

CSP INC /MA/  
Form 10-Q  
August 09, 2007

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**United States  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

\_\_\_\_\_  
**FORM 10-Q**  
\_\_\_\_\_

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

**For the Quarterly Period Ended June 30, 2007.**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission File Number 0-10843**

\_\_\_\_\_  
**CSP Inc.**  
**(Exact name of Registrant as specified in its Charter)**

**Massachusetts**  
**(State of incorporation)**

**04-2441294**  
**(I.R.S. Employer Identification No.)**

**43 Manning Road**  
**Billerica, Massachusetts 01821-3901**  
**(978) 663-7598**  
**(Address and telephone number of principal executive offices)**

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of August 1, 2007, the registrant had 3,815,276 of common stock issued and outstanding.

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**CSP INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(Amounts in thousands, except par value)

	<b>June 30,</b>	<b>September 30,</b>
	<b>2007</b>	<b>2006</b>
	(Unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 10,677	\$ 8,683
Short-term investments	3,370	2,173
Accounts receivable, net of allowances of \$134 and \$77	12,388	10,316
Inventories	9,476	7,407
Refundable income taxes	107	43
Deferred income taxes	998	1,361
Other current assets	2,128	1,632
<b>Total current assets</b>	<b>39,144</b>	<b>31,615</b>
Property, equipment and improvements, net	1,084	1,141
Other assets:		
Goodwill	2,779	2,779
Deferred income taxes	357	327
Cash surrender value of life insurance	1,900	2,185
Other assets	350	403
<b>Total other assets</b>	<b>5,386</b>	<b>5,694</b>
<b>Total assets</b>	<b>\$ 45,614</b>	<b>\$ 38,450</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 12,661	\$ 10,695
Pension and retirement plans	555	494
Income taxes payable	1,575	827
Deferred income taxes	606	—
<b>Total current liabilities</b>	<b>15,397</b>	<b>12,016</b>
Pension and retirement plans	7,810	7,283
Deferred income taxes	268	236
<b>Total liabilities</b>	<b>23,475</b>	<b>19,535</b>
Commitments and contingencies		
Shareholders' equity:		
Common stock, \$.01 par; authorized, 7,500 shares; issued 3,815 and 3,716 shares, respectively	38	37

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Additional paid-in capital	11,775	10,957
Retained earnings	13,302	11,187
Accumulated other comprehensive loss	(2,976)	(3,266)
Total shareholders' equity	22,139	18,915
Total liabilities and shareholders' equity	\$ 45,614	\$ 38,450

**See accompanying notes to unaudited consolidated financial statements.**

**CSP INC. AND SUBSIDIARIES**  
**UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Amounts in thousands, except for per share data)

	For the three months ended		For the nine months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
<b>Sales:</b>				
Product	\$ 21,871	\$ 14,468	\$ 54,929	\$ 41,342
Services	4,073	4,088	10,964	9,957
<b>Total sales</b>	<b>25,944</b>	<b>18,556</b>	<b>65,893</b>	<b>51,299</b>
<b>Cost of sales:</b>				
Product	16,837	12,588	42,217	33,388
Services	3,405	2,571	8,131	6,698
<b>Total cost of sales</b>	<b>20,242</b>	<b>15,159</b>	<b>50,348</b>	<b>40,086</b>
<b>Gross profit</b>	<b>5,702</b>	<b>3,397</b>	<b>15,545</b>	<b>11,213</b>
<b>Operating expenses:</b>				
Engineering and development	665	500	1,838	1,579
Selling, general and administrative	3,762	2,983	10,317	9,244
<b>Total operating expenses</b>	<b>4,427</b>	<b>3,483</b>	<b>12,155</b>	<b>10,823</b>
<b>Operating income (loss)</b>	<b>1,275</b>	<b>(86)</b>	<b>3,390</b>	<b>390</b>
Other income (expense):				
Foreign exchange gain (loss)	(1)	(3)	(1)	(5)
Other income (expense), net	333	71	503	309
<b>Total other income (expense), net</b>	<b>332</b>	<b>68</b>	<b>502</b>	<b>304</b>
Income (loss) before income taxes	1,607	(18)	3,892	694
Income tax expense	725	26	1,777	251
<b>Net income (loss)</b>	<b>\$ 882</b>	<b>\$ (44)</b>	<b>\$ 2,115</b>	<b>\$ 443</b>
Net income (loss) per share - basic	\$ 0.23	\$ (0.01)	\$ 0.56	\$ 0.12
Weighted average shares outstanding - basic	3,810	3,685	3,761	3,682
Net income (loss) per share - diluted	\$ 0.22	\$ (0.01)	\$ 0.54	\$ 0.12
Weighted average shares outstanding - diluted	3,967	3,685	3,926	3,791

**See accompanying notes to unaudited consolidated financial statements**

**CSP INC. AND SUBSIDIARIES**  
**UNAUDITED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**  
**For the Nine Months Ended June 30, 2007**  
**(Amounts in thousands)**

	Shares	Amount	Additional Paid-in Capital	Retained Earnings	Accumulated other comprehensive income (loss)	Total Shareholders' Equity	Comprehensive income (loss)
Balance as of September 30, 2006	3,716	\$ 37	\$ 10,957	\$ 11,187	\$ (3,266)	\$ 18,915	
Comprehensive income:							
Net income	—	—	—	2,115	—	2,115	\$ 2,115
Other comprehensive income (loss)							
Effect of foreign currency translation	—	—	—	—	290	290	290
Total Comprehensive income	—	—	—	—	—	—	—\$ 2,405
Exercise of stock options	70	1	362	—	—	363	
Stock-based compensation	—	—	257	—	—	257	
Issuance of shares under employee stock purchase plan	28	—	193	—	—	193	
Issuance of common stock	1	—	6	—	—	6	
Balance as of June 30, 2007	3,815	\$ 38	\$ 11,775	\$ 13,302	\$ (2,976)	\$ 22,139	

**See accompanying notes to unaudited consolidated financial statements**



**CSP INC. AND SUBSIDIARIES**  
**UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Amounts in thousands)

	<b>For the nine months ended</b>	
	<b>June 30,</b>	<b>June 30,</b>
	<b>2007</b>	<b>2006</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,115	\$ 443
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	486	410
Insurance Settlement Gain	(240)	—
Loss on disposal of property, net	1	5
Non-cash changes in accounts receivable	96	56
Non-cash compensation expense related to stock options	257	202
Deferred income taxes	994	53
Increase in cash surrender value of life insurance	—	(17)
Changes in operating assets and liabilities:		
Increase in accounts receivable	(1,823)	(4,340)
Increase in inventories	(1,945)	(1,445)
Increase in refundable income taxes	(60)	(12)
Increase in other current assets	145	(473)
Decrease in other assets	54	(198)
Increase in accounts payable and accrued expenses	1,629	5,503
Increase in pension and retirement plans	247	235
Increase in income taxes payable	730	155
Net cash provided by operating activities	2,686	577
<b>Cash flows from investing activities:</b>		
Purchases of available-for-sale securities	—	(31)
Purchases of held-to-maturity securities	(3,786)	(1,877)
Sales of available-for-sale securities	—	343
Maturities of held-to-maturity securities	2,589	2,073
Life insurance premiums paid	(48)	(91)
Purchases of property, equipment and improvements	(406)	(396)
Net cash provided by (used in) investing activities	(1,651)	21
<b>Cash flows from financing activities:</b>		
Proceeds from stock issued from the exercise of options	363	11
Proceeds from issuance of stock under employee stock purchase plan	193	158
Purchase of common stock	7	(110)
Net cash provided by financing activities	563	59
Effects of exchange rate changes on cash	396	430

Net increase in cash and cash equivalents	1,994	1,087
Cash and cash equivalents, beginning of period	8,683	9,724
<b>Cash and cash equivalents, end of period</b>	<b>\$ 10,677</b>	<b>\$ 10,811</b>
<b>Supplementary Cash flow information:</b>		
Cash paid for income taxes	\$ 104	\$ 91
Cash paid for interest	\$ 97	\$ 89

**See accompanying notes to unaudited consolidated financial statements.**

## CSP INC. AND SUBSIDIARIES

### NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS THREE AND NINE MONTHS ENDED JUNE 30, 2007 AND 2006

#### **Organization and Business**

CSP Inc. (CSPI or the Company) was founded in 1968 and is based in Billerica, Massachusetts. To meet the diverse requirements of its industrial, commercial, scientific, and defense customers worldwide, CSPI and its subsidiaries develop and market IT integration solutions and high-performance cluster computer systems. The Company operates in two segments, its Systems segment and its Service and System Integration segment.

#### ***1. Basis of Presentation***

The accompanying financial statements have been prepared by the Company, without audit, and reflect all adjustments which, in the opinion of management, are necessary for a fair statement of the results of the interim periods presented. All adjustments were of a normal recurring nature. Certain information and footnote disclosures normally included in the annual financial statements, which are prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. Accordingly, the Company believes that although the disclosures are adequate to make the information presented not misleading, the financial statements should be read in conjunction with the footnotes contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

#### ***2. New Accounting Pronouncements***

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (as amended)—an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes," and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are in the process of analyzing the impact of FIN 48, which we are required to adopt by the first quarter of fiscal 2008.

In September 2006, the FASB issued SFAS No. 158, "*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*" (SFAS 158), which requires recognition of the funded status of a benefit plan in the balance sheet. SFAS 158 also requires recognition, in other comprehensive income, of certain gains and losses that arise during the period but which are deferred under pension accounting rules. SFAS 158 also requires defined benefit plan assets and obligations to be measured as of the date of the employer's fiscal year-end. SFAS 158 provides recognition and disclosure elements that will be effective as of the end of fiscal years ending after December 15, 2006 (as of September 30, 2007 for the Company) and measurement date elements that will be effective for fiscal years ending after December 15, 2008 (as of September 30, 2009 for the Company). The Company is currently evaluating the recognition element of adopting SFAS 158. The measurement date element will not have an impact on the Company as the Company already measures the plan assets and obligations as of the end of its fiscal year.

#### ***3. Use of Estimates***

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets

and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates under different assumptions or conditions.

***4. Earnings Per Share of Common Stock***

Basic net income (loss) per common share is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per common share reflects the maximum dilution that would have resulted from the assumed exercise and share repurchase related to dilutive stock options and is computed by dividing net income (loss) by the assumed weighted average number of common shares outstanding.

The reconciliation of the denominators of the basic and diluted net income (loss) per share computations for the Company's reported net income (loss) is as follows:

	For the Three Months Ended		For the Nine Months Ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
	(Amounts in thousands, except per share data)			
Net income (loss)	\$ 882	\$ (44)	\$ 2,115	\$ 443
Weighted average number of shares outstanding - basic	3,810	3,685	3,761	3,682
Incremental shares from the assumed exercise of stock options	157	—	165	109
Weighted average number of shares outstanding - diluted	3,967	3,685	3,926	3,791
Net income (loss) per share - basic	\$ 0.23	\$ (0.01)	\$ 0.56	\$ 0.12
Net income (loss) per share - diluted	\$ 0.22	\$ (0.01)	\$ 0.54	\$ 0.12

For the three and nine months ended June 30, 2007, options of 325 thousand and 339 thousand, respectively, were excluded from the diluted net income per share calculation because their impact would have been anti-dilutive. For the nine months ended June 30, 2006, options of 145 thousand, were excluded from the diluted net income per share calculation because their impact would have been anti-dilutive.

## 5. Inventories

Inventories consist of the following:

	June 30, 2007	September 30, 2006
	(Amounts in thousands)	
Raw materials	\$ 2,113	\$ 1,329
Work-in-progress	1,413	1,379
Finished goods	5,950	4,699
Total	\$ 9,476	\$ 7,407

## 6. Comprehensive Income (Loss)

The components of comprehensive income (loss) are as follows:

	For the Three Months Ended		For the Nine Months Ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
	(Amounts in thousands, except per share data)			
Net income (loss)	\$ 882	\$ (44)	\$ 2,115	\$ 443
Unrealized loss on available-for-sale securities	—	—	—	(45)

Effect of foreign currency translation	62	311	290	231
Comprehensive income	\$ 944	\$ 267	\$ 2,405	\$ 629

The components of Accumulated Other Comprehensive Income (Loss) are as follows:

	<b>June 30, 2007</b>	<b>September 30, 2006</b>
	<b>(Amounts in thousands)</b>	
Cumulative effect of foreign currency translation	\$ (1,066)	\$ (1,356)
Additional minimum pension liability	(1,910)	(1,910)
Accumulated Comprehensive income (loss)	\$ (2,976)	\$ (3,266)

## 7. Pension and Retirement Plans

In the United Kingdom and Germany, the Company provides defined benefit pension plans and defined contribution plans for the majority of its employees. Domestically, the Company also provides benefits through supplemental retirement plans to certain current and former employees. These supplemental plans provide benefits derived out of cash surrender values relating to current and former employee and officer life insurance policies, equal to the difference between the amounts that would have been payable under the defined benefit pension plans, in the absence of legislation limiting pension benefits and earnings that may be considered in calculating pension benefits, and the amounts actually payable under the defined benefit pension plans. Domestically, the Company provides for officer death benefits through post-retirement plans to certain officers.

The Company funds its pension plans in amounts sufficient to meet the requirements set forth in applicable employee benefits laws and local tax laws. Liabilities for amounts in excess of these funding levels are accrued and reported in the consolidated balance sheet.

The plan assets comprise a diversified mix of assets including corporate equity securities, government securities and corporate debt securities.

The components of net periodic benefit costs related to the U.S. and international plans are as follows:

	For the Three Months Ended June 30					
	Foreign	2007 U.S.	Total	Foreign	2006 U.S.	Total
	(Amounts in thousands)					
<b>Pension:</b>						
Service cost	\$ 30	\$ 2	\$ 32	\$ 29	\$ 2	\$ 31
Interest cost	166	35	201	142	36	178
Expected return on plan assets	(122)	—	(122)	(99)	—	(99)
Amortization of:						
Prior service costs/(gains)	11	12	23	8	22	30
Net transition asset	(1)	—	(1)	(25)	—	(25)
Net periodic benefit cost	\$ 84	\$ 49	\$ 133	\$ 55	\$ 60	\$ 115
<b>Post Retirement:</b>						
Service cost	\$ —	\$ 14	\$ 14	\$ —	\$ 14	\$ 14
Interest cost	—	10	10	—	9	9
Expected return on plan assets	—	—	—	—	—	—
Amortization of:						
Prior service costs/(gains)	—	7	7	—	15	15
Net transition asset	—	—	—	—	—	—
Net periodic benefit cost	\$ —	\$ 31	\$ 31	\$ —	\$ 38	\$ 38

### For the Nine Months Ended June 30

	Foreign	2007 U.S.	Total	Foreign	2006 U.S.	Total
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## (Amounts in thousands)

**Pension:**

Service cost	\$	89	\$	5	\$	94	\$	86	\$	5	\$	91
Interest cost		495		107		602		421		107		528
Expected return on plan assets		(362)		—		(362)		(294)		—		(294)
Amortization of:												
Prior service costs/(gains)		33		35		68		35		65		100
Net transition asset		(4)		—		(4)		(85)		—		(85)
Net periodic benefit cost	\$	251	\$	147	\$	398	\$	164	\$	177	\$	340

**Post Retirement:**

Service cost	\$	—	\$	42	\$	42	\$	—	\$	41	\$	41
Interest cost		—		30		30		—		26		26
Expected return on plan assets		—		—		—		—		—		—
Amortization of:												
Prior service costs/(gains)		—		22		22		—		44		44
Net transition asset		—		—		—		—		—		—
Net periodic benefit cost	\$	—	\$	94	\$	94	\$	—	\$	111	\$	111



**8. Segment Information**

The following table presents certain operating segment information.

	Systems	Service and System Integration	Consolidated Total
<b>Three Months Ended June 30, 2007</b>			
Sales:			
Product	\$ 5,241	\$ 16,630	\$ 21,871
Service	\$ 106	\$ 3,967	\$ 4,073
Total sales	\$ 5,347	\$ 20,597	\$ 25,944
Operating income	\$ 1,230	\$ 45	\$ 1,275
Total assets	\$ 19,302	\$ 26,312	\$ 45,614
Capital expenditures	\$ 72	\$ 50	\$ 122
Depreciation	\$ 64	\$ 99	\$ 163
<b>Three Months Ended June 30, 2006</b>			
Sales:			
Product	\$ 282	\$ 14,186	\$ 14,468
Service	\$ 1,250	\$ 2,838	\$ 4,088
Total sales	\$ 1,532	\$ 17,024	\$ 18,556
Operating loss	\$ (307)	\$ 221	\$ (86)
Total assets	\$ 11,779	\$ 26,658	\$ 38,437
Capital expenditures	\$ 97	\$ 91	\$ 188
Depreciation	\$ 52	\$ 94	\$ 146

	Systems	Service and System Integration	Consolidated Total
<b>Nine Months Ended June 30, 2007</b>			
Sales:			
Product	\$ 12,551	\$ 42,378	\$ 54,929
Service	\$ 796	\$ 10,168	\$ 10,964
Total sales	\$ 13,347	\$ 52,546	\$ 65,893
Operating income	\$ 2,637	\$ 753	\$ 3,390
Total assets	\$ 19,302	\$ 26,312	\$ 45,614
Capital expenditures	\$ 258	\$ 148	\$ 406
Depreciation	\$ 199	\$ 287	\$ 486

**Nine Months Ended June, 2006**

Sales:			
Product	\$ 5,302	\$ 36,040	\$ 41,342
Service	\$ 1,754	\$ 8,203	\$ 9,957
Total sales	\$ 7,056	\$ 44,243	\$ 51,299
Operating income (loss)	\$ (181)	\$ 571	\$ 390
Total assets	\$ 11,779	\$ 26,658	\$ 38,437
Capital expenditures	\$ 144	\$ 252	\$ 396
Depreciation	\$ 156	\$ 254	\$ 410

Profit (loss) from operations is equal to sales, less: cost of sales, engineering and development and selling, general and administrative expenses, but is not affected by either non-operating charges/income or by income taxes.

Non-operating charges/ income consists principally of gain on sale of property, investment income and interest expense. All intercompany transactions have been eliminated.

Total assets include deferred income tax assets and other financial instruments owned by the Company.

The following table lists customers from which the Company derived revenues in excess of 10% of total revenues for the three and nine month periods ended June 30, 2007 and 2006.

	For the Three Months Ended		June 30,		June 30,		For the Nine Months Ended		June 30,	
	2007	% of	2006	% of	2007	% of	2006	% of		
	Amount	Revenues	Amount	Revenues	Amount	Revenues	Amount	Revenues		
(Amounts in millions)										
Raytheon Corporation	\$ 4.4	17%	\$ —	—%	\$ 9.5	14%	\$ 1.5	3%		
Atos Origin GmbH	\$ 3.5	14%	\$ 4.1	22%	\$ 8.6	13%	\$ 7.7	15%		
Kabel Deutschland	\$ 4.4	17%	\$ 0.5	3%	\$ 6.9	10%	\$ 5.9	12%		

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### ***Forward-Looking Statements***

The discussion below contains certain forward-looking statements related to, among others, but not limited to, statements concerning future revenues and future business plans. Actual results may vary from those contained in such forward-looking statements.

Markets for our products and services are characterized by rapidly changing technology, new product introductions and short product life cycles. These changes can adversely affect our business and operating results. Our success will depend on our ability to enhance our existing products and services and to develop and introduce, on a timely and cost effective basis, new products that keep pace with technological developments and address increasing customer requirements. The inability to meet these demands could adversely affect our business and operating results.

### ***Critical Accounting Policies***

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our estimates, including those related to uncollectible receivables, inventory valuation, goodwill, income taxes, deferred compensation and retirement plans, and contingencies. We base our estimates on historical performance and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. A description of our critical accounting policies is contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006 in the "Critical Accounting Policies" section of Management's Discussion and Analysis of Financial Condition and Results of Operations.

### **Results of Operations**

#### *Overview of the nine months ended June 30, 2007 Results of Operations*

CSP Inc. operates in two segments:

- Systems - the Systems segment consists of our MultiComputer division which designs, develops and manufactures signal processing computer platforms which are used primarily in military applications and the process control and data acquisition hardware business of our Modcomp division.
- Service and Systems Integration - the Service and Systems Integration Segment includes the computer systems' maintenance and integration services and third-party computer hardware and software products businesses of our Modcomp subsidiary. .

#### *Highlights include:*

- Revenue increased by approximately \$14.6 million, or 28%, to \$65.9 million for the nine months ended June 30, 2007 versus \$51.3 million for the nine months ended June 30, 2006.
- Operating income increased by approximately \$3.0 million, or 769%, to \$3.4 million for the nine months ended June 30, 2007 versus \$390 thousand for the nine months ended June 30, 2006.

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· Net income increased by approximately \$1.7 million, or 377%, to \$2.1 million for the nine months ended June 30, 2007 versus \$443 thousand for the nine months ended June 30, 2006.

· Net cash provided by operations was approximately \$2.7 million for the nine months ended June 30, 2007 compared to net cash provided by operations of \$577 thousand for the comparable period of 2006.

The following table details our results of operations in dollars and as a percentage of sales for the nine months ended June 30, 2007 and 2006:

	<b>June 30, 2007</b>	<b>% of sales</b>	<b>June 30, 2006</b>	<b>% of sales</b>
Sales	\$ 65,893	100%	\$ 51,299	100%
Costs and expenses:				
Cost of sales	50,348	76%	40,086	78%
Engineering and development	1,838	3%	1,579	3%
Selling, general and administrative	10,317	16%	9,244	18%
Total costs and expenses	62,503	95%	50,909	99%
Operating income	3,390	5%	390	1%
Other income	502	1%	304	—%
Income before income taxes	3,892	6%	694	1%
Provision for income taxes	1,777	3%	251	—%
Net income	\$ 2,115	3%	\$ 443	1%

**Sales**

The following table details our sales by operating segment for the nine months ended June 30, 2007 and 2006:

	Systems	Service and Systems Integration	Total	% of Total
<b>For the nine months ended June 30, 2007:</b>				
Product	\$ 12,551	\$ 42,378	\$ 54,929	83%
Services	796	10,168	10,964	17%
Total	\$ 13,347	\$ 52,546	\$ 65,893	100%
% of Total	20%	80%	100%	

	Systems	Service and Systems Integration	Total	% of Total
<b>For the nine months ended June 30, 2006:</b>				
Product	\$ 5,302	\$ 36,040	\$ 41,342	81%
Services	1,754	8,203	9,957	19%
Total	\$ 7,056	\$ 44,243	\$ 51,299	100%
% of Total	14%	86%	100%	

	Systems	Service and Systems Integration	Total	% increase (decrease)
<b>Increase (Decrease)</b>				
Product	\$ 7,249	\$ 6,338	\$ 13,587	33%
Services	(958)	1,965	1,007	10%
Total	\$ 6,291	\$ 8,303	\$ 14,594	28%
% increase	89%	19%	28%	

Total revenues increased by approximately \$14.6 million, or 28%, in the first nine months of fiscal year 2007 compared to the same period of fiscal year 2006. Approximately \$6.3 million of this increase was in the Systems segment and the remaining \$8.3 million was in the Service and System Integration segment.

Product revenues increased by approximately \$13.6 million, or 33% in the first nine months of fiscal year 2007 compared to the first nine months of fiscal 2006. Approximately \$7.2 million of this increase was in the Systems segment and \$6.4 million was in the Service and System Integration segment.

The \$7.2 million increase in the Systems segment product revenue was primarily due to the increase in sales to Raytheon of approximately \$8.0 million over the prior year period, related to sales under the new Raytheon contract that began shipping in the first nine months of fiscal 2007. In addition, sales to Kyokuto Boeki Kaisha ("KBK") increased by \$1.1 million for the nine months ended June 30, 2007 versus the prior year comparable period. These

sales increases were offset by a decline in sales to Lockheed Martin of \$1.9 million in the first nine months of fiscal 2007 versus the prior comparable period.

The \$6.4 million increase in the Service and System Integration segment product revenue was primarily due to a \$2.9 million increase in shipments of third-party hardware in the US Systems and Solutions division plus an increase in product sales in our German division of this segment of approximately \$3.5 million. Approximately \$2.8 million of the US Systems and Solutions division increase was from sales to new customers while the remaining \$0.1 million of the increase was due to increases in sales to existing customers. The increase in the German division product sales of approximately \$3.5 million was due to increased sales volume of \$2.0 million plus the effect of a stronger Euro versus the US dollar during the nine months ended June 30, 2007 compared to the same period of fiscal 2006, which accounted for approximately \$1.5 of the increase. The \$2.0 million increase in sales volume was due to \$1 million in sales to new customer and a net \$1 million increase in sales to existing customers.

Service revenues increased by \$1 million, or 10% in the first nine months of fiscal year 2007 compared to the first nine months of fiscal 2006. This change consisted of an increase of approximately \$2.0 million in the Service and System Integration segment offset by a \$1.0 million decrease in the Systems segment. The Service and System Integration segment increase was derived from a \$1.1 million increase in our German subsidiary, an increase in our UK subsidiary of \$1.2 million offset by a decrease in our US business of approximately \$300 thousand.

The German increase was from \$0.6 million of increased sales volume from existing customers; and \$0.5 million was due to the foreign exchange rate fluctuation of a stronger Euro versus the US dollar for the nine months ended June 30, 2007 versus the comparable period of fiscal 2006.

The UK division increase was due to increased volume of approximately \$1.0 million; and \$0.2 million was due to the foreign exchange rate fluctuation of a stronger British pound versus the US dollar for the nine months ended June 30, 2007 versus the comparable period of fiscal 2006. The increase in sales volume in the UK was due to the completion of a long-term software development contract for a single customer, which totaled approximately \$0.9 million. The software development contract began in fiscal 2005, and was completed and accepted by the customer in June of 2007. The Company accounted for this contract utilizing the completed contract method of accounting, because we were not able to reliably estimate its cost to complete, in accordance with AICPA Statement of Position (“SOP”) 97-2 *Software Revenue Recognition* (“SOP 97-2”), Accounting Research Bulletin No. 45 *Accounting for Long Term Construction-Type Contracts* (“ARB No. 45”) and SOP 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (“SOP 81-1”). The Company determined that the criteria for revenue recognition was met during the quarter ended June 30, 2007, and has thus recorded the revenue in the period. In the quarter ended September 30, 2006, the Company recognized a loss of approximately 33 thousand British Pounds (approximately \$60 thousand), which we estimated would be the loss on the contract once completed. The actual loss on the contract, determined upon its completion in the quarter ended June 30, 2007, was approximately 78 thousand British Pounds (approximately \$152 thousand), resulting in an additional loss on the contract of approximately \$92 thousand that was recognized in the quarter ended June 30, 2007.

The decrease in services revenues in our US division of the Service and System Integration Segment was due primarily to the expiration of annual maintenance contracts that supported legacy systems, which were not renewed. The Systems segment service revenue decrease of \$1.0 million was due to a decrease in royalty revenue from Lockheed Martin which was approximately \$1.5 million in the first nine months of fiscal 2006 compared to approximately \$0.5 million in the first nine months of fiscal 2007.

Our sales by geographic area, based on the location to which the products were shipped or services rendered, are as follows:

	June 30,		For the Nine Months Ended		\$ Increase/ (Decrease)	% Increase (Decrease)
	2007	%	June 30, 2006	%		
North America	\$ 34,460	52%	\$ 26,720	52%	\$ 7,740	29%
Europe	28,666	44%	22,853	45%	5,813	25%
Asia	2,767	4%	1,726	3%	1,041	60%
Totals	\$ 65,893	100%	\$ 51,299	100%	\$ 14,594	28%

North American revenue increased in the first nine months of fiscal 2007 versus the comparable period of fiscal 2006, largely due to the increase in product sales in the Systems segment related to the increase in sales to Raytheon of \$7.9 million offset by the reduction in sales to Lockheed Martin of \$2.8 million, referred to above. This combined with the

increase in product sales in the Systems and Solutions US division of \$2.9 million, offset further by the decrease of approximately \$0.3 million, in services revenue in the US division of the Service and Systems Integration segment, also referred to above, make up the increase in North American Revenue.



The increase in revenues in Europe for the nine months ended June 30, 2007 versus the comparable period of fiscal 2006 was due primarily to the reasons set forth above with respect to sales volumes and foreign exchange rate fluctuations in the German and UK subsidiaries, in the Service and System Integration segment. To summarize the data presented above, \$2.6 of the increase was related to higher sales volume from our German division, \$1.0 million was related to higher sales volume in our UK division, \$2.0 million of the increase was related to foreign exchange rate fluctuation of a stronger Euro versus the US dollar, and \$0.2 million of the increase was related to foreign exchange rate fluctuation of a stronger British Pound versus the US dollar.

The increase in Asia sales for the nine months ended June 30, 2007 versus the comparable period of fiscal 2006 was due to increased sales in the Systems division to KBK (see above.)

### *Cost of Sales and Gross Margins*

The following table details our cost of sales by operating segment for the nine months ended June 30, 2007 and 2006:

	Systems	Service and Systems Integration	Total	% of Total
<b>For the nine months ended June 30, 2007:</b>				
Product	\$ 4,965	\$ 37,252	\$ 42,217	84%
Services	190	7,941	8,131	16%
<b>Total</b>	<b>\$ 5,155</b>	<b>\$ 45,193</b>	<b>\$ 50,348</b>	<b>100%</b>
% of Total	10%	90%	100%	
% of Sales	39%	86%	76%	
<b>Gross Margins:</b>				
Product	60%	12%	23%	
Services	76%	22%	26%	
Total	61%	14%	24%	
	Systems	Service and Systems Integration	Total	% of Total
<b>For the nine months ended June 30, 2006:</b>				
Product	\$ 2,143	\$ 31,245	\$ 33,388	83%
Services	192	6,506	6,698	17%
<b>Total</b>	<b>\$ 2,335</b>	<b>\$ 37,751</b>	<b>\$ 40,086</b>	<b>100%</b>
% of Total	6%	94%	100%	
% of Sales	33%	85%	78%	
<b>Gross Margins:</b>				
Product	60%	13%	19%	
Services	89%	21%	33%	
Total	67%	15%	22%	

	Systems	Service and Systems Integration	Total	% of Total
<b>Increase (decrease)</b>				
Product	\$ 2,822	\$ 6,007	\$ 8,829	86%
Services	(2)	1,435	1,433	14%
<b>Total</b>	<b>\$ 2,820</b>	<b>\$ 7,442</b>	<b>\$ 10,262</b>	<b>100%</b>
% Increase	121%	20%	26%	
% of Sales	6%	1%	(2)%	

**Gross Margins:**

Product	—%	(1)%	4%
Services	(13)%	1%	(7)%
<b>Total</b>	<b>(6)%</b>	<b>(1)%</b>	<b>2%</b>

Total cost of sales increased by approximately \$10.3 million for the nine months ended June 30, 2007, over the comparable period in fiscal 2006, to \$50.3 million up from \$40.1 million in the prior year period. The increase in cost of sales was due, overall, to the increase in sales volume and revenues, reflecting an overall 2% improvement in gross margin to 24% for the current year nine month period versus 22% in the prior year. This improvement in the overall gross margin was due to better product gross margin, which increased by 4% to 23% for the nine months ended June 30, 2007 compared to 19% for the nine months ended June 30, 2006. The increase in total product gross margin was due to an increase in Systems segment product revenues as a percentage of total revenues, which increased to 23% of total product revenues for the nine months ended June 30, 2007 versus 13% of total product revenues for the comparable period of fiscal 2006. Because Systems segment product sales carry much higher gross margins (60%) versus Service and Systems Integration segment product sales (12% to 13%), this proportional increase in Systems segment sales produced higher overall gross margins in the nine month period ended June 30, 2007 vs. the comparable period of fiscal 2006.

Offsetting the increase in the product sales gross margin referred to above, the services gross margin decreased by 7%, comparing the nine month period ended June 30, 2007 versus the comparable prior year period. This decrease in services gross margin was due to lower gross margin in the Systems segment which resulted from the lower royalty revenue in the nine month period ended June 30, 2007 versus the prior year period, which decreased by \$1.0 million. Royalty revenues carry 100% gross margin because there are no associated costs of sales with royalties.

### ***Engineering and Development Expenses***

The following table details our engineering and development expenses by operating segment for the nine months ended June 30, 2007 and 2006:

	<b>June 30, 2007</b>	<b>For the Nine Months Ended % of Total</b>	<b>June 30, 2006</b>	<b>% of Total</b>	<b>\$ Increase (Decrease)</b>	<b>% Increase (Decrease)</b>
	<b>(Amounts in thousands)</b>					
<b>By Operating Segment:</b>						
Systems	\$ 1,767	96%	\$ 1,541	98%	\$ 226	15%
Service and System Integration	71	4%	38	2%	33	87%
Total	\$ 1,838	100%	\$ 1,579	100%	\$ 259	16%

Engineering and development expenses increased by \$259 thousand, or 16%, in the first nine months of fiscal 2007 compared to the first nine months of fiscal 2006. The increase relates to an increase in expenses of \$226 thousand in the Systems segment, related primarily to outside consultants and other costs that were incurred in connection with the development of the next generation of MultiComputer products.

### ***Selling, General and Administrative Expenses***

The following table details our selling, general and administrative expenses by operating segment for the nine months ended June 30, 2007 and 2006:

	June 30, 2007	For the Nine Months Ended		June 30, 2006	% of Total	\$ Increase	% Increase
		% of Total	(Amounts in thousands)				
<b>By Operating Segment:</b>							
Systems	\$ 3,788	37%	\$ 3,361	36%	\$ 427	13%	
Service and System Integration	6,529	63%	5,883	64%	646	11%	
<b>Total</b>	<b>\$ 10,317</b>	<b>100%</b>	<b>\$ 9,244</b>	<b>100%</b>	<b>\$ 1,073</b>	<b>12%</b>	

Total selling, general and administrative expenses increased by \$1.1 million, or 12%, in the first six months of 2007 compared to the corresponding period of fiscal 2006. The Systems division increase was due primarily to increases in commissions and incentive bonuses expenses, as a result of the higher sales volume and net income in the nine months ended June 30, 2007 versus the comparable prior year period. The \$646 thousand increase in the Service and System Integration segment was due primarily to higher sales commissions and incentive bonus expenses which increased by \$325 thousand as a result of the greater sales volume and profits, increases in salaries and related expenses due to headcount increases of \$49 thousand, temporary labor increases of \$19 thousand, an increase in bad debt expense of \$27 thousand, a restructuring charge for a force reduction in our UK division of \$150 thousand and other costs associated with the increased level of business activity.

#### Other Income/Expenses

The following table details our other income/expenses for the nine months ended June 30, 2007 and 2006:

	For the Nine Months Ended		\$ Increase (Decrease)
	June 30, 2007	June 30, 2006	
	(Amounts in thousands)		
Interest expense	(\$ 72)	(\$73)	\$ 1
Interest income	357	282	75
Dividend income	—	2	(2)
Foreign exchange gain (loss)	(1)	(5)	4
Insurance settlement gain	240	60	180
Realized gain on investments	—	65	(65)
Other income (expense), net	(22)	(27)	5
<b>Total other income, net</b>	<b>\$ 502</b>	<b>\$ 304</b>	<b>\$ 198</b>

Total other income increased by \$198 thousand for the first nine months of fiscal 2007 compared to the first nine months of fiscal 2006, as shown above. The increase in interest income was due to higher rates earned on cash, cash equivalents and short-term investments. The increase in insurance settlement income resulted from a gain associated with the payment to the Company on a life insurance policy, because the death benefit to the Company exceeded the carrying cash surrender value of the policy. This compares to the prior year item which was for payment on a disaster claim due to hurricane Wilma in Florida. Offsetting these increases was a reduction due to the non-recurring realized gain on an investment which were realized during the nine months ended June 30, 2006.

*Overview of the quarter ended June 30, 2007 Results of Operations*

*Highlights include:*

- Revenue increased by approximately \$7.4 million, or 40%, to \$25.9 million for the quarter ended June 30, 2007 versus \$18.6 million for the quarter ended June 30, 2006.
- Operating income increased by approximately \$1.4 million, or 1,583%, to \$1.3 million for the quarter ended June 30, 2007 versus an operating loss of \$86 thousand for the quarter ended June 30, 2006.
- Net income increased by \$926 thousand, or 2105%, to \$882 thousand for the quarter ended June 30, 2007 versus a net loss of \$44 thousand for the quarter ended June 30, 2006.

The following table details our results of operations in dollars and as a percentage of sales for the quarters ended June 30, 2007 and 2006:

	<b>June 30, 2007</b>	<b>% of sales</b>	<b>June 30, 2006</b>	<b>% of sales</b>
Sales	\$ 25,944	100%	\$ 18,556	100%
Costs and expenses:				
Cost of sales	20,242	78%	15,159	81%
Engineering and development	665	3%	500	3%
Selling, general and administrative	3,762	14%	2,983	16%
Total costs and expenses	24,669	95%	18,642	100%
Operating income	1,275	5%	(86)	--%
Other income	332	1%	68	--%
Income before income taxes	1,607	6%	(18)	--%
Provision for income taxes	725	3%	26	--%
		1		
Net income	\$ 882	3%	\$ (44)	--%

### Sales

The following table details our sales by operating segment for the three months ended June 30, 2007 and 2006:

	<b>Systems</b>	<b>Service and Systems Integration</b>	<b>Total</b>	<b>% of Total</b>
<b>For the three months ended June 30, 2007:</b>				
Product	\$ 5,241	\$ 16,630	\$ 21,871	84%
Services	106	3,967	4,073	16%
Total	\$ 5,347	\$ 20,597	\$ 25,944	100%
% of Total	21%	79%	100%	

	<b>Systems</b>	<b>Service and Systems Integration</b>	<b>Total</b>	<b>% of Total</b>
<b>For the three months ended June 30, 2006:</b>				
Product	\$ 282	\$ 14,186	\$ 14,468	78%
Services	1,250	2,838	4,088	22%
Total	\$ 1,532	\$ 17,024	\$ 18,556	100%
% of Total	8%	92%	100%	

<b>Systems</b>	<b>Service and</b>	<b>Total</b>	<b>%</b>
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<b>Increase (Decrease)</b>	<b>Systems Integration</b>			<b>increase (decrease)</b>
Product	\$ 4,959	\$ 2,444	\$ 7,403	51%
Services	(1,144)	1,129	(15)	—%
<b>Total</b>	<b>\$ 3,815</b>	<b>\$ 3,573</b>	<b>\$ 7,388</b>	<b>40%</b>
% increase (decrease)	249%	21%	40%	

As shown above, total revenues increased by approximately \$7.4 million, or 40%, in the quarter ended June 30, 2007 compared to the same period of fiscal year 2006. Revenue in the Systems segment increased in the current year quarter versus the prior year quarter by approximately \$3.8 million, and revenues in the Service and System Integration segment increased by approximately \$3.6 million, resulting in the overall increase of \$7.4 million.

Product revenues increased by approximately \$7.4 million, or 51% in the quarter ended June 30, 2007 compared to the comparable period of fiscal 2006. This change in product revenues was made up of an increase in product revenues in the Systems segment of \$5.0 million versus the prior year quarter and an increase in product revenues in the Service and System Integration segment of \$2.4 million over the prior year quarter.

The increase in the Systems segment product revenues of approximately \$5.0 million for the quarter ended June 30, 2007 versus the comparable period in fiscal 2006 was primarily the result of an increase in sales to Raytheon of approximately \$4.4 million and an increase in sales to KBK of \$500 thousand.

The \$2.4 million increase in the Service and System Integration segment was primarily due to an increase in product sales in our German subsidiary of \$2.7 million, and a \$0.3 million decrease in product sales in our US Systems and Solutions division. Of the \$2.7 million increase in the German subsidiary, approximately \$2.2 million was due to an increase in sales volume, while approximately \$0.5 million was due to the effect of a stronger Euro versus the US dollar, during the quarter ended June 30, 2007 versus the quarter ended June 30, 2006. The increase in sales volume of the German subsidiary was attributable to approximately \$0.1 million in new business and \$2.1 from increased business to existing customers. The \$0.3 million decrease in product sales of the US Systems and Solutions division was the result of lower sales to previously existing customers.

As shown in the table above, there was virtually no change in overall service revenues in the quarter ended June 30, 2007 compared to the comparable quarter of fiscal 2006. However, the Systems segment services revenues decreased by approximately \$1.1 million and service revenues in the Service and Systems Integration segment increased by approximately \$1.1 million.

The decrease in services revenues in the Systems segment in the quarter ended June 30, 2007 quarter versus the prior year quarter was due to a decrease in royalty revenues from Lockheed Martin. The increase in services sales in the Service and System Integration segment was due in large part to the completion of a long-term software development contract for a single customer, which totaled approximately \$0.9 million in the UK division plus additional sales volume increases and the impact of favorable foreign exchange rate fluctuations for both the British pound and the Euro. The software development contract began in fiscal 2005, and was completed and accepted by the customer in June of 2007. The Company accounted for this contract utilizing the completed contract method of accounting, because we were not able to reliably estimate its cost to complete, in accordance with SOP 97-2, ARB No. 45 and SOP 81-1. The Company determined that the criteria for revenue recognition was met during the quarter ended June 30, 2007, and has thus recorded the revenue in the period. In the quarter ended September 30, 2006, the Company recognized a loss of approximately 33 thousand British Pounds (approximately \$60 thousand), which we estimated would be the loss on the contract once completed. The actual loss on the contract, determined upon its completion in the quarter ended June 30, 2007, was approximately 78 thousand British Pounds (approximately \$152 thousand), resulting an additional loss on the contract of approximately \$92 thousand that was recognized in the quarter ended June 30, 2007.

Our sales by geographic area, based on the location to which the products were shipped or services rendered, are as follows:

	For the Three Months Ended (Amounts in thousands)					
	June 30, 2007	%	June 30, 2006	%	\$ Increase/ (Decrease)	% Increase (Decrease)
North America	\$ 12,654	49%	\$ 9,781	53%	\$ 2,873	29%
Europe	12,706	49%	8,649	47%	4,057	47%
Asia	584	2%	126	--%	458	363%
Totals	\$ 25,944	100%	\$ 18,556	100%	\$ 7,388	40%

The increase in North American revenue in the quarter ended June 30, 2007 was due to the sales in the Service and Systems Integration segment. The increases in sales to Europe are also discussed in the narrative above which refers to the increases in sales in the Service and Systems Integration segment that were derived from Germany and the UK.



The increase in Asia sales were the result of increased sales to KBK, from the Systems segment, also referred to above.

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**Cost of Sales**

The following table details our cost of sales by operating segment for the three months ended June 30, 2007 and 2006:

	Systems	Service and Systems Integration	Total	% of Total
<b>For the three months ended June 30, 2007:</b>				
Product	\$ 2,083	\$ 14,753	\$ 16,836	83%
Services	18	3,388	3,406	17%
<b>Total</b>	<b>\$ 2,101</b>	<b>\$ 18,141</b>	<b>\$ 20,242</b>	<b>100%</b>
% of Total	10%	90%	100%	
% of Sales	39%	88%	78%	

**Gross Margins:**

Product	60%	11%	23%
Services	84%	15%	16%
Total	61%	12%	22%

	Systems	Service and Systems Integration	Total	% of Total
<b>For the three months ended June 30, 2006:</b>				
Product	\$ 230	\$ 12,358	\$ 12,588	83%
Services	134	2,437	2,571	17%
<b>Total</b>	<b>\$ 364</b>	<b>\$ 14,795</b>	<b>\$ 15,159</b>	<b>100%</b>
% of Total	2%	98%	100%	
% of Sales	24%	87%	82%	

**Gross Margins:**

Product	18%	13%	13%
Services	89%	14%	37%
Total	76%	13%	18%

	Systems	Service and Systems Integration	Total	% increase (decrease)
<b>Increase (Decrease)</b>				
Product	\$ 1,853	\$ 2,395	\$ 4,248	34%
Services	(116)	951	835	32%
<b>Total</b>	<b>\$ 1,737</b>	<b>\$ 3,346</b>	<b>\$ 5,083</b>	<b>34%</b>
% Increase (decrease)	476%	23%	34%	

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% of Sales	15%	(1)%	(4)%
<b>Gross Margins:</b>			
Product	42%	(2)%	10%
Services	(5)%	1%	(21)%
Total	(15)%	(1)%	4%

Total cost of sales increased by approximately \$5.1 million for the quarter ended June 30, 2007, over the comparable period in fiscal 2006, to \$20.2 million up from \$15.1 million in the prior year period. The increase in cost of sales was due, overall, to the increase in sales volume and revenues, reflecting an overall 4% improvement in gross margin to 22% for the current year quarter versus 18% in the prior year. This improvement in the overall gross margin was due to better product gross margin, which increased by 10% to 23% for the nine months ended June 30, 2007 compared to 13% for the nine months ended June 30, 2006. The increase in total product gross margin was due to an increase in Systems segment product revenues as a percentage of total revenues, which increased to 24% of total product revenues for the quarter ended June 30, 2007 versus 2% of total product revenues for the comparable period of fiscal 2006. Because Systems segment product sales carry much higher gross margins (60%) versus Service and Systems Integration segment product sales (11% to 13%), this proportional increase in Systems segment sales produced higher overall gross margins in the quarter ended June 30, 2007 vs. the comparable period of fiscal 2006.

Offsetting the increase in the product sales gross margin referred to above, the services gross margin decreased by 21%, comparing quarter ended June 30, 2007 versus the comparable prior year quarter. This decrease in services gross margin was due to lower gross margin in the Systems segment which resulted from the lower royalty revenue in the quarter ended June 30, 2007 versus the prior year period, which decreased by \$1.2 million. Royalty revenues carry 100% gross margin because there are no associated costs of sales with royalties.

### ***Engineering and Development Expenses***

The following table details our engineering and development expenses by operating segment for the three months ended June 30, 2007 and 2006:

	For the Three Months Ended					
	June 30, 2007	% of Total	June 30, 2006	% of Total	\$ Increase (Decrease)	% Increase (Decrease)
<b>(Amounts in thousands)</b>						
<b>By Operating Segment:</b>						
Systems	\$ 625	94%	\$ 492	98%	\$ 133	27%
Service and System Integration	40	6%	8	2%	32	413%
<b>Total</b>	<b>\$ 665</b>	<b>100%</b>	<b>\$ 500</b>	<b>100%</b>	<b>\$ 165</b>	<b>33%</b>

Engineering and development expenses increased \$165 thousand, or 33%, in the quarter ended June 30, 2007 compared to the same period of fiscal 2006. The increase relates to an increase in expenses of \$133 thousand in the Systems segment, related primarily to outside consultants and other costs that were incurred in connection with the development of the next generation of MultiComputer products. Engineering and development expense increased by approximately \$32 thousand in the quarter ended June 30, 2007 versus the prior year quarter due to higher labor costs, fringe benefits and training costs.

### ***Selling, General and Administrative***

The following table details our selling, general and administrative expense by operating segment for the three months ended June 30, 2007 and 2006:

	For the Three Months Ended					
	June 30, 2007	% of Total	June 30, 2006	% of Total	\$ Increase	% Increase
<b>(Amounts in thousands)</b>						
<b>By Operating Segment:</b>						
Systems	\$ 1,391	37%	\$ 983	33%	\$ 408	42%
Service and System Integration	2,371	63%	2,000	67%	371	19%
<b>Total</b>	<b>\$ 3,762</b>	<b>100%</b>	<b>\$ 2,983</b>	<b>100%</b>	<b>\$ 779</b>	<b>26%</b>

Total selling, general and administrative (“SG&A”) expenses increased by \$779 thousand, or 26%, in the quarter ended June 30, 2007 compared to the corresponding quarter of fiscal 2006. The Systems segment SG&A expenses increased by approximately \$408 thousand, and SG&A expenses in the Services and System Integration segment increased by approximately \$371 thousand. The Systems division increase was due to increases in commissions and incentive bonuses expenses of \$308, as a result of the higher sales volume and net income in the nine months ended June 30, 2007 versus the comparable prior year period, and an increase of approximately \$81 thousand in salary and benefit increases resulting from headcount and salary rate increases. The \$371 thousand increase in the Service and System Integration segment was due to higher sales commissions and incentive bonus expenses which increased by \$124 thousand as a result of the greater sales volume and profits, increases in salaries and related expenses due to headcount increases of \$20 thousand, temporary labor increases of \$23 thousand, an increase in bad debt expense of \$34 thousand, a restructuring charge for a force reduction in our UK division of \$150 thousand and other costs associated with the increased level of business activity.

**Other Income/Expenses**

The following table details our other income/expenses for the three months ended June 30, 2007 and 2006:

	For the Three Months Ended		\$ Increase (Decrease)
	June 30, 2007	June 30, 2006	
	(Amounts in thousands)		
Interest expense	(\$ 24)	(\$23)	(\$1)
Interest income	117	105	12
Foreign exchange gain (loss)	(2)	(3)	1
Insurance settlement gain	240	—	240
Other income (expense), net	1	(11)	12
Total other income, net	\$ 332	\$ 68	\$ 264

Total other income increased by \$264 thousand for the quarter ended June 30, 2007 compared to the quarter ended June 30, 2006, as shown above. The increase in interest income was due to higher rates earned on cash, cash equivalents and short-term investments. The increase in insurance settlement income resulted from a gain associated with the payment to the Company on a life insurance policy, because the death benefit to the Company exceeded the carrying cash surrender value of the policy.

**Income Taxes****Income Tax Provision**

The company recorded an income tax provisions of \$725 thousand and \$1.8 million for the quarter and nine months ended June 30, 2007, respectively, reflecting an effective income tax rate of 46% for the nine months ended June 30, 2007, compared to an income tax provision of \$26 thousand and \$251 thousand for the quarter and nine months ended June 30, 2006, respectively. Our effective rate was higher than the U.S. statutory rate due to the increased profitability in our European subsidiary in Germany. The tax expense in the quarter and nine months ended June 30, 2007 and 2006 was due to the income generated by our US operations and our subsidiary in Germany, as well as for a deferred tax liability related to goodwill, which is not amortizable for financial statement purposes.

In assessing the realizability of deferred tax assets, we considered our taxable future earnings and the expected timing of the reversal of temporary differences. Accordingly, we have recorded a valuation allowance which reduces the gross deferred tax asset to an amount which we believe will more likely than not be realized. Our inability to project future profitability beyond fiscal year 2007 in the U.S. and cumulative losses incurred in recent years in the U.K. represent sufficient negative evidence under SFAS 109 to record a valuation allowance against certain deferred tax assets. Previously, we had recorded a full valuation allowance against our U.S. deferred tax assets due to our history of cumulative losses and our inability to reasonably project whether or not we would have future taxable income, primarily due to the erratic nature of our revenues in the Systems segment which primarily serves government customers. Late in fiscal 2006, we received a \$17 million order from Raytheon that we have concluded will result in significant taxable income in fiscal 2007. Based on this order, we concluded that it was more likely than not that we would generate sufficient taxable income in the U.S. in 2007 in order to realize an estimated \$1.4 million of deferred tax assets for the year ended September 30, 2006. We recognized this benefit in the fourth quarter of fiscal year 2006 through a reduction of the valuation allowance previously established against our net U.S. deferred tax assets, consisting primarily of inventory temporary differences and net operating loss carryforwards. We maintained a full valuation allowance against our U.K. deferred tax assets as we have experienced continued cumulative losses and do not have any indication that the operation will be profitable in the future to utilize any of our net operating loss carryforwards. To the extent that actual experience deviates from our assumptions, our projections would be affected

and hence our assessment of realizability of our deferred tax asset may change.

### **Liquidity and Capital Resources**

Our primary source of liquidity is our cash and cash equivalents and short-term investments, which increased by approximately \$3.2 million to approximately \$14.0 million as of June 30, 2007, as compared to approximately \$10.9 million as of September 30, 2006. In the nine months ended June 30, 2007, we generated approximately \$2.7 million of cash from operating activities compared to \$577 thousand in the same period of the prior fiscal year. The significant change in net cash provided from operating activities was primarily due to net income of \$2.1 million in the first nine months of fiscal 2007 versus net income of \$443 thousand for the same period of fiscal 2006. Working capital items which were significant uses of cash in the nine months ended June 30, 2007 were an increase in accounts receivable of \$1.8 million, related primarily to billings in our Services and Systems Integration segment, and an increase in inventory of approximately \$2.0 million, related primarily to the build up of inventory for the Raytheon contract in the MultiComputer segment. Working capital items that were significant sources of cash consisted of an increase in accounts payable and accrued expenses of approximately \$1.6 million, and increases in accrued and deferred taxes of approximately \$1.7 million. Additional operating sources of cash were depreciation and amortization of approximately \$0.5 million and stock option expense under SFAS 123R of approximately \$0.3 million.

In investing activities, \$0.4 million was used to purchase property, plant and equipment for the nine months ended June 30, 2007 versus \$0.4 million in the comparable period of fiscal 2006. Additionally, we used \$3.8 million to purchase short-term investments and generated \$2.6 million in cash from sales of short-term investments during the nine month period ended June 30, 2007 versus purchases and sales of short-term investments of \$1.9 million and \$2.1, respectively for the nine months ended June 30, 2006.

We generated approximately \$0.6 million from financing activities during the nine months ended June 30, 2007 compared to \$59 thousand during the prior comparable period. The cash provided in the first nine months of fiscal 2007 consisted of proceeds from the exercise of employee stock options totaling approximately \$0.4 and stock issued pursuant to the Company's employee stock purchase plan of approximately \$0.2 million.

Effects of foreign currency exchange rate changes provided approximately \$0.4 million in cash for the nine months ended June 30, 2007 versus a reduction in cash of approximately \$0.4 million for the prior fiscal year six month period ended June 30, 2006.

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

Based on our current plans and business conditions management believes that our available cash and investments and cash generated from operations will be sufficient to provide for our working capital and capital expenditure requirements for the foreseeable future.

### **Inflation and Changing Prices**

Management does not believe that inflation and changing prices had significant impact on sales, revenues or income from continued operations during the three and nine month periods ended June 30, 2007 and 2006. There is no assurance that our business will not be materially and adversely affected by inflation and changing prices in the future.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

There was no material change in our exposure to market risk during the three and nine months ended June 30, 2007.



#### **Item 4. Controls and Procedures**

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of June 30, 2007. Our chief executive officer, our chief financial officer, and other members of our senior management team supervised and participated in this evaluation. Based on the evaluation, because we have not completely remediated previously identified internal control weakness, which are detailed below, we concluded that we did not maintain effective controls over the preparation and disclosure of our consolidated financial statements as of that date. These control deficiencies led to (1) the delay in the filing of our 2006 Annual Report on Form 10-K, and (2) the delay in the filing of our Form 10-Q for the Quarter Ended December 31, 2006, as detailed in our 2006 Form 10-K for reasons described below. It should be noted that management is in the process of remediating these internal control weaknesses, and anticipates completing such remediation by the end of its fiscal year ending September 30, 2007.

In our 2004 and 2005 Annual Reports on Forms 10-K, we disclosed that we did not have adequate staffing and experience in our finance group to control the increased transaction activity, address non-routine accounting matters, and manage the financial reporting complexities resulting from the acquisition of Technisource and that this matter was considered a material weakness in internal control.

In 2005 and during 2006, we took steps to address this weakness. During the year end reporting of the 2006 Form 10-K, the following issues were noted : 1) the Modcomp Systems and Solutions Division experienced difficulties at the end of our fourth quarter with respect to revenue recognition, accounts payable and the related period end cutoff, and 2) in the corporate financial reporting process, the calculation of the tax provision and related deferred assets and liabilities at the end of our fourth quarter also contributed to the delay in issuing the financial statements.

Accordingly, management determined that these issues are indicative of control deficiencies that constitute a material weakness in our internal control over financial reporting. A material weakness is a control deficiency or a combination of control deficiencies that results in more than a remote likelihood that a material misstatement of the annual or interim consolidated financial statements will not be prevented or detected

Management has taken or is taking the following actions to address the weaknesses; (1) the Company added a Vice President of Finance/Chief Accounting Officer, which will enhance our management group experience and capabilities in the areas of technical accounting and internal controls over financial reporting. These enhanced capabilities extend to both corporate accounting functions, and increased oversight of the Modcomp Systems and Solutions Division. Management has determined that these enhancements, combined with additional remediation steps detailed herein, will be sufficient to remediate the internal control deficiencies experienced in the Modcomp Systems and Solutions Division, thereby alleviating the need to add a chief financial officer for the Division, which had been previously contemplated, (2) establishing strong internal controls over the procurement and fulfillment cycles at Modcomp Systems and Solutions division during 2007 and (3) the Company has acquired certain information technology solutions and/or outsourced certain functions to increase the accuracy, efficiency and timeliness of the financial reporting process including the calculation of the tax provision. The implementation of these improvements is expected to be completed in fiscal 2007. The Audit Committee has reviewed all of the matters discussed above and have been actively assessing the plan to improve our controls and procedures. The Committee will continue to monitor the situation and expects to take such further actions as are needed.

The effectiveness of a system of disclosure controls and procedures is subject to various inherent limitations, including cost limitations, judgments used in decision making, assumptions about the likelihood of future events, the soundness of internal controls, and fraud. Due to such inherent limitations, there can be no assurance that any system of disclosure controls and procedures will be successful in preventing all errors or fraud, or in making all material information known in a timely manner to appropriate levels of management.

During the first nine months of fiscal 2007, the Company has added a Vice President of Finance/Chief Accounting Officer to its corporate accounting staff. As stated above, management believes that the addition of this newly created position has added to the Company's capabilities in the areas of technical accounting and internal controls over financial reporting. Management believes that the addition of this position is reasonably likely to materially improve the Company's internal control over financial reporting. There were no other changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting, however, management continues to work towards implementing the actions referred to above to address the identified control weaknesses.

**PART II. OTHER INFORMATION**

**Item 6. Exhibits**

**Number Description**

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|------|--|
| 3.1  | Articles of Organization and amendments thereto (incorporated by reference to Exhibit 3.1 to our Form 10-K for the year ended August 31, 1990) |
| 3.2  | By-Laws, as amended (incorporated by reference to Exhibit 3.2 to our Form 10-K for the year ended August 25, 1995)                             |
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                 |

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CSP INC.

Date: August 8, 2007

By:

/s/ ALEXANDER R. LUPINETTI  
Alexander R. Lupinetti  
Chief Executive Officer,  
President and Chairman

Date: August 8, 2007

By:

/s/ GARY W. LEVINE  
Gary W. Levine  
Chief Financial Officer

**Exhibit Index**

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