CSP INC /MA/
Form 10-Q
August 14, 2008

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, 2008.

¨ 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	**04-2441294**
(State of incorporation)	**(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 þ No ¨.

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer (Do not check if a smaller reporting company) ¨ Smaller reporting company þ

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

As of July 31, 2008, the registrant had 3,757,176 shares of common stock issued and outstanding.

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

	June 30, 2008	September 30, 2007
ASSETS	(Unaudited)	
Current assets:		
Cash and cash equivalents	$ 15,787	$ 13,687
Short-term investments	450	7,690
Accounts receivable, net of allowances of $106 and $133	10,616	10,678
Inventories	6,533	6,072
Refundable income taxes	1,216	27
Deferred income taxes	229	229
Other current assets	1,537	1,587
Total current assets	36,368	39,970
Property, equipment and improvements, net	1,034	1,044
Other assets:		
Long term investments	4,800	–
Goodwill	2,779	2,779
Deferred income taxes	280	254
Cash surrender value of life insurance	2,248	2,045
Other assets	296	349
Total other assets	10,403	5,427
Total assets	$ 47,805	$ 46,441
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 9,819	$ 9,073
Deferred revenue	2,449	3,461
Pension and retirement plans	472	495
Income taxes payable	1,055	552
Deferred income taxes	280	279
Total current liabilities	14,075	13,860
Pension and retirement plans	7,288	6,859
Deferred income taxes	449	388
Other non current liabilities	260	–
Total liabilities	22,072	21,107
Commitments and contingencies		
Shareholders' equity:		
Common stock, $.01 par; 7,500 shares authorized, 3,764 and 3,812 shares issued and outstanding , respectively	38	39
Additional paid-in capital	11,522	11,707
Retained earnings	15,714	15,236
Accumulated other comprehensive loss	(1,541)	(1,648)
Total shareholders' equity	25,733	25,334
Total liabilities and shareholders' equity	$ 47,805	$ 46,441

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 June 30, 2008	For the three months ended June 30, 2007	For the nine months ended June 30, 2008	For the nine months ended June 30, 2007
Sales:				
Product	$ 14,730	$ 21,871	$ 46,254	$ 54,929
Services	4,425	4,073	12,455	10,964
Total sales	19,155	25,944	58,709	65,893
Cost of sales:				
Product	12,339	16,837	38,246	42,217
Services	3,385	3,405	9,520	8,131
Total cost of sales	15,724	20,242	47,766	50,348
Gross profit	3,431	5,702	10,943	15,545
Operating expenses:				
Engineering and development	471	665	1,650	1,838
Selling, general and administrative	3,113	3,762	9,875	10,317
Total operating expenses	3,584	4,427	11,525	12,155
Operating income (loss)	(153)	1,275	(582)	3,390
Other income (expense):				
Foreign exchange gain (loss)	5	(1)	28	(1)
Other income, net	118	333	436	503
Total other income, net	123	332	464	502
Income (loss) before income taxes	(30)	1,607	(118)	3,892
Income tax expense (benefit)	(22)	725	(40)	1,777
Net income (loss)	$ (8)	$ 882	$ (78)	$ 2,115
Net income (loss) per share – basic	$ -	$ 0.23	$ (0.02)	$ 0.56
Weighted average shares outstanding – basic	3,778	3,810	3,790	3,761
Net income (loss) per share – diluted	$ -	$ 0.22	$ (0.02)	$ 0.54
Weighted average shares outstanding – diluted	3,778	3,967	3,790	3,926

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, 2008
(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, 2007	3,812	$ 39	$ 11,707	$ 15,236	$ (1,648)	$ 25,334	
Comprehensive income:							
Net loss	—	—	—	(78)	—	(78)	$ (78)
Other comprehensive income							
Effect of foreign currency translation	—	—	—	—	45	45	45
Minimum pension liability	—	—	—	—	62	62	62
Total Comprehensive income	—	—	—	—	—	—	$ 29
Exercise of stock options	27	—	112	—	—	112	
Stock-based compensation			230	—	—	230	
Issuance of shares under employee stock purchase plan	29	—	170	—	—	170	
Purchase of treasury stock	(104)	(1)	(697)	—	—	(698)	
Cumulative impact from adoption of FIN 48	—	—	—	556	—	556	
Balance as of June 30, 2008	3,764	$ 38	$ 11,522	$ 15,714	$ (1,541)	$ 25,733	

See accompanying notes to unaudited consolidated financial statements

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

	For the nine months ended June 30, 2008	June 30, 2007
Cash flows from operating activities:		
Net income (loss)	$ (78)	$ 2,115
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	428	486
Insurance settlement gain	—	(240)
Loss on disposal of fixed assets, net	4	1
Non-cash changes in accounts receivable	1	96
Non-cash compensation expense related to stock options	230	257
Deferred income taxes	47	994
Increase in cash surrender value of life insurance	(58)	—
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable	577	(1,823)
Increase in inventories	(453)	(1,945)
Increase in refundable income taxes	(1,181)	(60)
Decrease in other current assets	140	145
Decrease in other assets	54	54
Increase in accounts payable and accrued expenses	411	1,254
(Decrease) increase in deferred revenue	(1,132)	375
Increase in pension and retirement plans	134	247
Increase in income taxes payable	1,272	730
Net cash provided by operating activities	396	2,686
Cash flows from investing activities:		
Purchases of held-to-maturity securities	(16,550)	(3,786)
Maturities of held-to-maturity securities	18,990	2,589
Premiums paid on officer life insurance	(144)	—
Change in cash surrender value of officer life insurance	—	(48)
Purchases of property, equipment and improvements	(396)	(406)
Net cash provided by (used in) investing activities	1,900	(1,651)
Cash flows from financing activities:		
Proceeds from stock issued from the exercise of options	112	363
Proceeds from issuance of stock under employee stock purchase plan	170	193
(Purchase) issuance of common stock	(698)	7
Net cash provided by (used in) financing activities	(416)	563
Effects of exchange rate changes on cash	220	396
Net increase in cash and cash equivalents	2,100	1,994
Cash and cash equivalents, beginning of period	13,687	8,683
Cash and cash equivalents, end of period	$ 15,787	$ 10,677
Supplementary Cash flow information:		
Cash paid for income taxes	$ 214	$ 104
Cash paid for interest	$ 89	$ 97

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, 2008 AND 2007

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, 2007.

2. 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.

3. Earnings Per Share of Common Stock

Basic net income per common share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted net income 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 by the assumed weighted average number of common shares outstanding.

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

	For the Three Months Ended June 30, 2008	For the Three Months Ended June 30, 2007	For the Nine Months Ended June 30, 2008	For the Nine Months Ended June 30, 2007
	(Amounts in thousands, except per share data)			
Net income (loss)	$ (8)	$ 882	$ (78)	$ 2,115
	3,778	3,810	3,790	3,761

Weighted average number of shares outstanding – basic								
Incremental shares from the assumed exercise of stock options		—		157		—		165
Weighted average number of shares outstanding – diluted		3,778		3,967		3,790		3,926
Net income (loss) per share – basic	$	—	$	0. 23	$	(0.02)	$	0.56
Net income (loss) per share - diluted	$	—	$	0. 22	$	(0.02)	$	0.54

For the three and nine months ended June 30, 2008, options of 323,000 and 249,000, respectively, were excluded from the diluted net income per share calculation because their impact would have been anti-dilutive. For the three and nine months ended June 30, 2007, options of 325,000 and 339,000, respectively, were excluded from the diluted net income per share calculation because their impact would have been anti-dilutive.

4. Inventories

Inventories consist of the following:

	June 30, 2008		September 30, 2007	
	(Amounts in thousands)			
Raw materials	$	1,603	$	1,716
Work-in-progress		366		351
Finished goods		4,564		4,005
Total	$	6,533	$	6,072

5. Long-Term Investments

As of June 30, 2008, we held investments totaling $5.25 million (par value) which consist of long-term debt instruments with variable interest rates that periodically reset through an auction process ("auction rate securities"). All of our auction rate securities were originally acquired as held to maturity investments, during the six months ended March 31, 2008 and have final maturity dates ranging from 2027 to 2057.

Recent auctions for our auction rate securities have failed. An auction failure, which is not a default in the underlying debt instrument, occurs when there are more sellers than buyers at a scheduled interest rate auction date and parties desiring to sell their securities are unable to do so. When an auction fails, the interest rate is adjusted according to the provisions of the associated security agreement, which generally results in an interest rate that is higher than the interest rate the issuer pays in connection with successful auctions. Because of these failed auctions, we reclassified our entire $5.25 million investment portfolio to available-for-sale securities during the six months ended March 31, 2008. Accordingly, these investments are classified as available-for-sales as of June 30, 2008.

Our investment in auction rate securities as of June 30, 2008 was diversified across six separate issues and each issue maintains scheduled interest rate auctions in either 7-day or 28-day intervals. All of our auction rate securities are currently rated Aaa by Moody's, AAA by Standard & Poor's and/or AAA by Fitch, which are the highest ratings issued by each respective rating agency. An aggregate $4.8 million (par value) of our auction rate securities which are classified as long term investments were issued by state agencies and are supported by student loans, for which repayment is substantially guaranteed by the U.S. government under the Federal Family Education Loan Program ("FFELP") or MBIA Insurance Co. The remaining $450 thousand is a closed end, preferred auction security secured by the assets of the closed end funds. These funds are legally required to maintain assets of 200% of the face value of the preferred auction securities. The $450 thousand will be redeemed in the near future, although no specific date has been set by the issuer.

Auction failures and the resulting lack of liquidity are affecting the entire auction rate securities market and we are currently unable to determine whether these conditions will be temporary. Some issuers have recently refinanced their auction rate securities and other issuers are in the process of doing so. We are currently unable to determine whether other issuers of our auction rate securities will attempt and/or be able to refinance. Several of the financial institutions that conduct auctions and broker auction rate securities have indicated that they plan to develop secondary markets for auction rate securities, but we are currently unable to determine whether such plans will succeed or if alternate markets that provide for orderly purchases and sales of auction rate securities will otherwise develop. Although we acquired our auction rate securities with the intention of selling them in the near term, due to the aforementioned uncertainties, all of our auction rate securities not redeemed or not intended to be redeemed, have been classified as long-term investments. Assets so classified totaled $4.8 million as of June 30, 2008. The $450 thousand closed end, preferred auction rate security that is expected to be redeemed within the next twelve months was classified as short term investments and are included in current assets as of June 30, 2008.

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6. Comprehensive Income

The components of comprehensive income are as follows:

	For the Three Months Ended June 30, 2008	For the Three Months Ended June 30, 2007	For the Nine Months Ended June 30, 2008	For the Nine Months Ended June 30, 2007
	(Amounts in thousands, except per share data)			
Net income (loss)	$ (8)	$ 882	$ (78)	$ 2,115
Effect of foreign currency translation	(11)	62	45	290
Minimum pension liability	10	–	62	–
Comprehensive income (loss)	$ (9)	$ 944	$ 29	$ 2,405

The components of Accumulated Other Comprehensive Loss are as follows:

	June 30, 2008	September 30, 2007
	(Amounts in thousands)	
Cumulative effect of foreign currency translation	$ (662)	$ (707)
Additional minimum pension liability	(879)	(941)
Accumulated Comprehensive loss	$ (1,541)	$ (1,648)

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.

Our pension plan in the United Kingdom is the only plan with plan assets. 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					
	2008			2007		
	Foreign	U.S.	Total	Foreign	U.S.	Total
	(Amounts in thousands)					
Pension:						
Service cost	$ 21	$ 2	$ 23	$ 30	$ 2	$ 32
Interest cost	183	35	218	166	35	201
	(125)	—	(125)	(122)	—	(122)

Expected return on plan assets												
Amortization of:												
Prior service costs		8		5		13		11		12		23
Net transition asset		(2)		—		(2)		(1)		—		(1)
Net periodic benefit cost	$	85	$	42	$	127	$	84	$	49	$	133

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	For the Three Months Ended June 30					
	2008			2007		
	Foreign	U.S.	Total	Foreign	U.S.	Total
	(Amounts in thousands)					
Post Retirement:						
Service cost	$ —	$ 16	$ 16	$ —	$ 14	$ 14
Interest cost	—	13	13	—	10	10
Amortization of:						
Prior service costs	—	—	—	—	7	7
Net periodic benefit cost	$ —	$ 29	$ 29	$ —	$ 31	$ 31

	For the Nine Months Ended June 30					
	2008			2007		
	Foreign	U.S.	Total	Foreign	U.S.	Total
	(Amounts in thousands)					
Pension:						
Service cost	$ 64	$ 6	$ 70	$ 89	$ 5	$ 94
Interest cost	553	104	657	495	107	602
Expected return on plan assets	(375)	-	(375)	(362)	—	(362)
Amortization of:						
Prior service costs	25	14	39	33	35	68
Net transition asset	(5)	-	(5)	(4)	—	(4)
Net periodic benefit cost	$ 262	$ 124	$ 386	$ 251	$ 147	$ 398
Post Retirement:						
Service cost	$ —	$ 48	$ 48	$ —	$ 42	$ 42
Interest cost	—	39	39	—	30	30
Amortization of:						
Prior service costs	—	1	1	—	22	22
Net periodic benefit cost	$ —	$ 88	$ 88	$ —	$ 94	$ 94

8. Income Taxes

On October 1, 2007, we adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"), which clarifies the accounting for uncertainty in income tax positions. This interpretation requires us to recognize in the consolidated financial statements only those tax positions determined to be more-likely-than-not of being sustained upon examination, based on the technical merits of the positions as of the reporting date. If a tax position is not considered more-likely-than-not to be sustained based solely on its technical merits, no benefits of the position are recognized. This is a different standard for recognition than was previously required. The more-likely-than-not threshold must continue to be met in each reporting period to support continued recognition of a benefit. At adoption of FIN 48, companies must adjust their financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. Any necessary adjustment is recorded directly to opening retained earnings in the period of adoption. The cumulative effect of adoption of FIN 48, as of October 1, 2007, resulted in an increase to retained earnings of $556,000.

As of October 1, 2007, the total amount of unrecognized tax benefits was $260,000, all of which would affect our effective tax rate if recognized. We recognize interest and potential penalties accrued related to unrecognized tax benefits in our provision for income taxes. There were no accrued interest and/or penalties in our tax provision for the quarter ended December 31, 2007, nor were there any accrued penalties and interest included in our liabilities for uncertain tax positions as of October 1, 2007 and June 30, 2008.

We file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. We have not been notified of intent to audit, nor are we currently undergoing an income tax audit in any jurisdiction. With few exceptions, our returns are no longer subject to U.S. federal, state, or non-U.S. income tax examinations for the years before 2004.

9. Segment Information

The following table presents certain operating segment information.

	Systems	Service and System Integration	Consolidated Total
Three Months Ended June 30, 2008			
Sales:			
Product	$ 1,193	$ 13,537	$ 14,730
Service	102	4,323	4,425
Total sales	$ 1,295	$ 17,860	$ 19,155
Operating Income (loss)	$ (615)	$ 462	$ (153)
Total assets	$ 16,621	$ 31,184	$ 47,805
Capital expenditures	$ 17	$ 109	$ 126
Depreciation	$ 55	$ 89	$ 144
Three Months Ended June 30, 2007			
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
Nine Months Ended June 30, 2008			
Sales:			
Product	$ 3,248	$ 43,006	$ 46,254
Service	231	12,224	12,455
Total sales	$ 3,479	$ 55,230	$ 58,709
Operating Income (loss)	$ (2,826)	$ 2,244	$ (582)
Total assets	$ 16,621	$ 31,184	$ 47,805
Capital expenditures	$ 101	$ 295	$ 396
Depreciation	$ 168	$ 260	$ 428
Nine Months Ended June 30, 2007			
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

Operating income (loss) 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 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, 2008 and 2007.

	For the Three Months Ended				For the Nine Months Ended			
	June 30, 2008		June 30, 2007		June 30, 2008		June 30, 2007	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
	(Amounts in millions)							
Raytheon Corporation	$ -*	-%	$ 4.4	17%	$ -*	-%	$ 9.5	14%
Atos Origin GmbH	$ 2.5	13%	$ 3.5	14%	$ 7.0	12%	$ 8.6	13%
Kabel Deutschland	$ 0.3	2%	$ 4.4	17%	$ 4.4	7%	$ 6.9	10%

* Less than $100 thousand

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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, 2007 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, 2008 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 System Integration - the Service and System 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 decreased by approximately $7.2 million, or 11%, to $58.7 million for the nine months ended June 30, 2008 versus $65.9 million for the nine months ended June 30, 2007.

- The operating loss for the nine months ended June 30, 2008 was $582 thousand versus operating income of $3.4 million for the nine months ended June 30, 2007, for a decrease of approximately $4.0 million, or 117%.

- The net loss for the nine months ended June 30, 2008 was $78 thousand versus net income of $2.1 million for the nine months ended June 30, 2007, for a decrease of approximately $2.2 million, or 104%.

- Net cash provided by operating activities was approximately $396 thousand for the nine months ended June 30, 2008 compared to net cash provided by operating activities of $2.7 million for the comparable period of 2007.

The following table details our results of operations in dollars and as a percentage of sales for the nine months ended June 30, 2008 and 2007:

	June 30, 2008	% of sales	June 30, 2007	% of sales
Sales	$ 58,709	100%	$ 65,893	100%
Costs and expenses:				
Cost of sales	47,766	81%	50,348	76%
Engineering and development	1,650	3%	1,838	3%
Selling, general and administrative	9,875	17%	10,317	16%
Total costs and expenses	59,291	101%	62,503	95%
Operating income (loss)	(582)	(1)%	3,390	5%
Other income	464	1%	502	1%
Income (loss) before income taxes	(118)	-%	3,892	6%
Provision for income taxes	(40)	-%	1,777	3%
Net income (loss)	$ (78)	-%	$ 2,115	3%

Sales

The following table details our sales by operating segment for the nine months ended June 30, 2008 and 2007:

	Systems	Service and System Integration	Total	% of Total
For the nine months ended June 30, 2008:				
Product	$ 3,248	$ 43,006	$ 46,254	79%
Services	231	12,224	12,455	21%
Total	$ 3,479	$ 55,230	$ 58,709	100%
% of Total	6%	94%	100%	

	Systems	Service and System Integration	Total	% of Total
For the nine months ended June 30, 2007:				
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 System Integration	Total	% increase (decrease)
Increase (Decrease)				
Product	$ (9,303)	$ 628	$ (8,675)	(16)%
Services	(565)	2,056	1,491	14%
Total	$ (9,868)	$ 2,684	$ (7,184)	(11)%
% increase (decrease)	(74)%	5%	(11)%	

Total revenues decreased by approximately $7.2 million or 11%, in the first nine months of fiscal year 2008 compared to the same period of fiscal year 2007. Systems segment revenue decreased by approximately $9.9 million while Service and System Integration segment revenues increased by approximately $2.7 million**.**

Product revenues decreased by approximately $8.7 million, or 16% in the first nine months of fiscal year 2008 compared to the first nine months of fiscal 2007. Systems segment product revenue decreased by approximately $9.3 million, while Service and System Integration segment product revenue increased by approximately $628 thousand.

The $9.3 million decrease in the Systems segment product revenue was primarily due to the decrease in sales to Raytheon of $9.4 million over the prior year period. Prior year sales to Raytheon were in connection with an order for sixteen systems that were shipped over the course of fiscal 2007. Sales to Raytheon for the nine months ended June 30, 2008 were approximately $78,000 consisting of spare parts and repairs. In addition, sales to Kyokuto Boeki Kaisha (“KBK”) decreased by approximately $664 thousand for the nine months ended June 30, 2008 versus the prior year comparable period, while product sales to Lockheed Martin and General Dynamics increased by $605 thousand and $189 thousand, respectively.

The $628 thousand increase in the Service and System Integration segment product revenue was due to a $2.9 million increase in product sales from the segment’s US operations offset by a $2.3 million decrease in shipments in the segment’s German operations. In the US operation, the increase was driven primarily by increased new-customer sales versus prior year new-customer sales, which accounted for approximately $3.1 million of the increase. This increase was offset by total net decreases to all other customers totaling approximately $200 thousand. The German division decrease was due to lower sales volume of $4.4 million offset by an increase due to the stronger Euro versus the US dollar during the nine months ended June 30, 2008 versus the comparable period of fiscal 2007, which totaled approximately $2.1 million. The decrease in sales volume was due to lower sales to large customers, Kabel Deutschland, Atos Origin and Bytemobile. Sales to these customers decreased by $3.0 million, $2.6 million and $700 thousand, respectively. These decreases were due to large project wins in the prior year, which did not recur in the current year due to the lack of significant IT investment and projects in fiscal year 2008. Offsetting these decreases, were sales to two new customers, UnityMedia which totaled approximately $2.0 million and Bayer which totaled approximately $700 thousand. The remaining $800 thousand decrease was from decreases to all other customers combined.

Service revenues increased by approximately $1.5 million, or 14% for the first nine months of fiscal year 2008 compared to the first nine months of fiscal 2007. Service and System Integration segment service revenues increased by approximately $2.1 million, while service revenue in the Systems segment decreased by approximately $565 thousand. In the Service and System Integration segment, service revenues from the German division increased by approximately $2.6 million, approximately $1.0 million of which was the result of the foreign currency fluctuation impact and approximately $1.6 million was due to increased sales volume. The increase in sales volume was due to higher levels of professional services for consulting work in archiving and identity and access management. Offsetting the increased services revenues in Germany, service revenue in the UK subsidiary of the Service and System Integration segment decreased by approximately $663 thousand, resulting from the non-recurrence of a large development project to a single customer, NCH, delivered in the third quarter of fiscal 2007. Service revenues in the Systems segment decreased primarily as a result of the absence of any royalty revenue from Lockheed Martin which totaled approximately $522 thousand for the nine months 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 Nine Months Ended
(Amounts in thousands)

	June 30, 2008	**%**	**June 30, 2007**	**%**	**$ Increase/** (Decrease)	**% Increase/** (Decrease)
North America	$ 27,246	46%	$ 34,460	52%	$ (7,214)	(21)%
Europe	28,210	48%	28,666	44%	$ (456)	(2)%
Asia Pacific	3,253	6%	2,767	4%	$ 486	18%
Totals	$ 58,709	100%	$ 65,893	100%	$ (7,184)	

North American revenue, in the first nine months of fiscal 2008, decreased versus the comparable period of fiscal 2007, largely due to the decrease in sales in the Systems segment related to the decrease in sales to Raytheon of $9.4 million offset by the increases in sales to General Dynamics of approximately $189 thousand, referred to above combined with the increases in product sales in the US operation of Service and System Integration segment to domestic customers, which totaled $1.8 million.

The decrease in revenues in Europe for the nine months ended June 30, 2008 versus the comparable period of fiscal 2007 was due primarily to the reasons set forth above with respect to sales volumes and foreign exchange rate fluctuations in the German operations of the Service and System Integration segment. To summarize the data presented above, approximately $2.8 million of the decrease was related to decreased sales volume from the German division and approximately $700 thousand was due to lower sales volume in from the UK division. Offsetting these decreases, the foreign exchange rate change of a stronger Euro versus the US dollar accounted for an increase in Europe sales of $3.1 million. The increase in sales in Asia Pacific was due to sales from the US division of the Service and System Integration segment of approximately $1.1 million offset by lower sales in the Systems segment to KBK in the nine month period ended June 30, 2008 versus the nine months ended June 30, 2007 of approximately $664 thousand.

Cost of Sales and Gross Margins

The following table details our cost of sales by operating segment for the nine months ended June 30, 2008 and 2007:

	Systems	Service and Systems Integration	Total	% of Total
For the nine months ended June 30, 2008:				
Product	$ 1,956	$ 36,290	$ 38,246	80%
Services	91	9,429	9,520	20%
Total	$ 2,047	$ 45,719	$ 47,766	100%
% of Total	4%	96%	100%	
% of Sales	59%	83%	81%	
Gross Margins:				
Product	40%	16%	17%	
Services	61%	23%	24%	
Total	41%	17%	19%	

	Systems	Service and Systems Integration	Total	% of Total
For the nine months ended June 30, 2007:				
Product	$ 4,965	$ 37,252	$ 42,217	84%
Services	190	7,941	8,131	16%
Total	$ 5,155	$ 45,193	$ 50,348	100%
% of Total	10%	90%	100%	
% of Sales	39%	86%	76%	
Gross Margins:				
Product	60%	12%	23%	
Services	76%	22%	26%	
Total	61%	14%	24%	

	Systems	Service and Systems Integration	Total	% increase (decrease)
Increase (decrease)				
Product	$ (3,009)	$ (962)	$ (3,971)	(9)%
Services	(99)	1,488	1,389	17%
Total	$ (3,108)	$ 526	$ (2,582)	(5)%
% Increase	(60)%	1%	(5)%	
% of Sales	20%	(3)%	5%	
Gross Margins:				
Product	(20)%	4%	(6)%	
Services	(15)%	1%	(2)%	
Total	(20)%	3%	(5)%	

Total cost of sales decreased by approximately $2.6 million for the nine months ended June 30, 2008, over the comparable period in fiscal 2007, to $47.8 million, down from $50.3 million in the prior year period. The decrease in cost of sales was due, overall, to the decrease in sales, but reflected an overall 5% decline in gross margin to 19% for the current year nine month period versus 24% in the prior year nine month period. This decrease in the overall gross margin was due to (i) the lower level of Systems segment sales as discussed above, coupled with the significant decline in the gross margins in the Systems segment which decreased from 61% gross margin for the nine months ended June 30, 2007 to 41% for the nine months ended June 30, 2008, a decline of 20% in the gross margin. The decline was due, in large part to low production levels associated with the low level of sales in the segment, resulting in a higher volume of unabsorbed overhead charged to cost of sales, and also to prior year Systems segment revenues having included approximately $522 thousand in royalty revenue, which carry no cost of sales; versus no royalty revenue in the nine months ended June 30, 2008.

The gross profit margin for the Service and System Integration segment increased by 3% gross margin from 14% for the prior year nine-month period to 17% for the nine month period ended June 30, 2008. This increase was due primarily to a greater number of smaller orders, which generally carry higher gross margin than large, high volume orders, coupled with greater sales volume of products that carry higher margins than those sold in the prior year nine month period. In addition, a greater percentage of Service and System Integration segment sales were from services (22%) in the Fiscal 2008 nine-month period versus the prior year nine-month period (19%). Gross margin on service revenues ranged from between 22% to 23% versus product gross margins which ranged from between 12% to 16%, in the Service and System Integration segment.

Engineering and Development Expenses

The following table details our engineering and development expenses by operating segment for the nine months ended June 30, 2008 and 2007:

	For the Nine Months Ended					
	June 30, 2008	% of Total	June 30, 2007	% of Total	$ (Decrease)	% (Decrease)
	(Amounts in thousands)					
By Operating Segment:						
Systems	$ 1,650	100%	$ 1,767	96%	$ (117)	(7)%
Service and System Integration	-	-%	71	4%	(71)	(100)%
Total	$ 1,650	100%	$ 1,838	100%	$ (188)	(10)%

Engineering and development expenses decreased by $188 thousand, or approximately 10%, in the first nine months of fiscal 2008 compared to the first nine months of fiscal 2007, due primarily to lower consulting costs in connection with reduced R&D activities in the Systems segment and lower costs in the Service and System Integration segment due to reduction in headcount in the UK division.

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, 2008 and 2007:

	For the Nine Months Ended					
	June 30, 2008	% of Total	June 30, 2007	% of Total	$ Increase/ (Decrease)	% Increase/ (Decrease)
	(Amounts in thousands)					
By Operating Segment:						
Systems	$ 2,608	26%	$ 3,788	37%	$ (1,180)	(31)%
Service and System Integration	7,267	74%	6,529	63%	$ 738	11%
Total	$ 9,875	100%	$ 10,317	100%	$ (442)	(4)%

Total selling, general and administrative ("SG&A") expenses decreased by approximately $442 thousand, or 4%, for the first nine months of 2008 compared to the corresponding period of fiscal 2007. The decrease in Systems segment SG&A as shown above, resulted from lower commission and bonus expense of approximately $505 thousand, and lower audit fees of approximately $614 thousand. The increase in SG&A expenses in the Service and System Integration segment as shown in the table above resulted from higher commission expense of approximately $385 thousand, due primarily to the higher sales volume in the US operations. SG&A expenses were higher in the German division of the Service and System integration segment due to higher sales and marketing headcount, which accounted for $259 thousand of the increase and the foreign currency fluctuation impact related to the higher Euro vs. the US dollar, which accounted for $260 thousand of the increase in expense. SG&A expenses in the UK division decreased by approximately $218 thousand due a reduction in headcount versus the prior year

Other Income/Expenses

The following table details our other income/expenses for the nine months ended June 30, 2008 and 2007:

	For the Nine Months Ended June 30, 2008	June 30, 2007	$ Increase (Decrease)
	(Amounts in thousands)		
Interest expense	$ (68)	$ (72)	$ 4
Interest income	519	357	162
Foreign exchange gain (loss)	28	(1)	29
Insurance settlement gain ent gain	-	240	(240)
Other expense, net	(15)	(22)	7
Total other income, net	$ 464	$ 502	$ (38)

Total other income decreased by $38 thousand for the first nine months of fiscal 2008 compared to the first nine months of fiscal 2007, as shown above. The increase in interest income was due to larger holdings of investments and interest bearing deposits in the current year period. The increase in interest income was offset by a decrease due to the non-recurrence of the insurance settlement gain that was realized in the prior year nine-month period. This gain resulted from the death benefit received by the Company exceeding the carrying cash surrender value on the policy.

Overview of the quarter ended June 30, 2008 Results of Operations

Highlights include:

- Revenue decreased by approximately $6.8 million, or 26%, to $19.2 million for the quarter ended June 30, 2008 versus $25.9 million for the quarter ended June 30, 2007.

- Operating income decreased by approximately $1.4 million, or 112%, to an operating loss of $153 thousand for the quarter ended June 30, 2008 versus operating income of $1.3 million for the quarter ended June 30, 2007.

- Net income decreased by $890 thousand, or 101%, to a net loss of $8 thousand for the quarter ended June 30, 2008 versus net income of $882 thousand for the quarter ended June 30, 2007.

The following table details our results of operations in dollars and as a percentage of sales for the quarters ended June 30, 2008 and 2007:

	June 30, 2008	% of sales	June 30, 2007	% of sales
Sales	$ 19,155	100%	$ 25,944	100%
Costs and expenses:				
Cost of sales	15,724	82%	20,242	78%
Engineering and development	471	3%	665	3%
Selling, general and administrative	3,113	16%	3,762	14%
Total costs and expenses	19,308	101%	24,669	95%
Operating income	(153)	(1)%	1,275	5%
Other income	123	1%	332	1%
Income before income taxes	(30)	-%	1,607	6%
Provision for income taxes	(22)	-%	725	3%

Net income	$	(8)	-%	$	882	3%

Sales

The following table details our sales by operating segment for the three months ended June 30, 2008 and 2007:

	Systems	Service and System Integration	Total	% of Total
For the three months ended June 30, 2008:				
Product	$ 1,193	$ 13,537	$ 14,730	77%
Services	102	4,323	4,425	23%
Total	$ 1,295	$ 17,860	$ 19,155	100%
% of Total	7%	93%	100%	

	Systems	Service and Systems Integration	Total	% of Total
For the three months ended June 30, 2007:				
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%	

	Systems	Service and System Integration	Total	% increase
Increase (Decrease)				
Product	$ (4,048)	$ (3,093)	$ (7,141)	(33)%
Services	(4)	356	352	9%
Total	$ (4,052)	$ (2,737)	$ (6,789)	(26)%
% increase (decrease)	(76)%	(13)%	(26)%	

As shown above, total revenues decreased by approximately $6.8 million, or 26%, for the quarter ended June 30, 2008 compared to the same period of fiscal year 2007. Systems segment revenues decreased by approximately $4.1 million for the current year quarter versus the prior year quarter and Service and System Integration segment revenues decreased by approximately $2.7 million.

Product revenues decreased by approximately $7.1 million, or 33% for the quarter ended June 30, 2008 compared to the comparable period of fiscal 2007. This change in product revenues was made up of a decrease in product revenues in the Service and System Integration segment of approximately $3.1 million over the prior year quarter and a decrease in product revenues in the Systems segment of $4.0 million versus the prior year quarter.

The decrease in the Service and System Integration segment product revenue was primarily due to a decrease in product sales in the German operation of $4.2 million, offset by an increase of approximately $1.1 million in product sales in our US operations of this segment. The $4.2 million decrease from the German operations, consisted of a decrease of approximately $5.0 million caused by lower sales volume, offset by an increase of approximately $800 thousand due to the effect of a stronger Euro versus the US dollar, during the quarter ended June 30, 2008 versus the quarter ended June 30, 2007. The decrease in sales volume was due to lower sales to large customers, Kabel Deutschland and Atos Origin. Sales to these customers decreased by $4.2 million and $2.0 million, respectively.

These decreases were due to large project wins realized in the prior year quarter, which did not recur in the current year quarter due to the lack of significant IT investment and projects in fiscal year 2008. Offsetting these decreases, were sales to two new customers, UnityMedia which totaled approximately $507 thousand and Bayer which totaled approximately $647 thousand.

The decrease in the Systems segment product revenues of approximately $4.0 million for the quarter ended June 30, 2008 versus the comparable period in fiscal 2007 was primarily due to the decrease in sales to Raytheon of approximately $4.4 million over the prior year period. Prior year sales to Raytheon were in connection with an order for sixteen systems that were shipped over the course of fiscal 2007. Sales to Raytheon for the three months ended June 30, 2008 were approximately $40 thousand consisting of spare parts and repairs. In addition, sales to Lockheed Martin decreased by approximately $133 thousand, while sales to KBK increased by approximately $562 thousand for the three months ended June 30, 2008 versus the prior year comparable period.

As shown in the table above, service revenues increased by approximately $352 thousand, or 9% for the quarter ended June 30, 2008 compared to the comparable quarter of fiscal 2007. This increase was substantially from the Service and System Integration segment wherein service revenue increased by approximately $356 thousand. This increase was driven primarily from the German division wherein service revenue increased by approximately $1.2 million, approximately $409 thousand of which was the result of the foreign currency fluctuation impact and approximately $791 thousand was due to increased sales volume. The increase in sales volume was to higher levels of professional services for consulting work in archiving and identity and access management. Offsetting the increased services revenues in Germany, service revenue in the UK subsidiary of the Service and System Integration segment decreased by approximately $754 thousand, resulting from the non-recurrence of a large development project to a single customer, NCH, delivered in the third quarter of fiscal 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, 2008	%	June 30, 2007	%	$ Increase/ (Decrease)	% Increase(Decrease)
North America	$ 8,026	42%	$ 12,654	49%	$ (4,628)	(37)%
Europe	8,867	46%	12,706	49%	(3,839)	(30)%
Asia Pacific	2,262	12%	584	2%	1,678	287%
Totals	$ 19,155	100%	$ 25,944	100%	$ (6,789)	(26)%

The decrease in North American revenue in for quarter ended June 30, 2008 versus the prior year quarter, was due to the decrease in sales to Raytheon of $4.4 million.

The decrease in revenues in Europe for the three months ended June 30, 2008 versus the comparable period of fiscal 2007 was due primarily to the reasons set forth above with respect to sales volumes and foreign exchange rate fluctuations in the German operations of the Service and System Integration segment. To summarize the data presented above approximately $4.2 million of the decrease was related to decreased sales volume from the German division and approximately $754 thousand was due to lower sales volume in from the UK division. Offsetting these decreases, there was an increase of $1.2 million related to the foreign exchange rate change of a stronger Euro versus the US dollar.

The increase in sales in Asia Pacific was due to sales from the US division of the Service and System Integration segment of approximately $1.1 million plus increased sales in the Systems segment to KBK in the quarter ended June 30, 2008 versus the quarter ended June 30, 2007 of approximately $562 thousand.

Cost of Sales

The following table details our cost of sales by operating segment for the three months ended June 30, 2008 and 2007:

	Systems	Service and System Integration	Total	% of Total
For the three months ended June 30, 2008:				
Product	$ 629	$ 11,710	$ 12,339	78%
Services	20	3,365	3,385	22%
Total	$ 649	$ 15,075	$ 15,724	100%

% of Total	4%	96%	100%
% of Sales	50%	84%	82%
Gross Margins:			
Product	47%	13%	16%
Services	80%	22%	24%
Total	50%	16%	18%

	Systems	Service and System Integration	Total	% of Total
For the three months ended June 30, 2007:				
Product	$ 2,083	$ 14,753	$ 16,836	83%
Services	18	3,388	3,406	17%
Total	$ 2,101	$ 18,141	$ 20,242	100%

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	Systems	Service and System Integration	Total	% of Total