

CSP INC /MA/
Form 10-K
February 20, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT

PURSUANT TO SECTIONS 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

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

For the Fiscal Year Ended September 30, 2006.

☐ 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 000-10843

CSP Inc.

(Exact name of Registrant as specified in its Charter)

Massachusetts
(State of incorporation)

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

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43 Manning Road Billerica, Massachusetts 01821-3901 (978) 663-7598

(Address and telephone number of principal executive offices)

Securities Registered Pursuant to Section 12(b) of the Act:

None

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

Common Stock (par value \$0.01 per share)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

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

Indicate by check mark whether the registrant is 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).

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Yes ☐ No ☒

As of March 31, 2006, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$23,350,689 based on the closing sale price of \$8.68 as reported on the Nasdaq Stock Market.

As of January 16, 2007, we had outstanding 3,731,320 shares of common stock.

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EXPLANATORY NOTE

CONSOLIDATED FINANCIAL STATEMENTS

Related Regulatory Actions

Because our 2006 Form 10-K was not timely filed, on January 17, 2007 we received a letter from the Nasdaq Stock Market notifying us that our common stock was subject to delisting. In accordance with Nasdaq rules, we requested a hearing with Nasdaq that is scheduled for March 1, 2007 but we filed our Form 10-K prior to the hearing date thus fulfilling the Company's obligation.

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PART I

Item 1. Business

CSP Inc. (CSPI) was incorporated in 1968 and is based in Billerica, Massachusetts, just off Route 128 in the Boston computer corridor. To meet the diverse requirements of our industrial, commercial, and scientific and defense customers worldwide, CSPI and its subsidiaries develop and market IT integration solutions and high-performance cluster computer systems.

The Company sold substantially all of the net assets of its Scanalytics subsidiary in June 2005. The operating results of Scanalytics have been segregated from continuing operations and are reported as discontinued operations in the accompanying consolidated statements of operations and cash flows and the related notes to the consolidated financial statements for all periods presented.

Segments

CSPI operates in two segments:

Systems, which includes manufactured hardware products;

Service and System Integration, which includes maintenance and integration and sale of third-party hardware products and services and software application development

Our MultiComputer Division reports its activity in the Systems segment. The MultiComputer Division helps its customers solve high-performance computing problems in the defense market by supplying very dense cluster computer systems distinguished by elegant packaging and high-speed node-to-node communications in a completely integrated architecture. These systems are used in a broad array of applications, including radar, sonar and surveillance signal processing. The MultiComputer Division sells all products through its own direct sales force in the United States and via distributors in the rest of the world.

Our MODCOMP, Inc. subsidiary is a multinational business operation that develops and markets IT solutions for complex IT environments and provides network management, storage systems and network security integration services including consulting, systems integration and outsourcing. In addition, MODCOMP develops and markets middleware software for messaging and legacy integration. Revenues from these sources are recorded in the Service and System Integration segment except for sales of legacy classic systems which are included in the Systems segment. MODCOMP expanded its United States integrator operations for hardware, software and services with the acquisition of certain assets of Technisource Hardware, Inc. on May 30, 2003. The former Technisource business operates in the Service and System Integration segment. MODCOMP sells products through our own direct sales force in the United States, Germany, and the United Kingdom.

Financial Information about Industry Segments

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The following table details our sales by operating segment for fiscal years ending September 30, 2006, 2005 and 2004. A measure of our profits and losses and total assets by segment are listed in footnote number 13 to our financial statements.

Segment	2006	%	2005	%	2004	%
(Amounts in thousands)						
Systems	\$ 8,949	13%	\$ 9,414	16%	\$ 9,003	18%
Service and System Integration	59,988	87%	48,076	84%	42,399	82%
Total Sales	\$ 68,937	100%	\$ 57,490	100%	\$ 51,402	100%

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Products and Services

Systems Segment

Our MultiComputer Division designs, manufactures, sells and services cluster computer systems and real-time embedded computer systems. These systems are characterized by high-performance, high-density, low power consumption, standards-based hardware and software components (blades) ideally suited for use in the aerospace and defense market and the high-end scientific/technical computing market. The incorporation of open and standard technologies ensures that customers purchase systems based on the latest technology without the risks associated with proprietary solutions.

Applications expertise, product innovation, strong technical support, and dedicated customer service make us one of the industry's leading providers of high-performance cluster computer systems.

In fiscal year 2004, we introduced the StarGate I/O blade, which bolstered our product offerings in software-defined radio, radar, sonar and surveillance DSP by providing the high-speed data acquisition capabilities and rapid execution times necessary for the complex signal processing demands of these applications. The StarGate I/O blade was the initial product in a new generation of our MultiComputer that benefit from the exceptional performance provided by the 1GHz Motorola 7457 PowerPC microprocessors and related technologies. Customers purchasing these products have the option of selecting either an open-source Linux operating system and GNU toolkit or the industry standard VxWorks real-time operating system, coupled with the Tornado II development tools suite.

Also in 2004, the FastCluster product line was enhanced with the addition of rugged system capabilities for blades and enclosures. The new rugged chassis was specifically designed to meet MIL-STD specifications for mission-critical, airborne defense programs. The advanced packaging maintains scalability to hundreds of processors and leverages the latest Myrinet-2000 fiber clustering technology for multi chassis configurations. This packaging offers better fault detection, hot-swap capability, plug-in power supply and blower assembly components for improved serviceability, and addresses MIL-STD requirements for shock, vibration and EMC/EMI.

Building upon the momentum of the 2000 SERIES, in fiscal 2006, the 3000 SERIES was announced. The next generation 3000 SERIES systems deliver unrivaled performance in bi-section bandwidth and processing density while preserving absolute code reuse at the application layer. The 3000 SERIES is targeted to high performance digital signal processing (DSP), SIGINT, radar and sonar applications in airborne, shipboard and UAV platforms where space and power are at a premium.

The 3000 SERIES redefines processing per-cubic-foot-per-watt and interconnect bi-section bandwidth by integrating the reconfigurable processing capabilities of Xilinx's FPGA (Field Programmable Gate Array) technology with the latest Freescale Multi-Core processors and Myri-10G high performance networking technology. With its built-in 10-Gigabit Ethernet technology, the 3000 SERIES supports the DOD's vision of systems of systems in which embedded systems are not designed, deployed, and used in isolation but rather in a cooperative way.

Hardware Products

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Our MultiComputer Division produces high-density, high-performance cluster computing systems incorporating tens to hundreds of processors all interconnected by a very high-bandwidth network. These systems are specifically designed for analysis of complex signals and images in real-time or in modeling and simulations. Typical computationally intense applications requiring these products include radar, sonar, and command, control, communications, computers, intelligence, surveillance, and reconnaissance (C⁴ISR) within the defense market segment.

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Our MultiComputer cluster computing systems offer customers an open hardware architecture with the most advanced processors, large memory subsystems and high-bandwidth networking components. These systems are scalable and easy to upgrade, allowing for continuous insertion of the latest technologies. The superior architectural design of these systems is based on Motorola G4 PowerPC RISC processors with AltiVec technology; high-speed memory and Myrinet-2000 cluster interconnect. To meet the demands of mission-critical applications the MultiComputer systems incorporate high-availability features including instant booting from a cold start, error-correcting memory, hot-swappable hardware, extended environmental specifications and built-in self-test. Systems ship in a variety of configurations ranging from small desktop systems to multiple-chassis systems with over 400 processors.

Supporting both open source Linux and the industry standard VxWorks real-time operating system, MultiComputer products offer the user a choice in selecting the system software best suited to their application requirements.

All MultiComputer cluster computing systems use the best of open systems software technologies, such as message passing interface (MPI) software for interprocessor communications and the highly optimized industry standard math libraries: Industry Standard Signal Processing Library and Vector Signal and Image Processing Library. These libraries facilitate the development of truly portable code for seamless reuse across applications, while taking advantage of optimized performance on the PowerPC with AltiVec.

Service and System Integration Segment

Integration Solutions

Over the past several years, our product offering has evolved away from the sales of proprietary systems toward integration solutions including third-party hardware and software with consulting services. Our value proposition is integrating these third party components together into a complete solution and installing the system at the customer site. These services are offered by all MODCOMP locations. In particular, our German subsidiary has had significant successes in the telecommunication market.

Internet Integration and Security Solutions

We also offer third-party software products as well as specialized programming and engineering services to supply customers with customized legacy integration, virtual private networks and Internet security solutions.

Our German subsidiary has had several successes in the Internet security market in the telecommunications and financial services industries. The ability to offer 24 X 7 service level agreements is an important factor in this market.

Third-Party Offerings and Professional Services

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MODCOMP sells third-party offerings and professional services in the United States in the IT market with a strategic focus on storage systems, security and networking. Key third party product offerings include IBM, HP, Citrix, APC, EMC, Cisco, Microsoft and CA.

We offer competitively priced best-of-breed products from a wide variety of vendors to meet the customer's diverse systems and technology needs, providing sales and engineering expertise in storage, security and networking to the small-to-medium sized businesses. These small-to-medium sized businesses have unique technology needs, and typically lack technical purchasing expertise or have very limited engineering resources on staff. We offer small-to-medium sized businesses a single point of contact for complex multi-vendor technology purchases. We also provide installation, integration, logistical assistance and other value-added

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services that customers may require. Our current customers are in education, telecommunications, health services, distribution, financial, manufacturing and entertainment industries. We target the small-to-medium sized business market across all industries.

In addition, we provide Internet security consulting and implementation services for enterprise intrusion prevention and protection. Using third-party products from companies like Checkpoint and NetScreen, our services are designed to ensure data security and integrity through the establishment of virtual private networks and firewalls.

Markets, Marketing and Dependence on Certain Customers

Systems Segment

We market our high-performance cluster computing systems to the high-end scientific/technical computing market and the aerospace and defense market with emphasis on applications requiring the analysis of complex signals. We distribute our products in these markets as an original equipment manufacturer supplier to system integrators, distributors and value-added resellers. In these markets, the supplier/customer relationship is viewed as a long-term strategic partnership.

Aerospace and Defense Market

MultiComputer systems are sold primarily to prime contractors within the defense industry and are used in sonar, radar, C⁴ ISR systems, simulators, and signal and image analysis computers. Customers in this market segment have unique requirements. A prime contractor will be incorporating our products into their own future product developments and, therefore, will need early access to low-level, detailed technical specifications; prototype units; form, fit and function compatibility with previous products; and long term product availability and support. As a supplier in this market space, we recognize that there may be a significant up-front investment of time and resources in building a business partnership, however, the result is a strong potential for long-term revenue streams as products progress from development phases into deployment.

Our cluster computing technologies that support network centric warfare and information exchange in real-time are becoming increasingly significant to twenty-first century military operations. There has been steady growth of new programs requiring signal/image processing and analysis equipment as well as upgrades to existing military programs. However, the efficiency inherent in these technologies reduces the number of systems required to achieve the same results. Both new and upgraded programs require a substantial period of development and evaluation time before products are deployed into field use. Time from development to deployment varies based on the program, however, it may extend beyond a twenty-four month time period.

This market segment represents the largest growth potential for us as the Department of Defense continues to encourage prime contractors to use commercial-off-the-shelf solutions to contain program costs and improve the time-to-deployment when inserting new technology into existing field equipment. This initiative has lead to wide spread acceptance of standard, open technology products and is now being adopted by other governmental procurement agencies around the world. Our systems have been shipped to a number of customers developing commercial-off-the-shelf based systems or evaluating systems for use in future programs.

High-End Scientific/Technical Computing Market

Rapid technological change and the introduction of new products characterize the high-end scientific/technical computing market addressed by our MultiComputer systems with superior capabilities at lower pricing. This market segment is driven in large part by cost sensitivity. Moreover, many of the application performance requirements can often be met with general-purpose computers. Larger companies with greater technical

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resources and high capacity manufacturing facilities are now providing solutions in this space. In this market, our ability to compete may be limited to the extent that we lack the high volume production capabilities of a larger company, and thus are less able to realize the cost savings associated with economies of scale.

Service and System Integration Segment

MODCOMP supplies and integrates network management, network security and storage IT solutions as well as maintenance services for our legacy mini-computers worldwide. This focus as an IT solutions provider allows us to meet the needs of our customers with a variety of integration services as well as products from third-party manufacturers.

We market our products through various sales offices in the U.S., Germany and United Kingdom (for a detailed list see Item 2 of this Form 10-K). Throughout the remainder of the world, these offices coordinate the activities of manufacturers' representatives who represent other companies' product lines not competitive with ours and are either paid a commission on units sold or are permitted to buy units for resale at a discount.

Significant customers

Two customers comprised more than ten percent of consolidated revenues in 2006. Sales to Atos Origin GmbH (Atos), a systems integrator in Germany were \$9.3 million, or 14% of consolidated revenues. Sales to Kabel Deutschland, a cable television provider in Germany, were \$8.0 million, or 12% of consolidated revenues. No single customer constituted 10% or more of consolidated revenues in 2005. However, for the first quarter of 2005, significant sales were made directly to E-Plus, a wireless telecommunications company in Germany. In the second quarter of 2005, E-Plus outsourced its equipment procurement function to Atos. The combined sales to Atos and E-Plus during 2005 was \$8.7 million, or 15% of consolidated revenues. Sales to E-Plus and the associated percent of consolidated sales in the year ended September 30, 2004 was \$11.3 million (22%). Sales to Lockheed Martin, a large defense contractor, were \$5.8 million, or 11% of consolidated sales in the year ended September 30, 2004.

At our German operation, two large integration service customers significantly decreased their contract service levels in an effort to reduce costs. As a result, we had to take a cost cutting action, reducing our German workforce by approximately 10% in order to meet the requirements of the business.

Competition

Systems Segment

The MultiComputer systems market is very competitive. Customer requirements coupled with advancements in technology drive our efforts to continuously improve existing products and develop new ones. Starting with Intel i860 microprocessors used in the SuperCards of the 1980s to the Motorola PowerPCs with AltiVec incorporated in the 2000 SERIES and the addition of Linux open source software on the FastCluster

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product line, we have responded with product offerings vital to remaining competitive. Product development efforts in fiscal year 2006 were focused on providing our defense customers with increased capabilities for both blades and enclosures intended for deployment under rigorous environmental conditions. Blade product enhancements ranged from increased memory to an improved board layout designed to withstand harsher shock, vibration and thermal conditions. Rugged packaging options for chassis products addressed MIL-STD requirements while enhancing the serviceability of the enclosures.

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Aerospace & Defense Market

Our direct competitors in the aerospace and defense market are Mercury Computer Inc., Curtis Wright, G. E. Fanuc, Thales Computers and VMetro. Our indirect competitors are the board manufacturers that specialize in the DSP segment of this market. In the low performance segment of the general-purpose computer and single board computer market, manufacturers such as Motorola, Force, HP, IBM and Dell may compete. New companies enter the field periodically, and larger companies with greater technical resources and marketing organizations could decide to compete in the future. The future growth of this market depends upon continued growth in strategic partnerships and providing high density and scalability in a compact, low-power and cost effective package that can be easily integrated into OEM designs for high performance computation. Since the majority of sales are to OEMs, the principal barrier to gaining market share is the reluctance of established users to redesign their product once it is in production. A key area of opportunity exists in design wins on new programs.

High-End Scientific/Technical Computing Market

Competitors in the high-end scientific/technical cluster computing market include general-purpose computer and single board computer manufacturers such as IBM, Motorola, Force, HP and Dell. Companies manufacturing general-purpose computer systems incorporating multiple processors will be the principal competitors in this market. While our products offer the best overall value in combined performance, features and price, we may not overcome the capabilities of larger companies to address the needs of the cost sensitive customer, where price, not system size/packaging, is the primary factor in the buying decision.

Service and System Integration Segment

In the network management, security and storage systems integration services business, our competitors are extensive and vary to a certain degree in each of the geographical markets, but they include such competitors as EDS, IBM and Cap Gemini.

Competitors in the third-party offerings and professional services business range from catalog houses such as CDW, PC Connection, Insite, More Direct, and MicroWarehouse to customers buying directly from the manufacturers with solutions services such as IBM, Unisys, iData, Foresyth, Dell, and HP. Nearly all of our product offerings are available through other channels. For this reason the combination of personalized attention, technical expertise, add-on services and competitive pricing has been the key to our current success.

Manufacturing, Assembly and Testing

All of our MultiComputer systems manufacturing is performed at our plant in Billerica, Massachusetts. The primary manufacturing process is the assembly and testing of printed circuit boards and systems, designed by us and fabricated by other vendors. We offer products in a variety of standard formats and primarily build products based on customer orders. A varying percentage of sales reflect products customized to a particular customer's specification, and even these products are easily reconfigurable should the customer cancel the order for any reason.

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Upon receipt of material by us from outside suppliers, our QC/QA technicians inspect products and components. During manufacture and assembly, both subassemblies and completed systems are subjected to extensive testing, including burn-in and environmental stress screening designed to minimize equipment failure at delivery and over its useful service life. We also use diagnostic programs to detect and isolate potential component failures. A comprehensive log is maintained of all past failures to monitor quality procedures and improve design standards.

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We do not consider the risk of interruption of supply to be significant to meet our projected revenue requirements for the immediate future.

We provide a warranty covering defects arising from products sold and service performed, which varies from 90 days to one year, depending upon the particular unit. In the past, warranties of substantially greater scope have been extended to certain major customers for financial and other considerations.

Customer Support

Our MultiComputer Division and MODCOMP subsidiary support our customers with telephone assistance, on-site service, system installation, and training and education. We provide product support service during the warranty period. Customers may purchase extended software and hardware maintenance and on-site service contracts for support beyond the warranty period.

We offer training courses at our corporate headquarters, the customer site, or at each MODCOMP location. Field and customer service support is provided through our headquarters in Billerica, Massachusetts for Systems customers and at each MODCOMP location for Service and Systems Integration customers.

Research and Development

During fiscal year 2006, our expenses for engineering and development were approximately \$2.1 million (3% of sales) compared to approximately \$2.7 million (5% of sales) and \$2.5 million (5% of sales) in fiscal years 2005 and 2004, respectively. Expenditures for engineering and development are expensed as they are incurred. Our Systems segment expects to continue to have substantial expenditures related to the development of our next generation of hardware products and the software which enables the hardware to function. Our Systems products and development currently in process are intended to extend the usefulness and marketability of existing products and introduce new products into existing market segments.

We do not have any patents that are material to our business.

Backlog

Our backlog of customer orders and contracts was approximately \$24.7 million at September 30, 2006 as compared to \$6.9 million at September 30, 2005. Approximately \$16.8 million of the backlog is attributable to the Raytheon contract at our MultiComputer division and is expected to be completely fulfilled in fiscal year 2007. Our backlog can fluctuate greatly. These fluctuations can be due to the timing of receiving large orders for integration services and OEM purchases. All of the customer orders in backlog are expected to be shipped within the next twelve months.

Employees

On September 30, 2006, we had 138 employees. None of our employees are represented by a labor union and we had no work stoppages. We consider relations with our employees to be good.

Financial Information about Foreign and Domestic Operations and Export Sales

Our sales and percentage of sales by geographic area based on the location to which the products are shipped or services are rendered are in footnote number 13 of our financial statements.

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Item 1A. Risk Factors

This document contains forward-looking statements based on current expectations that involve a number of risks and uncertainties. Further, any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made. As it is not possible to predict every new factor that may emerge, forward-looking statements should not be relied upon as a prediction of actual future financial condition or results. In response to competitive pressures or new product introductions, we may take certain pricing or marketing actions that could adversely affect our operating results. In addition, changes in the products and services mix may cause fluctuations in our gross margin. Due to the potential quarterly fluctuations in operating results, we believe that quarter-to-quarter comparisons of our results of operations are not necessarily an indicator of future performance.

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 upon 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.

We Depend on a Small Number of Customers for a Significant Portion of our Revenue and Loss of any Customer Could Significantly Affect the Business

We are dependent on a small number of customers for a large portion of our revenues. Sales to E-Plus, a wireless telecommunications company in Germany, and those to E-Plus through its system integrator, Atos, accounted for 14%, 15% and 22% of sales in fiscal years ended September 30, 2006, 2005 and 2004, respectively. Sales to Kabel Deutschland accounted for 12% of consolidated revenues in 2006. Lockheed-Martin, a large defense contractor, accounted for 8% of our sales in 2006 and 5% and 11% of our sales in fiscal years 2005 and 2004, respectively. A significant diminution in the sales to or loss of any of our major customers would have a material adverse effect on our business, financial condition and results of operations. In addition, our revenues are largely dependent upon the ability of our customers to have continued growth or need for services or to develop and sell products that incorporate our products. No assurance can be given that our customers will not experience financial or other difficulties that could adversely affect their operations and, in turn, our results of operations.

We Depend on Defense Business for a Significant Amount of our Revenue and the Loss or Decline of Existing or Future Defense Business Could Adversely Affect our Financial Results

Sales of our systems to the defense market accounted for approximately 13%, 16% and 18% of our consolidated revenues and 98%, 97% and 97% of the Systems segment sales for the fiscal years ended September 30, 2006, 2005 and 2004, respectively. Reductions in government spending on programs that incorporate our products could have a material adverse effect on our business, financial condition and results of operations. Moreover, our subcontracts are subject to special risks, such as:

delays in funding;

ability of the government agency to unilaterally terminate the prime contract;

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reduction or modification in the event of changes in government policies or as the result of budgetary constraints or political changes;

increased or unexpected costs under fixed price contracts; and

other factors that are not under our control.

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In addition, consolidation among defense industry contractors has resulted in fewer contractors with increased bargaining power relative to our bargaining power. No assurance can be given that such increased bargaining power will not adversely affect our business, financial condition or results of operations in the future.

Changes in government administration, as well as changes in the geo-political environment such as the current War on Terrorism, can have significant impact on defense spending priorities and the efficient handling of routine contractual matters. Such changes could have a negative impact on our business, financial condition, or results of operations in the future.

We Face Competition That Could Adversely Affect our Sales and Profitability

The markets for our products are highly competitive and are characterized by rapidly changing technology, frequent product performance improvements and evolving industry standards. Due to the rapidly changing nature of technology, new competitors may emerge of which we have no current awareness. Competitors may be able to offer more attractive pricing or develop products that could offer performance features that are superior to our products, resulting in reduced demand for our products. Such competitors could have a negative impact on our ability to win future business opportunities. There can be no assurance that a new competitor will not attempt to penetrate the various markets for our products and services. Their entry into markets historically targeted by us may have a material adverse effect on our business, financial condition and results of operations.

Slowdown in the Economy Can Affect our Revenue and Profitability

The uncertainty regarding the growth rate of the worldwide economies has caused companies to reduce capital investment and this may cause further reduction of demand for our products and services. These reductions have been particularly severe in the electronics and technology industries.

Our Operating Results May Fluctuate Significantly

Our operating results have fluctuated widely on a quarterly and annual basis during the last several years, and we expect to experience significant fluctuations in future operating results. Many factors, some of which are beyond our control, have contributed to these fluctuations in the past and may continue to do so. Such factors include:

sales in relatively large dollar amounts to a relatively small number of customers;

competitive pricing programs and volume discounts;

loss of customers;

market acceptance of our products;

product obsolescence;

general economic conditions;

change in the mix of products sold;

obtaining or failure to obtain design wins for significant customer systems;

timing of significant orders;

delays in completion of internal product development projects;

delays in shipping our products;

delays in acceptance testing by customers;

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production delays due to quality programs with outsourced components;

shortages of components;

timing of product line transitions;

declines of revenues from previous generations of products following announcement of replacement products containing more advance technology; and

fixed nature of our expenditures on personnel, facilities and marketing programs.

We believe that period-to-period comparisons of our results of operations will not necessarily be meaningful and should not be relied upon as indicative of our future performance. It is also possible that in some periods, our operating results may be below the expectations of securities analysts and investors. In such circumstances, the price of our common stock may decline.

We Rely on Single Sources for Supply of Certain Components and our Business may be Seriously Harmed if our Supply of any of These Components or Other Components is Disrupted

Several components used in our Systems products are currently obtained from sole-source suppliers. We are dependent on key vendors like Myricom as well as Freescale for many of our PowerPC line of processors. Generally, suppliers may terminate their purchase order with us without cause upon 30-days notice and may cease offering products to us upon 180-days notice. If Freescale were to limit or reduce the sale of such components to us, or if these or other component suppliers to us, some of which are small companies, were to experience financial difficulties or other problems which prevented them from supplying us with the necessary components, such events could have a material adverse effect on our business, financial condition and results of operations. These sole source and other suppliers are each subject to quality and performance issues, materials shortages, excess demand, reduction in capacity and other factors that may disrupt the flow of goods to us or our customers, which thereby may adversely affect our business and customer relationships.

We have no guaranteed supply arrangements with our suppliers and there can be no assurance that our suppliers will continue to meet our requirements. If our supply arrangements are interrupted, there can be no assurance that we would be able to find another supplier on a timely or satisfactory basis. Any shortage or interruption in the supply of any of the components used in our products, or the inability to procure these components from alternate sources on acceptable terms could have a material adverse effect on our business, financial condition and results of operations. There can be no assurance that severe shortages of components will not occur in the future. Such shortages could increase the cost or delay the shipment of our products, which could have a material adverse effect on our business, financial condition and results of operations. Significant increases in the prices of these components would also materially adversely affect our financial performance since we may not be able to adjust product pricing to reflect the increase in component costs. We could incur set-up costs and delays in manufacturing should it become necessary to replace any key vendors due to work stoppages, shipping delays, financial difficulties or other factors and, under certain circumstances, these costs and delays could have a material adverse effect on our business, financial condition and results of operations.

We Depend on Key Personnel and Skilled Employees and Face Competition in Hiring and Retaining Qualified Employees

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We are largely dependent upon the skills and efforts of our senior management, managerial, sales and technical employees. None of our senior management or other key employees are subject to any employment contract which require services for a period of time. The loss of services of any of our executives or other key personnel could have a material adverse effect on our business, financial condition and results of operations. Our future success will depend to a significant extent on our ability to attract, train, motivate and retain highly skilled technical professionals. Our ability to maintain and renew existing engagements and obtain new business

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depends, in large part, on our ability to hire and retain technical personnel with the skills that keep pace with continuing changes in industry standards and technologies. The inability to hire additional qualified personnel could impair our ability to satisfy our growing client base, requiring an increase in the level of responsibility for both existing and new personnel. There can be no assurance that we will be successful in retaining current or future employees.

Our International Operations are Subject to a Number of Risks

We market and sell our products in certain international markets, and we have established subsidiaries in the United Kingdom and Germany. Foreign-based revenue is determined based on the location to which the product is shipped or services are rendered, and represented 46%, 50% and 46% of our total revenue for the fiscal years ended September 30, 2006, 2005 and 2004, respectively. If revenues generated by foreign activities are not adequate to offset the expense of establishing and maintaining these foreign subsidiaries and activities our business, financial condition and results of operations could be materially adversely affected. In addition, there are certain risks inherent in transacting business internationally, such as changes in applicable laws and regulatory requirements, export and import restrictions, export controls relating to technology, tariffs and other trade barriers, less favorable operations, longer payment cycles, problems in collecting accounts receivable, political instability, fluctuations in currency exchange rates, expatriation controls and potential adverse tax consequences, any of which could adversely impact the success of our international activities. In the recent past, the financial markets in Asia have experienced significant turmoil. A portion of our revenues are from sales to foreign entities, including foreign governments, which are primarily paid in the form of foreign currencies. There can be no assurance that one or more of such factors will not have a material adverse effect on our future international activities and, consequently, on our business, financial condition or results of operations.

To be Successful, We Must Respond to the Rapid Changes in Technology

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

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

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We Need to Maintain our Research and Development Effort to Meet the Needs of our Customers

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

We May be Unable to Successfully Integrate Acquisitions

We may in the future acquire or make investments in complementary companies, products or technologies. Acquisitions may pose risks to our operations, including:

problems and increased costs in connection with the integration of the personnel, operations, technologies or products of the acquired companies;

unanticipated costs;

diversion of management's attention from our core business;

adverse effects on business relationships with suppliers and customers and those of the acquired company;

acquired assets becoming impaired as a result of technical advancements or worse-than-expected performance by the acquired company;

entering markets in which we have no, or limited, prior experience; and

potential loss of key employees, particularly those of the acquired organization.

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

issue stock that would dilute existing shareholders' percentage of ownership;

incur debt and assume liabilities;

obtain financing on unfavorable terms;

incur amortization expenses related to acquired intangible assets or incur large and immediate write-offs;

incur large expenditures related to office closures of the acquired companies, including costs relating to termination of employees and leasehold improvement charges relating to vacating the acquired companies' premises; and

reduce the cash that would otherwise be available to fund operations or to use for other purposes.

The failure to successfully integrate any acquisition or for acquisitions to yield expected results may negatively impact our financial condition and operating results. Any resulting impairment of goodwill would have a negative effect on results of operations.

Our Stock Price May Continue to be Volatile

Historically, the market for technology stocks has been extremely volatile. Our common stock has experienced, and may continue to experience, substantial price volatility. The following factors could cause the market price of our common stock to fluctuate significantly:

our loss of a major customer;

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the addition or departure of key personnel;

variations in our quarterly operating results;

announcements by us or our competitors of significant contracts, new products or product enhancements;

acquisitions, distribution partnerships, joint ventures or capital commitments;

regulatory changes;

sales of our common stock or other securities in the future;

changes in market valuations of technology companies; and

fluctuations in stock market prices and volumes.

In addition, the stock market in general, and the NASDAQ Stock Market and technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of such companies. These broad market and industry factors may materially adversely affect the market price of our common stock, regardless of our actual operating performance. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted against such companies.

Our material weaknesses in internal control over financial reporting may continue to affect our ability to timely meet our regulatory reporting requirements.

We were unable to timely file our Annual Report on Form 10-K for the period ended September 30, 2006 due to the continued material weaknesses in internal control as discussed in Item 9A herein. As a result, Management concluded in its Annual Report that internal control over financial reporting was not effective as of the end of the period covered by the report. We have taken, and plan to take, additional steps to remediate these material weaknesses, by hiring additional senior accounting personnel and outsourcing certain functions to external consultants with appropriate expertise, but there can be no assurance that we will be able to completely remediate our material weaknesses such that we will be able to timely meet our future regulatory reporting requirements and conclude that our internal control over financial reporting is effective. Our inability to timely meet our regulatory reporting requirements will continue to affect our ability to maintain our listing status on the Nasdaq Stock Market.

Item 1B.