per share. The number of shares and the exercise price are both subject to appropriate adjustment in the event of stock splits, reverse stock splits and the granting of a stock dividend on our outstanding common stock. These warrants will be exercisable for cash or through a "cashless exercise" feature. The warrants are exercisable immediately and have a term of approximately five years.

Upon the reclassification of our common stock or a capital reorganization, each holder of these warrants has the right to receive the same amount and kind of securities, cash or property upon exercise as it would have been entitled to receive had it been the owner of the shares of common stock underlying the warrants at the time of such transaction. Upon a merger or consolidation, a transfer of all or substantially all of our voting securities, or the sale of all or substantially all of our assets, the warrants will terminate if they have not been previously exercised. The holders of the warrants have registration rights under the registration rights agreement described below.

PBF Warrants. In connection with the credit facilities with our senior lender, PBF, we issued warrants to PBF that may be exercised to acquire up to 360,000 shares of common stock at an initial exercise price of $0.01 per share. All other terms of these warrants mirrored the terms of the warrants issued to the Investors.

Other Agreements with the Investors

Issuance of Equity. Other than certain issuances of equity in connection with our option plan and as part of the restructuring of our obligations to creditors, the investment agreement contains provisions that prohibit us from issuing any equity or warrants, options, rights or other instruments exercisable or convertible into equity of Southwall to any creditor, landlord, employee, director, agent or consultant until such time as we have received the approval of our stockholders to increase the number of authorized shares of our common stock issuable under our certificate of incorporation.

Anti-Dilution Protection. If, as part of our restructuring efforts, we issue any equity or warrants, options, rights or other instruments exercisable or convertible into equity, to any creditor, landlord, employee, director, agent or consultant, then we are required to issue additional warrants to each of the Investors in such amounts as would allow the investors to maintain their aggregate ownership percentage (on a fully-diluted basis) as if such issuance had not occurred. Likewise, as part of our restructuring efforts, if we issue notes or other debt instruments to any of our creditors, then we are required to issue additional warrants to each of the Investors representing the right to purchase that number of shares of common stock equal to the product of (x) 1.25 and (y) the original principal amount of such note or debt instrument.

Stockholder Meeting. The investment agreement requires us to hold a stockholder meeting for the purpose of seeking approval of an amendment to our certificate of incorporation increasing the number of authorized shares available for issuance to a number that would allow us to meet fully our obligations to issue shares of capital stock under the investment agreement.

Agreements with Major Creditors

Teijin Limited. Teijin Limited, or Teijin, previously guaranteed our outstanding debt owed to UFJ Bank Limited (formerly known as "Sanwa Bank Limited"). On November 5, 2003, we defaulted on this debt and Teijin honored its guarantee by satisfying the obligation. Under the terms of Teijin s guarantee, we were obligated to immediately repay the amounts paid by Teijin. As part of the restructuring plan, we entered into an agreement with Teijin to satisfy Teijin s claim. The agreement included a payment schedule that spread the payments out over a period of four years until 2008. The obligations owed to Teijin will not accrue interest if paid according to the payment schedule. Teijin previously held a security interest in one of our production machines, which they have released. We may dispose of the machine provided that we pay to Teijin the net proceeds of any disposition. Our obligations to Teijin are guaranteed by our subsidiary, Southwall Europe GmbH. On June 9, 2004, the original loan agreement was amended as the production machine was sold to a third party. The amended agreement required us to pay down its loan from the net proceeds of any disposition of the production machine. During the second quarter of 2004, we sold the production machine to a Chinese company, and the proceeds from the sale will be remitted to us on an installment basis. On June 17, 2004, the Company paid down the amount owed to Teijin under the agreement by $560,000 from the net proceeds received from the buyer. Additional payments will be made in the future when additional proceeds from the sale are received.

Judd Properties, LLC. We reached an agreement with Judd Properties, LLC, or Judd, to restructure our obligations under the lease for our executive offices and Palo Alto manufacturing facilities. We agreed to a payment schedule that extends our obligations and provides us with options to extend the lease. We further agreed to issue a warrant issuable for 4% of our capital stock on a fully diluted basis to be held in an escrow account pending our departure from the premises. Upon our departure, if we fail to restore the property in accordance with the original lease the warrant will be released to Judd. The warrant is exercisable for 1,437,396 shares of our common stock at a nominal exercise price. The other terms of the warrant mirror the terms of the warrants issued to the Investors. Judd will be a party to the registration rights agreement described above and hold certain other registration rights with respect to the warrant shares. Because we did not have available enough authorized shares of common stock to issue upon exercise of the warrant, we were required to issue a letter of credit in the amount of $1.0 million to be held by Judd as security for our obligations until such time as the requisite number of authorized shares are approved by our stockholders.

Portfolio Financial Servicing Company, Bank of America and Lehman Brothers. On February 20, 2004, we entered into a settlement agreement with Portfolio Financial Servicing Company, Bank of America and Lehman Brothers, which extinguished a claim arising out of sale-leaseback agreements that we had entered into in connection with the acquisition of two of our production machines. As part of the settlement, we agreed to pay an aggregate of $2.0 million plus interest over a period of six years. The settlement requires us to make an interest payment in 2004 and, beginning in 2005, to make quarterly principal and interest payments until 2010.

Richard A. Christina and Diane L. Christina Trust. On December 1, 2003, we reached an agreement with the Richard A. Christina and the Diane L. Christina Trust to modify the lease agreement for a building that we rent from the Trust in Palo Alto, California. Under the terms of the agreement, we agreed to pay the Trust $0.3 million.

Greenwood and Son Real Estate Investments. On January 29, 2004, we reached an agreement with Greenwood and Son Real Estate Investments to restructure the remaining scheduled lease payments for our Tempe facility following our decision to discontinue operations in our Tempe facility as of December 31, 2003. Under the terms of the settlement agreement, we agreed to pay the regular monthly rent of $40,000 for the months of February and March 2004, and agreed to pay a cash buy-out of $368,000 for the remaining obligations under the existing lease agreement. The first payment under the settlement agreement was $50,000, which was paid in April 2004. The remaining cash payments will be paid ratably over a twelve-month starting on April 1, 2004. As a result of the settlement agreement, we recorded a charge of $296,000 and $13,000, net of certain accounting credits, in the first and second quarters of 2004, respectively.