

CSP INC /MA/  
Form 10-K  
December 23, 2010

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

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Fiscal Year Ended September 30, 2010.

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.)

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:

| Title of Each Class                      | Name of Exchange of Which Registered |
|--|--------------------------------------|
| Common Stock, par value \$0.01 per share | NASDAQ Global Market                 |

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

None

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller Reporting Company

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

As of March 31, 2010, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$9,970,722 based on the closing sale price of \$3.60 as reported on the Nasdaq Global Market.

As of December 17, 2010, we had outstanding 3,543,547 shares of common stock.

#### DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the information required in Part III of this Form 10-K are incorporated by reference from our definitive proxy statement for our 2011 annual meeting of stockholders to be filed with the Securities and Exchange Commission within 120 days after the end of our fiscal year ended September 30, 2010.

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Note: Items 1B, 6 and 7A are not required for smaller reporting companies and therefore not furnished.

## PART I

## Item 1. Business

CSP Inc. (“CSPI” or “the Company” or “we” or “our”) 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 defense customers worldwide, CSPI and its subsidiaries develop and market IT integration solutions and high-performance cluster computer systems.

## Segments

CSPI operates in two segments, the Systems segment and the Service and System Integration segment.

•The Systems segment consists primarily of CSPI’s MultiComputer Division (the “MultiComputer Division”) which designs and manufactures specialty, high-performance computer signal processing systems for the aerospace and defense markets. The MultiComputer Division’s products are known as multicomputers or cluster computers, which use multiple microprocessors linked together in a specialized network to achieve very high performance processing capabilities. Our MultiComputer systems utilize “blades” (self-contained, high-density computer boards) to achieve a high level of compute processing per-cubic-foot-per-watt. The blades and other components that make up the system are housed in a ruggedized chassis, designed to withstand physically demanding environments such as those found on board a ship or airplane. In addition, CSPI’s MultiComputer products are designed to operate in environments that have low power, cooling and space requirements. These systems are used on land and in airborne and shipboard platforms for high-speed digital signal processing (“DSP”) in radar, sonar and surveillance applications. The MultiComputer Division sells all its products through its own direct sales force in the United States and via distributors and authorized resellers in the Asia-Pacific region.

•The Service and System Integration Segment consists of the computer maintenance and integration services and third-party computer hardware and software value added reseller (“VAR”) businesses of our Modcomp subsidiary (“Modcomp”). Modcomp is a wholly owned subsidiary of CSPI which operates in the United States, Germany and the United Kingdom (the “U.K.”). Modcomp markets and sells its products through its own direct sales force. Modcomp provides solutions and services for complex IT environments including storage and servers, unified communications solutions, IT security solutions and consulting services. Modcomp also provides managed IT services through its state of the art network operations center (“NOC”).

## Financial Information about Industry Segments

The following table details our sales by operating segment for fiscal years ending September 30, 2010 and 2009. Additional segment and geographical information is set forth in Note 13 to our financial statements.

| Segment                        | 2010                   | %     | 2009      | %     |
|--------------------------------|------------------------|-------|-----------|-------|
|                                | (Amounts in thousands) |       |           |       |
| Systems                        | \$ 8,311               | 9 %   | \$ 7,987  | 10 %  |
| Service and System Integration | 86,707                 | 91 %  | 75,370    | 90 %  |
| Total Sales                    | \$ 95,018              | 100 % | \$ 83,357 | 100 % |

## Systems Segment

## Products and Services

The Systems segment's MultiComputer systems utilize commodity hardware components that are compliant with industry standards and open source software and deliver a high-performance, high density and low power consuming computer solution to our customers. These systems incorporate tens to hundreds of processors, all interconnected by a very high-bandwidth network. They 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, command, control, communications, computers, intelligence, surveillance and reconnaissance ("C4ISR") within the defense market segment.

We utilize the most recent, currently available high performance processor technology, large memory subsystems and high-bandwidth networking components in the open hardware architecture of our MultiComputer systems. These systems are scalable and easy to upgrade, allowing for continuous insertion of the latest technologies. To meet the demands of mission-critical applications, our MultiComputer systems incorporate high-availability features to facilitate continuous operation of the system. These features include instant booting from a cold start, error-correcting memory, hot-swappable hardware, extended environmental specifications and built-in self-test. These systems ship in a variety of configurations ranging from small lab systems with as few as ten processors to multiple-chassis systems with over 400 processors.

## Hardware Products

Our MultiComputer Division cluster computer systems are currently marketed under the brand name FastCluster. Introduced in 1997, the first generation of FastCluster products were referred to as the FastCluster 2000 SERIES. Based upon industry standards, the 2000 SERIES systems included a VME 6U form factor (the form factor best suited for use in rugged applications), the Motorola™ G4 PowerPC RISC processors with AltiVec™ technology, high-speed memory and Myrinet-2000™ cluster interconnect. The 2000 SERIES product line is ideally suited for use by customers in the aerospace and defense markets seeking Commercial-Off-The-Shelf (“COTS”) solutions to reduce costs and ensure widespread availability. To remain competitive, our COTS solutions incorporate the latest industry standard technologies and minimize the risks associated with proprietary solutions.

Our StarGate I/O blade is a 2000 SERIES board-level component designed specifically for high-speed data acquisition. The StarGate bolstered our product offerings in radar, sonar and surveillance DSP by providing the rapid execution times that are necessary for the complex signal processing demands of these applications. The StarGate I/O blade was the first 2000 SERIES product to benefit from the increased performance provided by the 1GHz Motorola 7457 PowerPC microprocessors and related technologies.

The FastCluster product line was enhanced with the addition of rugged system capabilities for blades and enclosures with the introduction of the FastCluster 220R to our 2000 SERIES product line. The FastCluster 220R introduced a new rugged chassis, specifically designed to meet military standard (“MIL-STD”) specifications for mission-critical, airborne defense programs. The advanced packaging maintained scalability to hundreds of processors and leveraged the latest Myrinet-2000 fiber clustering technology for multi-chassis configurations. This packaging offered better fault detection, hot-swap capability, plug-in power supply and blower assembly components for improved serviceability and addressed MIL-STD requirements for shock, vibration and EMC/EMI.

Building upon the momentum of the 2000 SERIES, we announced the next generation FastCluster product line, the 3000 SERIES, in fiscal 2006. The first prototype of a 3000 SERIES component was shipped to a customer for evaluation purposes in September 2007. This prototype was successfully evaluated by the customer during fiscal 2008. We received and shipped additional 3000 SERIES orders in fiscal 2010 and we expect to receive a significant order for 3000 SERIES systems in fiscal 2011. The 3000 SERIES product line is being designed to deliver performance that is superior to our predecessor products in bi-section bandwidth and processing density while preserving absolute code reuse at the application layer. The 3000 SERIES product line is targeting high performance DSP, signal intelligence (“SIGINT”), radar and sonar applications in airborne, shipboard and unmanned aerial vehicle (“UAV”) platforms where space, power and cooling are at a premium. With its built-in 10-Gigabit Ethernet technology, the 3000 SERIES supports the United States (“U.S.”) Government Department of Defense (“DOD”) vision of “systems of systems” in which embedded systems are not designed, deployed and used in isolation but rather in a cooperative way.

In fiscal 2010, we announced 3000 SERIES OpenVPXTM with Intel multi-core processors and the OpenVPXTM VITA/ANSI standard (Vita 65) to support high performance radar, sonar, C4ISR and SIGINT applications. OpenVPXTM is the architecture framework that defines system-level interoperability for multivendor, multimode, integrated system environments. OpenVPXTM’s consideration of system-level requirements improves interoperability between computing and communications platforms and reduces customization, testing, cost and risk.

Also, in fiscal 2010, we announced our new 4000 SERIES ATCA products. The 4000 SERIES is based on InfiniBand, Advanced Telecom Computing Architecture (“AdvancedTCA” or “ATCA”) & NEBS standards to deliver affordability, sustainability and high availability to manned and unmanned large mobile platforms (land, sea and air.) ATCA was originally designed to address the high availability, robust system management and DC power distribution needs of the telecom and communications markets. ATCA has since become attractive to the military and defense markets as well.

Military computing and communication applications share the need for increased bandwidth and reliability, extremely robust mechanical and electrical definitions, power efficiency and unprecedented processor density. ATCA provides built-in high reliability features such as a 40 gigabit Ethernet backplane, redundant shelf managers, fail-over capability and support of live insertion of boards, power supplies and fans. These features are ideal for the DOD's network-centric warfare initiative.

All of the products of the MultiComputer Division offer the user a choice in selecting the system software best suited to their application requirements. For customers wanting a lower cost solution, our cluster computer systems are available with the open-source Linux operating system and toolkit. Customer applications requiring real-time response have the option of purchasing systems with the industry standard VxWorks real-time operating system and Tornado II development tools suite.

All MultiComputer cluster computer 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.

## Markets, Marketing and Dependence on Certain Customers

### Aerospace & Defense Market

We market our MultiComputer systems to the aerospace and defense markets with emphasis on applications requiring the analysis of complex signals such as sonar and radar. We distribute our products in these markets as an original equipment manufacturer (“OEM”) supplier to system integrators, distributors and value-added resellers. In these markets, the supplier/customer relationship is viewed as a long-term strategic partnership.

MultiComputer systems are sold primarily to prime contractors (serving as systems integrators) within the defense industry and are used in sonar, radar, C4ISR systems, simulators and signal and image analysis computers. Customers in this market segment have unique requirements. A prime contractor will typically incorporate 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, long term product availability and support. As a supplier in this market, we recognize that there may be a significant up-front investment of time and resources in building a business partnership. However, the result of this partnership 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 investment in development and evaluation before products deploy into field use. The time from development to deployment varies based on the program; however, it very often extends beyond twenty-four months. Looking forward to fiscal 2011 and beyond, our focus is to build interest in our 3000 SERIES and 4000 SERIES multicompilers among our customers.

### Competition

The Systems segment’s markets are very competitive. Customer requirements coupled with advances 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 processors incorporated in the early FastCluster 2000 SERIES and later the addition of Linux open source software, we have responded with product offerings that are vital to remaining competitive. Product development efforts in fiscal year 2009 involved completing and launching new enhancements to our 3000 SERIES product line, with a focus on continuing to provide our defense customers with increased processing capabilities based on the latest industry standard technologies: VXS (VITA 41), multi-core processors, FPGAs and Myricom’s Myri-10G high speed interconnect with 10 Gigabit Ethernet support.

Applications expertise, product innovation, strong technical support and dedicated customer service allow us to compete favorably as a provider of high-performance cluster computer systems.

Our direct competitors in the aerospace and defense market are Mercury Computer Inc., AP Labs, Curtis Wright and G. E. Intelligent Platforms. Our indirect competitors are the board manufacturers that specialize in the DSP segment of this market. In the past, manufacturers such as Emerson, HP, IBM and Dell participated in the low performance segment of the general-purpose computer and single board computer market. Today, those companies manufacture general-purpose computer systems incorporating multi-core processors and have the potential to become formidable competitors in compute intensive applications, such as radar and sonar. While our products are designed to 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, as opposed to system performance, size and specialized packaging, is the primary factor in the buying decision.

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 easily be integrated into OEM designs for high performance computation. Since the majority of sales are to prime contractors, 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.

#### Manufacturing, Assembly and Testing

All MultiComputer systems are shipped to our customers directly from our plant in Billerica, Massachusetts. Our manufacturing activities consist mainly of final assembly and testing of printed circuit boards and systems that are designed by us and fabricated by outside vendors.

Upon receipt of material and components by us from outside suppliers, our quality assurance technicians inspect these 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.

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.

#### Customer Support

Our MultiComputer Division supports our customers with telephone assistance, on-site service, system installation, 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 or the customer site. Field and customer service support is provided by employees located at our headquarters in Billerica, Massachusetts for Systems segment customers.

#### Sources and Availability of Raw Materials

Several components used in our Systems segment products are obtained from sole-source suppliers. We are dependent on key vendors like Myricom, Inc. for our high-speed interconnect components, Freescale Semiconductor, Inc. for our PowerPC processors and Wind River Systems, Inc. for VxWorks operating system software. Despite our dependence on these sole-source suppliers, we do not consider the risk of interruption of supply to be significant to meet our projected revenue requirements for the near term. Also, all components used to build our new 3000 SERIES and 4000 SERIES systems are currently available in a timely manner.

#### Research and Development

For the year ended September 30, 2010, our expenses for research and development were approximately \$2.0 million compared to approximately \$2.0 million for fiscal year 2009. Expenditures for research and development are expensed as they are incurred. Our Systems segment expects to continue to have substantial expenditures related to the development of new hardware products and the software that 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, including the 3000 SERIES and 4000 SERIES product lines.

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

#### Backlog

The backlog of customer orders and contracts in the Systems segment was approximately \$2.0 million at September 30, 2010 as compared to \$4.1 million at September 30, 2009. Our backlog can fluctuate greatly. These fluctuations can be due to the timing of receiving large orders representing prime contractor purchases. It is expected that all of the customer orders in backlog will ship within the next twelve months.

#### Service and System Integration Segment

##### Products and Services

## Integration Solutions

Over the past several years, the business of our Service and System Integration segment has evolved away from selling our proprietary process control and data acquisition (“PCDA”) computer systems, into becoming a systems integrator and VAR of integrated solutions including third-party hardware, software and technical computer-related consulting services and managed services via a state of the art NOC. Our value proposition is our ability to integrate diverse third-party components together into a complete solution and install the system at the customer site and to offer high value IT consulting services to deliver solutions.

## Third-Party Hardware and Software

Modcomp sells third-party hardware and software products in the information technology market, with a strategic focus on industry standard servers and data center infrastructure solutions, midrange data storage infrastructure products, network products, unified communications and IT security hardware and software solutions. Our key offerings include products from HP, Cisco Systems, Sun Microsystems, IBM, Juniper Networks, Hitachi, QLogic, Dell, Enterasys, Citrix, APC, EMC, Intel, VMWare, Fortinet, nCirlce, Microsoft and Checkpoint. Through our supplier relationships with these vendors, we are able to offer competitively priced best-of-breed products to meet our customers’ diverse technology needs, providing procurement and engineering expertise in server infrastructure, storage, security, unified communications and networking, to the small-to-medium sized businesses (“SMBs”) and large enterprise businesses (“LEBs”) with complex IT environments. We offer our customers a single point of contact for complex multi-vendor technology purchases. Many of our SMB customers have unique technology needs and may lack technical purchasing expertise or have very limited IT engineering resources on staff. We also provide installation, integration, logistical assistance and other value-added services that customers may require. Our current customers are in web and infrastructure hosting, education, telecommunications, health services, distribution, financial services, professional services, manufacturing and entertainment industries. We target SMB and LEB customers across all industries.

## Professional Services

We provide professional IT consulting services in the following areas:

• Maintenance and technical support both for third-party products and proprietary Modcomp legacy PCDA systems—hardware and software, operating system and user support.

• Implementation, integration, configuration and installation services.

• Storage area network (“SAN”) solutions – We help our customers implement SAN solutions using products from Hitachi, EMC, HP, DataDomain and NetApp. SANs allow system administrators to realize the benefits of SANs over conventional storage architecture. These benefits include cost savings from better utilization of hardware and lower headcount requirements to run and maintain data storage systems, higher availability and faster data access rates resulting in increased productivity.

• Virtualization – We implement virtualization solutions using products from companies such as VMWare. Virtualization allows one computer to do the job of multiple computers by sharing resources of a single computer across multiple environments. With virtual servers and desktops, users can host multiple operating systems and applications, which can eliminate physical and geographical limitations. Other benefits include energy cost savings, lower capital expenditure requirements, high availability of resources, better desktop management, increased security and improved disaster recovery processes.

• Enterprise security intrusion prevention, network access control and unified threat management—Using third-party products from companies like Checkpoint, Juniper Networks and Cisco Systems, our services are designed to ensure data security and integrity through the establishment of virtual private networks, firewalls and other technologies.

• IT security compliance services—We provide services for IT security compliance with personal privacy laws such as HIPAA and corporate governance laws such as Sarbanes-Oxley.

• Unified communications, wireless and routing and switching solutions using Cisco Systems’ products and services.

• Custom software applications and solutions development and support—We develop custom applications to customer specifications using industry standard platforms such as Microsoft.Net, Sharepoint and OnBase. We are a Microsoft Gold Partner.

• NOC managed IT services that include monitoring, reporting and management of alerts for the resolution and preventive general IT and IT security support tasks.

## Markets, Marketing and Dependence on Certain Customers

We are an IT systems integrator and computer hardware and software VAR. We also provide technical services to achieve a value-add to our customers. We operate within the VAR sales channels of major computer hardware and software OEMs, primarily within the geographic areas of our sales offices and across the U.S. We provide innovative IT solutions, including a myriad of infrastructure products with customized integration consulting services and managed services to meet the unique requirements of our customers. We market the products we sell and services we provide through various sales offices in the U.S., Germany and the U.K. through our direct sales force (for a detailed list of our locations, see Item 2 of this Form 10-K).

## Competition

The primary competition in the Service and System Integration segment are other VARs, ranging from small companies that number in the thousands, to large enterprises such as CDW, PC Connection, Insight, MoreDirect, Dimension Data, Bechtle AG and Computacenter. In addition, we compete directly with many of the companies who manufacture the third-party products that we sell including IBM, HP EMC, Hitachi and others. 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 HP/EDS, IBM and Cap Gemini.

Nearly all of our product offerings are available through other channels. Favorable competitive factors for the Service and System Integration segment include procurement capability, product diversity allowing for delivery of complete and custom solutions to our customers, strength of key partner relationships with the major IT OEMs, ability to supply unique and/or specialized needs of the SMB and LEB markets, strong knowledge of the IT products that we sell, ability to provide managed services through our NOC and the consulting integration services required to design and install the custom solutions that fit our customers' IT needs. Unfavorable competitive factors include low name recognition, limited geographic coverage and pricing.

#### Backlog

The backlog of customer orders and contracts for the Service and System Integration segment was approximately \$6.3 million at September 30, 2010, as compared to \$4.8 million at September 30, 2009. Our backlog can fluctuate greatly. These fluctuations can be due to the timing of receiving large orders for third- party products and/or IT services. It is expected that all of the customer orders in backlog will ship and/or be provided within the next twelve months.

#### Significant Customers

See Note 13 for detailed information regarding customers which comprised 10% or more of consolidated revenues for the years ended September 30, 2010 and 2009.

#### Employees

On September 30, 2010, we had approximately 139 full time equivalent employees worldwide for our consolidated operations. 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 Geographic Areas

Information regarding our sales by geographic area and percentage of sales based on the location to which the products are shipped or services are rendered are in Note 13 of our consolidated financial statements.

#### Item 1A.

#### Risk Factors

##### Factors that may Affect Future Performance

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. Both the Systems and Service and System Integration segments are reliant upon a small number of significant customers, the loss of any one of which could have a material adverse effect on our business. 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.

Our largest customer for fiscal year 2010 acquired one of our largest competitors and this customer also expects a downturn in business from one of its own customers that was creating significant demand for our products. These events could result in a significant reduction in our sales volume for fiscal 2011 and beyond.

Our largest customer for fiscal 2010 is a large hosting company that provides outsourcing of computer infrastructure, storage and communications resources. Our sales to this customer were \$22.5 million for fiscal 2010, which comprised 24% of our total revenues. Two events occurred late in our fiscal year 2010 that may have a significant impact on our sales volume for fiscal 2011 and beyond.

First, our customer expects a downturn in business from one of its own customers that was creating significant demand for our products. This will likely have an unfavorable impact on our sales because our customer may no longer need to purchase the same volume of products from us in fiscal year 2011 as they did in fiscal year 2010.

Secondly, this customer has acquired a major competitor of ours that supplies some of the same IT networking equipment that we were supplying to them during fiscal 2010. We believe that in the future, it is likely that this customer will procure some or most of these products from our competitor rather than purchase them from us.

#### 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 products and services to the defense market accounted for approximately 9% and 9% of our consolidated revenues and 99% and 99% of the Systems segment sales for the fiscal years ended September 30, 2010 and 2009, 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;
- 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.

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;
- 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, Inc. as well as Freescale Semiconductor, Inc. (“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 Myricom or 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 could prevent 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

We are largely dependent upon the skills and efforts of our senior management, managerial, sales and technical employees. None of our senior management personnel except Alex Lupinetti, our Chief Executive Officer, and Victor Dellovo, Vice President and General Manager of the Modcomp Division or other key employees are subject to any employment contracts. 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 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 operations in the U.K. and Germany. Foreign-based revenue is determined based on the location to which the product is shipped or services are rendered and represented 30% and 36% of our total revenue for the fiscal years ended September 30, 2010 and 2009, 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, 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. 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.

Our business could be adversely impacted if we have deficiencies in our disclosure controls and procedures or internal controls over financial reporting.

Effective internal control over financial reporting and disclosure controls and procedures are necessary in order for us to provide reliable financial and other reports and effectively prevent fraud. These types of controls are designed to provide reasonable assurance regarding the reliability of financial reporting and the proper preparation of our financial statements, as well as regarding the timely reporting of material information. If we cannot maintain effective internal control or disclosure controls and procedures, or provide reliable financial or Securities and Exchange Commission (“SEC”) reports or prevent fraud, investors may lose confidence in our reported financial information, our common stock could be subject to delisting on the stock exchange where it is traded, our operating results and the trading price of our common stock could suffer and we might become subject to litigation.

While our management will continue to review the effectiveness of our internal control over financial reporting and disclosure controls and procedures, there is no assurance that our disclosure controls and procedures or our internal control over financial reporting will be effective in accomplishing all control objectives, including the prevention and detection of fraud, all of the time.

## 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 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, particularly in our Systems segment. 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.

#### We Need to Continue to Expend Resources on Research and Development Efforts 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

In order to achieve strategic objectives to maintain and grow our market position, we may have a need to 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:

- loss of a major customer;
- loss of a major supplier;

- 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 Global 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.



## Item 2. Properties

Listed below are our principal facilities as of September 30, 2010. Management considers all facilities listed below to be suitable for the purpose(s) for which they are used, including manufacturing, research and development, sales, marketing, service and administration.

| Location   | Principal Use  | Owned or Leased | Approximate Floor Area |
|--|--|-----------------|------------------------|
| <b>Systems Segment Properties:</b>   |  |                 |                        |
| CSP Inc.<br>43 Manning Road<br>Billerica, MA   | Corporate Headquarters<br>Manufacturing, Sales,<br>Marketing and<br>Administration | Leased          | 21,500 S.F.            |
| <b>Service and Systems Integration Segment Properties:</b>   |  |                 |                        |
| Modcomp, Inc.<br>1500 S. Powerline Road<br>Deerfield Beach, FL                                       | Division Headquarters<br>Sales, Marketing and<br>Administration                    | Leased          | 15,482 S.F.            |
| Modcomp, Inc.<br>9155 South Dadeland Blvd, Suite 1112<br>Miami, FL                                   | Sales, Marketing and Service   | Leased          | 1,356 S.F.             |
| Modular Computer Systems GmbH<br>Oskar-Jager-Strasse 50<br>D-50825 Koln<br>Germany                   | Sales, Marketing, Service<br>and Administration                                    | Leased          | 12,443 S.F.            |
| Modcomp, Ltd.<br>12a Oaklands Business Park, Fishponds Road<br>Wokingham Berkshire<br>United Kingdom | Sales, Marketing and<br>Administration   | Leased          | 2,490 S.F.             |
| Modcomp Systemhaus GmbH<br>Gartenstr. 23-27<br>D-61352 Bad Homburg<br>Germany                        | Sales, Marketing and Service   | Leased          | 2,819 S.F.             |

## Item 3. Legal Proceedings

We are currently not a party to any material legal proceedings.

## Item 4. [Reserved]

## PART II

## Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market information. Our common stock is traded on the Nasdaq Global Market under the symbol CSPI. The following table provides the high and low sales prices of our common stock as reported on the Nasdaq Global Market for the periods indicated.

| Fiscal Year: | 2010    |         | 2009    |         |
|--------------|---------|---------|---------|---------|
|              | High    | Low     | High    | Low     |
| 1st Quarter  | \$ 4.06 | \$ 3.30 | \$ 5.27 | \$ 1.51 |
| 2nd Quarter  | 3.98    | 3.20    | 3.90    | 2.50    |
| 3rd Quarter  | 4.70    | 3.32    | 3.74    | 2.55    |
| 4th Quarter  | 4.65    | 3.85    | 4.25    | 3.38    |

Stockholders. We had approximately 87 holders of record of our common stock as of December 17, 2010. This number does not include stockholders for whom shares were held in a "nominee" or "street" name. We believe the number of beneficial owners of our shares of common stock (including shares held in street name) at that date was approximately 1,400.

Dividends. We have never paid any cash dividends on our common stock. Our present policy is to retain earnings to finance expansion and growth and no change in the policy is anticipated.

Share Repurchase Plans. The following table provides information with respect to shares of our common stock that we repurchased during the year ended September 30, 2010:

| Month Ended        | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans (1) | Maximum number of Shares that May Yet Be Purchased Under the Plans |
|--------------------|----------------------------------|------------------------------|--|--|
| October 31, 2009   | —                                | \$ —                         | —  |  |
| November 30, 2009  | —                                | —                            | —  |  |
| December 31, 2009  | —                                | —                            | —  |  |
| January 31, 2010   | —                                | —                            | —  |  |
| February 28, 2010  | 500                              | 3.60                         | 500  |  |
| March 31, 2010     | 10,693                           | 3.62                         | 10,693   |  |
| April 30, 2010     | 10,500                           | 3.53                         | 10,500   |  |
| May 31, 2010       | 4,200                            | 4.08                         | 4,200  |  |
| June 30, 2010      | 7,295                            | 4.27                         | 7,295  |  |
| July 31, 2010      | 4,739                            | 4.25                         | 4,739  |  |
| August 31, 2010    | 43,780                           | 4.18                         | 43,780   |  |
| September 30, 2010 | 13,783                           | 4.21                         | 13,783   |  |
| Total              | 95,490                           | \$ 4.05                      | 95,490   | 144,556  |

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(1) All shares were purchased under publicly announced plans. For additional information about these publicly announced plans please refer to Note 12 of our financial statements.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The discussion below contains certain forward-looking statements related to statements concerning future revenues and future business plans. Actual results may vary from those contained in such forward-looking statements.

Overview of Fiscal 2011 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 that are used primarily in military applications and the process control and data acquisition ("PCDA") proprietary hardware business of our Modcomp subsidiary.

**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 increased by approximately \$11.7 million, or 14%, to \$95 million for the year ended September 30, 2010 versus \$83.4 million for the year ended September 30, 2009.

Operating income increased by approximately \$6.1 million, to operating income of approximately \$1.1 million for the year ended September 30, 2010 versus an operating loss of approximately \$5.0 million for the year ended September 30, 2009.

Net income was approximately \$0.9 million, for the year ended September 30, 2010 versus a net loss of approximately \$3.8 million for the year ended September 30, 2009, an improvement of \$4.7 million.

A non-cash goodwill impairment charge was taken in fiscal 2009 for \$3.9 million which was the total value of goodwill on the Company's balance sheet prior to the impairment charge. This goodwill impairment charge was a significant factor in the increase in operating income and net income for fiscal 2010 versus fiscal 2009. There was no asset impairment charges in the fiscal year ended September 30, 2010.

In fiscal year 2010 the Company adopted Accounting Standards Update ("ASU") 2009-13 - "Multiple-Deliverable Revenue Arrangements—a Consensus of the FASB Emerging Issues Task Force" ("ASU 2009-13") and ASU 2009-14 - "Certain Revenue Arrangements that Contain Software Elements." (ASU 2009-14"). The impact of adopting these new standards for the year ended September 30, 2010 was an increase in revenue of \$3.5 million, an increase to net income of \$284 thousand and an increase of \$0.08 to both basic and fully diluted earnings per share.

Net cash used in operating activities was approximately \$1.9 million for the year ended September 30, 2010 compared to net cash provided by operating activities of \$3.4 million for the year ended September 30, 2009.

The increase in revenues of \$11.7 million was due to in large part to increased revenues in our Service and System Integration segment where revenues were up by approximately \$11.3 million versus the year ended September 30, 2009. Revenues in fiscal 2010 in the Systems segment were \$8.3 million compared with \$8.0 million for fiscal 2009, which is an increase of approximately \$0.3 million versus the prior year.

Also, in fiscal 2010, we were engaged in significant research and development efforts in the Systems segment making significant progress with on-going development of our newest product lines, the Fast Cluster Series 3000 and 4000 SERIES product lines, which are designed to provide what we believe is the most advanced interconnect technology available today. The 3000 and 4000 SERIES products are expected to provide our customers with another state-of-the-art, fully ruggedized open source system, which will be essential to our future growth opportunities.

We do not expect that Systems segment revenues for fiscal year 2011 will show growth compared to fiscal 2010. However we do expect to receive orders from existing programs for our 2000 SERIES products and high-margin royalties. We also expect to receive a significant order for our 3000 SERIES product line in fiscal year 2011.

Revenues in the Service and System Integration segment for fiscal 2010 were \$86.7 million versus fiscal 2009 revenues of \$75.4 million, which was an increase of \$11.3 million. The U.S. operations of this segment experienced strong sales growth in fiscal 2010 of \$12.9 million, a 27% increase over fiscal year 2009. This growth was due to in large part to revenues from a large web-site hosting company, which accounted for approximately \$14.3 million of the increase. Offsetting the growth in the U.S. operation, revenues declined in the European operations (Germany and the U.K.) segment for fiscal year 2010 versus fiscal 2009 by approximately \$1.5 million, or 6%. The decline was due primarily to the economic recession in Europe resulting in an overall decline in large orders in fiscal 2010 compared

with fiscal 2009 from the division's largest customers.

Based on the current economic environment, we plan to manage the Service and System Integration segment assuming relatively weak demand in fiscal 2011. We plan to focus our attention and resources on higher-margin business and away from low margin business as we move forward. While this may put pressure on sales growth in fiscal 2011, we believe this strategy will accelerate profitable growth for the long term.

In addition, there were two significant adverse events concerning our largest customer for fiscal 2010, the web-site hosting company mentioned above. This customer provides outsourcing of computer infrastructure, storage and communications resources. Our sales to this customer were \$22.5 million for fiscal 2010, which comprised 24% of our total revenues, and accounted for \$14.3 million of the increase in sales for fiscal 2010 versus fiscal 2009.

First, our customer expects a downturn in business from one of its own customers that was creating significant demand for our products. This will likely have an unfavorable impact on our sales because our customer may no longer need to purchase the same volume of products from us in fiscal year 2011 as they did in fiscal year 2010.

Secondly, this customer has acquired a major competitor of ours that supplies some of the same IT networking equipment that we were supplying to them during fiscal 2010. We believe that in the future, it is likely that this customer will procure some or most of these products from our competitor rather than purchase them from us.

The following table sets forth certain information which is based on data from our Consolidated Statements of Operations:

|                                     | Percentage of sales                 |   |       |    | Period to Period<br>Dollar increase<br>(decrease) |          |
|-------------------------------------|-------------------------------------|---|-------|----|---|----------|
|                                     | Fiscal year ended September<br>2010 |   | 2009  |    | 2010 compared to 2009                             |          |
|                                     | (Dollar amounts in thousands)       |   |       |    |   |          |
| Sales                               | 100.0                               | % | 100.0 | %  | \$  | 11,661   |
| Costs and expenses:                 |                                     |   |       |    |   |          |
| Cost of sales                       | 81.9                                | % | 82.1  | %  |   | 9,421    |
| Engineering and development         | 2.1                                 | % | 2.3   | %  |   | (17 )    |
| Selling, general and administrative | 14.8                                | % | 16.8  | %  |   | 127      |
| Impairment on goodwill              | —                                   | % | 4.7   | %  |   | (3,941 ) |
| Total costs and expenses            | 98.8                                | % | 105.9 | %  |   | 5,590    |
| Operating income (loss)             | 1.2                                 | % | (5.9  | )% |   | 6,071    |
| Other income                        | —                                   | % | —     | %  |   | 34       |
| Income (loss) before income taxes   | 1.2                                 | % | (5.9  | )% |   | 6,105    |
| Income tax expense (benefit)        | 0.2                                 | % | (1.4  | )% |   | 1,408    |
| Net income (loss)                   | 1.0                                 | % | (4.5  | )% | \$  | 4,697    |

#### Results of Operations—2010 Compared to 2009

For the fiscal year ended September 30, 2010, sales increased to \$95.0 million, compared to \$83.4 million for fiscal year ended September 30, 2009. Net income for the year ended September 30, 2010 was \$0.9 million, or \$0.25 per diluted share compared with a net loss of \$3.8 million, or \$1.05 per diluted share for fiscal year ended September 30, 2009.

#### Revenue

The following table details the Company's sales by geographical region for fiscal years September 30, 2010 and 2009:

|              | September 30,                 |     | For the Year Ended |           | September 30, |   | \$ Increase/<br>(Decrease) | % Increase<br>(Decrease) |    |
|--------------|-------------------------------|-----|--------------------|-----------|---------------|---|----------------------------|--------------------------|----|
|              | 2010                          | %   | September 30,      | %         | 2009          | % |                            |                          |    |
|              | (Dollar amounts in thousands) |     |                    |           |               |   |                            |                          |    |
| Americas     | \$67,794                      | 71  | %                  | \$ 53,748 | 64            | % | \$14,046                   | 26                       | %  |
| Europe       | 26,118                        | 28  | %                  | 27,387    | 33            | % | (1,269 )                   | (5                       | )% |
| Asia Pacific | 1,106                         | 1   | %                  | 2,222     | 3             | % | (1,116 )                   | (50                      | )% |
| Totals       | \$95,018                      | 100 | %                  | \$ 83,357 | 100           | % | \$11,661                   | 14                       | %  |

The increase in Americas revenue for the year ended September 30, 2010 versus the year ended September 30, 2009 was primarily the result of the increase in revenues from the U.S. operations of the Service and System Integration segment which accounted for approximately \$12.6 million of the increase. Additionally, sales from the Systems

segment to U.S. customers increased by approximately \$1.5 million, primarily resulting from an increase in royalty income, which is part of our service revenue. The decrease in sales in Europe was primarily the result of lower sales from the German and United Kingdom divisions of the Service and System Integration segment, where sales in Europe decreased by approximately \$1.0 million and \$0.6 million, respectively. The decrease in sales volume in constant U.S. dollars for the fiscal year ended September 30, 2010 versus the same year in 2009 was due to the reasons described below. Offsetting the decreases in European sales from the German and UK divisions, sales to Europe from the U.S. division of the Service and System Integration segment increased by approximately \$0.3 million. The decrease in sales to Asia Pacific was the result of the decrease in sales into our program which supplies the Japanese defense market.

The following table details the Company's sales for products and services by operating segment for the fiscal years ended September 30, 2010 and 2009:

|                               | Systems    | Service and<br>System<br>Integration | Total    | % of<br>Total |   |
|-------------------------------|------------|--------------------------------------|----------|---------------|---|
| (Dollar amounts in thousands) |            |                                      |          |               |   |
| 2010                          |            |                                      |          |               |   |
| Product                       | \$4,888    | \$73,855                             | \$78,743 | 83            | % |
| Services                      | 3,423      | 12,852                               | 16,275   | 17            | % |
| Total                         | \$8,311    | \$86,707                             | \$95,018 | 100           | % |
| % of Total                    | 9          | % 91                                 | % 100    | %             |   |
| 2009                          |            |                                      |          |               |   |
| Product                       | \$6,055    | \$61,182                             | \$67,237 | 81            | % |
| Services                      | 1,932      | 14,188                               | 16,120   | 19            | % |
| Total                         | \$7,987    | \$75,370                             | \$83,357 | 100           | % |
| % of Total                    | 10         | % 90                                 | % 100    | %             |   |
|                               | Systems    | Service and<br>System<br>Integration | Total    | %<br>Increase |   |
| (Dollar amounts in thousands) |            |                                      |          |               |   |
| Increase (Decrease)           |            |                                      |          |               |   |
| Product                       | \$(1,167 ) | \$12,673                             | \$11,506 | 17            | % |
| Services                      | 1,491      | (1,336 )                             | 155      | 1             | % |
| Total                         | \$324      | \$11,337                             | \$11,661 | 14            | % |
| % Increase                    | 4          | % 15                                 | % 14     | %             |   |

As shown above, total revenues increased by approximately \$11.7 million, or 14%, for the year ended September 30, 2010 compared to the same period of fiscal year 2009. Revenue in the Systems segment increased for the current year versus the prior year by approximately \$0.3 million, while revenues in the Service and System Integration segment increased by approximately \$11.3 million, resulting in the overall increase of approximately \$11.7 million.

Product revenues increased by approximately \$11.5 million, or 17% for the year ended September 30, 2010 compared to the year ended September 30, 2009. This change in product revenues was made up of an increase in product revenues in the Service and System Integration segment of approximately \$12.7 million offset by a decrease in the Systems segment of approximately \$1.2 million versus the prior year.

The increase in the Service and System Integration segment product sales of approximately \$12.7 million was due primarily to increased product sales in the U.S. division of the segment of approximately \$13.0 million, offset by a decrease of approximately \$0.3 million in the segment's European divisions (Germany and the UK). The increase in the U.S. was attributable in large part to several large hardware orders which shipped to the US division's largest customer. Sales to this customer increased by approximately \$14.3 million, comparing the year ended September 30, 2010 to the year ended September 30, 2009. In addition, sales to other major customers increased by a net total of approximately \$3.5 million. Offsetting these increases, the loss of a major customer, which filed for bankruptcy protection during the prior fiscal year, resulted in a decrease in product sales of approximately \$4.8 million, when comparing the years ended September 30, 2010 versus 2009. The decrease in Europe was due primarily to weak demand caused by the overall economic and technology sector slowdown which is continuing to put downward



pressure on sales volume.

The decrease in the Systems segment product revenues of approximately \$1.2 million for the year ended September 30, 2010 versus the comparable period in fiscal 2009 was the result of a decrease in product sales into our existing program which supplies the Japanese defense market.

As shown in the table above, service revenues increased by approximately \$0.2 million, or 1% for the year ended September 30, 2010 compared to the comparable year of fiscal 2009. Service revenue in the Systems segment increased by approximately \$1.5 million, while service revenue in the Service and System Integration segment decreased by approximately \$1.3 million.

The \$1.5 million increase in Systems segment service revenue was the result of an increase in royalty revenue from Lockheed Martin which was approximately \$3.0 million for the year ended September 30, 2010, versus approximately \$1.6 million for the year ended September 30, 2009, for a total increase of approximately \$1.4 million. In addition, service revenues to Raytheon increased by approximately \$0.1 million in connection with the large product order which shipped in the second quarter of 2010, which is described above.

The decrease in the Service and System Integration segment service revenue was driven by lower service revenues from the segment's German and United Kingdom divisions which decreased by approximately \$0.8 million, \$0.5 million, respectively. These decreases in service revenue from our German and United Kingdom divisions were attributed to the unfavorable economic conditions which negatively impacted those divisions' revenue performance.

#### Cost of Sales, Gross Profit and Gross Margins

The following table details our cost of sales by operating segment for fiscal years ended September 30, 2010 and 2009:

|                       | Systems |        | Service and<br>system<br>integration<br>(Dollar amounts in thousands) |          | Total |          |
|-----------------------|---------|--------|---|----------|-------|----------|
| 2010                  |         |        |   |          |       |          |
| Cost of Sales:        |         |        |   |          |       |          |
| Product               | \$      | 2,449  | \$  | 64,936   | \$    | 67,385   |
| Services              |         | 306    |   | 10,136   |       | 10,442   |
| Total                 |         | 2,755  |   | 75,072   |       | 77,827   |
| % of Total            |         | 4      | %   | 96       | %     | 100      |
| % of Sales            |         | 33     | %   | 86       | %     | 82       |
| Gross Profit:         |         |        |   |          |       |          |
| Product               | \$      | 2,439  | \$  | 8,919    | \$    | 11,358   |
| Services              |         | 3,117  |   | 2,716    |       | 5,833    |
| Total                 |         | 5,556  |   | 11,635   |       | 17,191   |
| % of Total            |         | 32     | %   | 68       | %     | 100      |
| Gross Margins:        |         |        |   |          |       |          |
| Product               |         | 50     | %   | 12       | %     | 14       |
| Services              |         | 91     | %   | 21       | %     | 36       |
| Total                 |         | 67     | %   | 13       | %     | 18       |
| 2009                  |         |        |   |          |       |          |
| Cost of Sales:        |         |        |   |          |       |          |
| Product               | \$      | 3,134  | \$  | 53,475   | \$    | 56,609   |
| Services              |         | 143    |   | 11,654   |       | 11,797   |
| Total                 |         | 3,277  |   | 65,129   |       | 68,406   |
| % of Total            |         | 5      | %   | 95       | %     | 100      |
| % of Sales            |         | 41     | %   | 86       | %     | 82       |
| Gross Profit:         |         |        |   |          |       |          |
| Product               | \$      | 2,921  | \$  | 7,707    | \$    | 10,628   |
| Services              |         | 1,789  |   | 2,534    |       | 4,323    |
| Total                 |         | 4,710  |   | 10,241   |       | 14,951   |
| % of Total            |         | 32     | %   | 68       | %     | 100      |
| Gross Margins:        |         |        |   |          |       |          |
| Product               |         | 48     | %   | 13       | %     | 16       |
| Services              |         | 93     | %   | 18       | %     | 27       |
| Total                 |         | 59     | %   | 14       | %     | 18       |
| Increase (Decrease)   |         |        |   |          |       |          |
| Cost of Sales:        |         |        |   |          |       |          |
| Product               | \$      | (685 ) | \$  | 11,461   | \$    | 10,776   |
| Services              |         | 163    |   | (1,518 ) |       | (1,355 ) |
| Total                 |         | (522 ) |   | 9,943    |       | 9,421    |
| % Increase (decrease) |         | (16 )% |   | 15       | %     | 14       |
| % of Sales            |         | (8 )%  |   | —        | %     | —        |
| Gross Profit:         |         |        |   |          |       |          |
| Product               | \$      | (482 ) | \$  | 1,212    | \$    | 730      |
| Services              |         | 1,328  |   | 182      |       | 1,510    |
| Total                 |         | 846    |   | 1,394    |       | 2,240    |
| % Increase            |         | 18     | %   | 14       | %     | 15       |

|                                    |    |    |    |    |    |    |
|------------------------------------|----|----|----|----|----|----|
| Change in Gross Margin percentage: |    |    |    |    |    |    |
| Product                            | 2  | %  | (1 | )% | (2 | )% |
| Services                           | (2 | )% | 3  | %  | 9  | %  |
| Total                              | 8  | %  | (1 | )% | —  | %  |

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Total cost of sales increased by \$9.4 million when comparing the year ended September 30, 2010 versus the year ended September 30, 2009, which is an increase of 14%. The increase in costs of sales was consistent overall with the increase in sales which also increased by 14% when comparing the year ended September 30, 2010 with the year ended September 30, 2009.

Cost of sales in the Systems segment decreased by approximately \$0.5 million comparing the current year versus the prior year despite the fact that sales in the systems segment increased by approximately \$0.3 million. This is due to two reasons. First, for the year ended September 30, 2010, substantially all of the product sales were manufactured hardware versus 3rd party parts that were resold for the year ended September 30, 2009. Manufactured products carry lower cost of sales as a percentage of selling price than do 3rd party parts. Secondly, royalty sales to Lockheed Martin for the year ended September 30, 2010 exceeded royalty sales for the year ended September 30, 2009 by approximately \$1.4 million. Royalty income has no cost of sales.

Cost of sales in the Service and System Integration segment increased by approximately \$9.9 million, which is a 15% increase in cost of sales when comparing the current year versus the prior year. This increase in cost of sales was due to the increase in Service and System Integration segment sales as described above, which also increased by 15%.

The overall gross margin was unchanged at 18% comparing the year ended September 30, 2010 to the same period of fiscal 2009. While the gross margin improvement from 59% to 67% in the Systems segment was driven by the higher mix of manufactured products and royalty revenues as described above, the gross margin in the Service and System Integration segment decrease from 14% to 13% when comparing fiscal 2009 to 2010, due to lower product gross margins as shown in the table above. The increase in gross margin in the Systems segment and the slightly lower gross margin in the Service and System Integration segment, combined to result in the overall gross margin being unchanged.

#### Engineering and Development Expenses

The following table details engineering and development expenses by operating segment for fiscal years ended September 30, 2010 and 2009:

|                                   | 2010    | % of<br>Total | 2009      | % of<br>Total | \$<br>Decrease | %<br>Decrease |
|-----------------------------------|---------|---------------|-----------|---------------|----------------|---------------|
| (Dollar amounts in thousands)     |         |               |           |               |                |               |
| By Operating Segment:             |         |               |           |               |                |               |
| Systems                           | \$1,953 | 100           | % \$1,970 | 100           | % \$(17 )      | (1 )%         |
| Service and System<br>Integration | —       | —             | % —       | —             | % —            | — %           |
| Total                             | \$1,953 | 100           | % \$1,970 | 100           | % \$(17 )      | (1 )%         |

Engineering and development expenses remained virtually unchanged, for the year ended September 30, 2010 compared to the same period of fiscal 2009.

#### Selling, General and Administrative

The following table details selling, general and administrative (“SG&A”) expense by operating segment for fiscal years ending September 30, 2010 and 2009:

|  | 2010 | % of<br>Total | 2009 | % of<br>Total | \$ Increase<br>(Decrease) | % Increase<br>(Decrease) |
|--|------|---------------|------|---------------|---------------------------|--------------------------|
|--|------|---------------|------|---------------|---------------------------|--------------------------|

(Dollar amounts in thousands)

## By Operating Segment:

|                                   |          |     |   |          |     |   |        |      |   |
|-----------------------------------|----------|-----|---|----------|-----|---|--------|------|---|
| Systems                           | \$3,919  | 28  | % | \$3,367  | 24  | % | \$552  | 16   | % |
| Service and System<br>Integration | 10,177   | 72  | % | 10,602   | 76  | % | (425 ) | (4 ) | % |
| Total                             | \$14,096 | 100 | % | \$13,969 | 100 | % | \$127  | 1    | % |

Total selling, general and administrative (“SG&A”) expenses increased by \$0.1 million, or 1%, for the year ended September 30, 2010 compared to the corresponding year of fiscal 2009. The Systems segment SG&A expense increased for the year ended September 30, 2010 versus the prior year by approximately \$0.6 million, due primarily to higher bonus expenses of approximately \$0.5 million, as a result of higher revenues and operating profits and higher retirement plan expense of approximately \$0.1million, due to a higher net pension benefit calculation. The Service and System Integration segment SG&A expense decreased for the year ended September 30, 2010 versus the prior year by approximately \$0.4 million, due primarily to lower salaries of approximately \$0.3 million due to headcount reductions and lower facilities expenses of approximately \$0.1 million, due to reduction in facilities and lower depreciation expense.

## Goodwill Impairment

The global economic downturn led to significant market volatility and a reduction in the Company's profitability in the second half of fiscal 2009. These changes to market and business conditions caused lower multiples and resulted in our lowering our projected forecast for 2010. The fair value of our Systems and Solutions reporting unit declined due to these deteriorating market and business conditions, which ultimately resulted in a \$3.9 million non-cash impairment charge to our goodwill as of September 30, 2009. This impairment charge of \$3.9 million was equal to the carrying value of the Company's goodwill prior to the impairment charge. There were no asset impairment charges for the year ended September 30, 2010.

## Other Income/Expenses

The following table details Other Income/(Expense) for fiscal years ended September 30, 2010 and 2009:

|                                      | 2010 | % of<br>Total | 2009   | % of<br>Total | \$ Increase<br>(Decrease) | % Increase<br>(Decrease) |
|--------------------------------------|------|---------------|--------|---------------|---------------------------|--------------------------|
| (Dollar amounts in thousands)        |      |               |        |               |                           |                          |
| Interest income                      | \$61 | 871           | \$225  | (833)         | \$(164)                   | (73)                     |
| Interest expense                     | (90) | (1,286)       | (112)  | 415           | 22                        | 20                       |
| Foreign exchange loss                | (1)  | (14)          | (104)  | 385           | 103                       | 99                       |
| Other income<br>(expense), net       | 37   | 529           | (36)   | 133           | 73                        | 203                      |
| Total other income<br>(expense), net | \$7  | 100           | \$(27) | 100           | \$34                      | 126                      |

Total other income (expense), net, changed from other, net expense of \$27 thousand to other net income of \$7 thousand, resulting in a favorable change of approximately \$34 thousand for the year of fiscal 2010 compared to the same year of fiscal 2009. This change was primarily due to a decrease in foreign exchange losses, which were greater in fiscal 2009 due to foreign exchange transaction losses which did not recur in fiscal 2010, and a favorable change in other, net of \$73 thousand in fiscal 2010 versus 2009. These favorable variances were offset by a decrease in interest income of \$164 thousand. Interest income in fiscal year 2010 was earned primarily on money market funds as opposed to auction rate securities ("ARS") which were held for a portion of fiscal 2009. The ARSs carried much higher interest rates than our money market funds. We divested our holdings in ARSs because of the preponderance of failed auctions in the ARS market.

## Income Taxes

For the year ended September 30, 2010, the Company recorded an income tax provision of \$0.2 million reflecting an effective income tax rate of 20% compared to an income tax benefit of \$1.2 million for the fiscal year ended September 30, 2009, which reflected an effective tax benefit rate of 24%. The effective tax rate for the year ended September 30, 2010, was impacted favorably by the de-recognition of a liability of approximately \$334 thousand for an unrecognized tax benefit, which the company had recorded pursuant to accounting principles regarding uncertain tax positions. This de-recognition was the result of the lapsing of the statute of limitations and the completion of an audit by the Internal Revenue Service, which did not result in any adjustment related to the uncertain tax position. The lower than statutory tax benefit rate for the fiscal year ended September 30, 2009 was due primarily to a valuation allowance established for a substantial portion of the deferred tax asset related to the goodwill impairment charge.

In assessing the realizability of deferred tax assets, we considered our taxable future earnings and the expected timing of the reversal of temporary differences. Accordingly, we have recorded a valuation allowance which reduces the gross deferred tax asset to an amount which we believe will more likely than not be realized. Our inability to project future profitability beyond fiscal year 2011 in the U.S. and cumulative losses incurred in recent years in the United Kingdom represent sufficient negative evidence to record a valuation allowance against certain deferred tax assets. We maintained a substantial valuation allowance against our United Kingdom deferred tax assets as we have experienced cumulative losses and do not have any indication that the operation will be profitable in the future to an extent that will allow us to utilize much of our net operating loss carryforwards. To the extent that actual experience deviates from our assumptions, our projections would be affected and hence our assessment of realizability of our deferred tax asset may change. Our German subsidiary has no valuation allowance recorded against their gross deferred tax assets since they have projected sufficient future income that we believe it is more likely than not to be realized.

#### Liquidity and Capital Resources

Our primary source of liquidity is our cash and cash equivalents, which decreased by approximately \$3.4 million to \$15.5 million as of September 30, 2010. This compares to \$18.9 million as of September 30, 2009. At September 30, 2010, the Company's cash equivalents of \$3.5 million were held in money market funds.



The significant uses of cash during the period were an increase in accounts receivable of approximately \$4.9 million, decrease in deferred taxes of approximately \$0.4 million, purchases of property and equipment of approximately \$0.5 million, re-purchase of the Company's common stock of approximately \$0.4 million and an unfavorable foreign exchange impact of \$0.6 million. Significant sources of cash included net income of \$0.9 million, an increase in deferred revenue of approximately \$1.1 million, a decrease in refundable income taxes of approximately \$0.4 million, an increase in income taxes payable of approximately \$0.4 million, depreciation and amortization expense of approximately \$0.5 million and equity plan compensation of \$0.2 million.

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

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

## 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 and intangibles, income taxes, deferred compensation, revenue recognition, retirement plans, restructuring costs 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.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements: revenue recognition; valuation allowances, specifically the allowance for doubtful accounts and net deferred tax asset valuation allowance; inventory valuation; goodwill and intangibles; and pension and retirement plans.

### Revenue recognition

The Company recognizes product revenue from customers at the time of transfer of title and risk of loss which is generally at the time of shipment, provided that persuasive evidence of an arrangement exists, the price is fixed or determinable and collectability of sales proceeds is reasonably assured. We include freight billed to our customers as sales and the related freight costs as cost of sales. The Company reduces revenue for estimated customer returns.

The Company recognizes revenue from software licenses when persuasive evidence of an arrangement exists, delivery of the product has occurred and the fee is fixed or determinable and collectability is probable. When delivery of services accompany software sales, and vendor specific objective evidence does not exist, and the only undelivered element is services that do not involve significant modification, or customization, of software, then the entire fee is recognized as the services are performed. If no pattern of performance is discernable, the fee is recognized straight line over the service period.

The Company also offers training, maintenance agreements and support services. The Company has established fair value on its training, maintenance and support services based on prices charged in separate sales to customers at prices established and published in its standard price lists. These prices are not discounted. Revenue from these service obligations under maintenance contracts is deferred and recognized on a straight-line basis over the contractual period, which is typically three to twelve months, if all other revenue recognition criteria have been met. Support services provided on a time and material basis are recognized as provided if all of the revenue recognition criteria have been met for that element and the support services have been provided. Training revenue is recognized when performed.

In certain multiple-element revenue arrangements, the Company is obligated to deliver to its customers multiple products and/or services (“multiple elements”). In these transactions, the Company allocates the total revenue to be earned under the arrangement among the various elements based on the Company’s best estimate of the standalone selling price. The allocation is based on vendor specific objective evidence, third party evidence or estimated selling price when that element is sold separately. The Company recognizes revenue related to the delivered products or services only if the above revenue recognition criteria are met and the delivered element has standalone value.

In October 2009, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2009-13 - “Multiple-Deliverable Revenue Arrangements—a Consensus of the FASB Emerging Issues Task Force” (“ASU

2009-13”) and ASU 2009-14 – “Certain Revenue Arrangements that Contain Software Elements.” (‘ASU 2009-14”). ASU 2009-13 amends existing revenue recognition accounting principles regarding multiple-deliverable revenue arrangements. The consensus provides accounting principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and how the consideration should be allocated. This guidance eliminates the requirement to establish verifiable, objective evidence of the fair value of undelivered products and services and also eliminates the residual method of allocating arrangement consideration. The new guidance provides for separate revenue recognition based upon management’s estimate of the selling price for an undelivered item when there is no other means to determine the fair value of that undelivered item. Under the previous guidance, if the fair value of all of the elements in the arrangement was not determinable, then revenue was deferred until all of the items were delivered or fair value was determined. This pronouncement is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted.

ASU 2009-14 removes the sale of tangible products containing software components and non-software components that function together to deliver the tangible product’s essential functionality from the scope of software revenue recognition guidance.

Adoption of the new revenue recognition guidance has had an impact on the pattern and timing of revenue recognition. In some cases, revenue that would have been deferred pursuant to the previously existing multiple-element revenue recognition guidance, has been recognized pursuant to the newly issued guidance. This is because in some cases we are not able to determine VSOE or third-party evidence of the service element in our arrangements. Under the new guidance, because the requirement to determine fair value of undelivered elements has been eliminated, and we may use estimated selling price to allocate revenue to elements in an arrangement, we are now more likely to be able to separate arrangements into separate units of accounting, and thereby recognize the delivered elements (typically product revenue) without having delivered the other elements in the arrangements (typically services). The impact of adopting this new accounting guidance on revenue for year ended September 30, 2010 was that \$3.5 million in additional revenue was recognized under the newly adopted guidance that wouldn't have been recognized had we not adopted the new standards. The impact of adopting this new accounting guidance on net income and EPS was an increase to net income of \$284 thousand for the year ended September 30, 2010, and an increase of \$0.08, to both basic and fully diluted earnings per share for the year ended September 30, 2010.

The Company has adopted these standards as of October 1, 2009.

#### Description of multiple-deliverable arrangements and Software Elements

In many cases, our multiple-deliverable arrangements involve initial shipment of hardware (including tangible products that include software and non-software elements), software products and subsequent delivery of services which add value to the products that have been shipped. In some instances, services are performed prior to product shipment, but more typically services are performed subsequent to shipment of the hardware products. The timing of the delivery and performance of deliverables may vary case-by-case. We evaluate whether we can determine vendor-specific objective evidence ("VSOE") or third-party evidence to allocate revenue among the various elements in an arrangement. When VSOE or third-party evidence cannot be determined, we use estimated selling prices to allocate revenue to the various elements. Estimated selling prices are determined using the targeted gross margin for each element and calculating the gross revenue for each element that would have been required to achieve the targeted gross margin, and allocating revenue to each element based on those relative values.

Typically, product revenue, which may consist of hardware (including tangible products that include software and non-software elements) and/or software elements, are recognized upon shipment, or when risk of loss passes to the customer. Services elements are typically recognized upon completion for fixed-price service arrangements, and as services are performed for time and materials service arrangements. For software elements that include services that do not involve significant production, modification or customization, and VSOE does not exist, the entire fee allocable to that element is recognized as the services are performed. If no pattern of performance is discernable, the fee is recognized straight line over the service period. The period over which services are delivered typically ranges from approximately sixty to ninety days, or longer in some cases.

For tangible products containing software components and non-software components, we determine whether these elements function together to deliver the tangible product essential functionality. If the software and non-software components of the tangible product function together to deliver the tangible product's essential functionality, software revenue recognition guidance is not applied, but rather other appropriate revenue recognition guidance as described above.

The following policies are applicable to the Company's major categories of segment revenue transactions:

#### Systems Segment Revenue

Revenue in the Systems Segment consists of product and service revenue. Generally, product revenue is recognized when product is shipped, provided that all revenue recognition criteria are met. Service revenue consists principally of royalty revenue related to the licensing of certain of the Company's proprietary system technology and repair services. The Company recognizes royalty revenues upon notification by the customer of shipment of the systems produced pursuant to the royalty agreement. Repair service revenue is generally based upon a fixed price and is recognized upon completion of the repair.

From time to time we enter into multiple element arrangements in the Systems Segment. We follow the accounting policies described above for such arrangements.

The Company's standard sales agreements generally do not include customer acceptance provisions. However, in certain instances when arrangements include a customer acceptance provision or there is uncertainty about customer acceptance, revenue is deferred until the Company has evidence of customer acceptance. Customers generally do not have the right of return, once customer acceptance has occurred.

#### Service and System Integration Segment Revenue

Revenue in the Service and System Integration Segment consists of product and service revenue.

Revenue from the sale of third-party hardware and third-party software is recognized when the revenue recognition criteria are met. The Company's standard sales agreements generally do not include customer acceptance provisions. However, in certain instances when arrangements include a customer acceptance provision or there is uncertainty about customer acceptance, revenue is deferred until the Company has evidence of customer acceptance. Customers do not have the right of return.

Service revenue is comprised of information technology consulting development, installation, implementation and maintenance services. We follow the accounting policies described above for service transactions. For arrangements that include a customer acceptance provision, or if there is uncertainty about customer acceptance of services rendered, revenue is deferred until the Company has evidence of customer acceptance.

For sales that are financed by customers through leases with a third party when risk of loss does not pass to the customer until the lease is executed, revenue is recognized upon cash receipt and execution of the lease.

We sell certain third party service contracts, which are evaluated to determine whether the sale of such service revenue should be recorded as gross sales or net sales in accordance with the sales recognition criteria as required by U.S. Generally Accepted Accounting Principles (“GAAP”). We must determine whether we act as a principal in the transaction and assume the risks and reward of ownership or if we are simply acting as an agent or broker. Under gross sales recognition, the entire selling price is recorded in sales and our cost to the third-party service provider or vendor is recorded in cost of goods sold. Under net sales recognition, the cost to the third-party service provider or vendor is recorded as a reduction to sales resulting in net sales equal to the gross profit on the transaction and there are no costs of goods sold. We use the gross sales recognition method for the third party service contracts that we sell, as we have determined that we act as a principal in these sales transactions.

#### Engineering and Development Expenses

Engineering and development expenses include payroll, employee benefits, stock-based compensation and other headcount-related expenses associated with product development. Engineering and development expenses also include third-party development and programming costs. We consider technological feasibility for our software products is reached upon the release of the software and, accordingly, no internal software development costs have been capitalized.

#### Product Warranty Accrual

Our product sales generally include a 90-day to one-year hardware warranty. At time of product shipment, we accrue for the estimated cost to repair or replace potentially defective products. Estimated warranty costs are based upon prior actual warranty costs for substantially similar products.

#### Income Taxes

We use the asset and liability method of accounting for income taxes whereby deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. We also reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods. This methodology requires estimates and judgments in the determination of the recoverability of deferred tax assets and in the calculation of certain tax liabilities. Valuation allowances are recorded against the gross deferred tax assets that management believes, after considering all available positive and negative objective evidence, historical and prospective, with greater weight given to historical evidence, that it is more likely than not that these assets will not be realized.



In addition, we are required to recognize in the consolidated financial statements, 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. Upon adoption of this standard on October 1, 2007, we were required to adjust our financial statements to reflect only those tax positions that are more-likely-than-not to be sustained. Any necessary adjustment was recorded directly to opening retained earnings in the period of adoption.

In addition, the calculation of the Company's tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions. The Company records liabilities for estimated tax obligations in the U.S. and other tax jurisdictions. These estimated tax liabilities include the provision for taxes that may become payable in the future.

#### Inventory

Inventories are stated at the lower of cost or market, with cost determined using the first-in, first-out method. The recoverability of inventories is based upon the types and levels of inventories held, forecasted demand, pricing, competition and changes in technology. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

#### Trade Accounts Receivable and Allowance for Doubtful Accounts

Trade accounts receivable are stated at amounts that have been billed to customers less an allowance for doubtful accounts. Allowances for doubtful accounts are recorded for the estimated losses resulting from the inability of our customers to make required payments. The estimates for allowance for doubtful accounts are based on the length of time the receivables are past due, current business environment and our historical experience. If the financial condition of our customers were to deteriorate, resulting in impairment of their ability to make payments, additional allowances may be required.

#### Goodwill and Intangible Assets

We test goodwill annually for impairment and more frequently if events and circumstances indicate that the asset might be impaired. We recognize impairment losses to the extent that the carrying amount of goodwill exceeds its fair value. The impairment determination is made at the reporting unit level and consists of two steps. First, the Company determines the fair value of the reporting unit and compares it to its carrying amount. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. The Company's policy is to perform its annual impairment testing for all reporting units as of the end of each fiscal year. For the year ended September 30, 2009, we recorded a goodwill impairment charge for approximately \$3.9 million. There was no impairment of goodwill for the year ended September 30, 2010. All goodwill was written off in the prior year.

Intangible assets other than goodwill that are not subject to amortization are also required to be tested annually, or more frequently if events or circumstances indicate that the asset may be impaired. We did not have intangible assets with indefinite lives other than goodwill at any time during the two years ended September 30, 2010. Intangible assets



subject to amortization are amortized over their estimated useful lives, generally three to ten years, and are carried at cost, less accumulated amortization. The remaining useful lives of intangible assets are evaluated on an annual basis. Intangible assets subject to amortization are also tested for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. If the fair value of an intangible asset subject to amortization is determined to be less than its carrying value, then an impairment charge is recorded to write down that asset to its fair value.

#### Pension and Retirement Plans

The funded status of pension and other postretirement benefit plans is recognized prospectively on the balance sheet. Gains and losses, prior service costs and credits and any remaining transition amounts that have not yet been recognized through pension expense will be recognized in accumulated other comprehensive income, net of tax, until they are amortized as a component of net periodic pension/postretirement benefits expense. Additionally, plan assets and obligations are measured as of our fiscal year-end balance sheet date (September 30).

We have defined benefit and defined contribution plans in the U.K., Germany and in the U.S. In the U.K. and Germany, the Company provides defined benefit pension plans for certain employees and former employees and defined contribution plans for the majority of the employees. The defined benefit plans in both the U.K. and Germany are closed to newly hired employees and have been for the two years ended September 30, 2010. In the U.S., the Company also provides defined contribution plans that cover most employees and supplementary retirement plans to certain employees and former employees who are now retired. These supplementary retirement plans are also closed to newly hired employees and have been for the two years ended September 30, 2010. These supplemental plans are funded through whole life insurance policies. The Company expects to recover all insurance premiums paid under these policies in the future, through the cash surrender value of the policies and any death benefits or portions thereof to be paid upon the death of the participant. These whole life insurance policies are carried on the balance sheet at their cash surrender values as they are owned by the Company and are not assets of the defined benefit plans. In the U.S., the Company also provides for officer death benefits and post-retirement health insurance benefits through supplemental post-retirement plans to certain officers. The Company also funds these supplemental plans' obligations through whole life insurance policies on the officers.

Pension expense is based on an actuarial computation of current future benefits using estimates for expected return on assets, expected compensation increases and applicable discount rates. Management has reviewed the discount rates with our consulting actuary and investment advisor and concluded they were reasonable. A decrease in the expected return on pension assets would increase pension expense. Expected compensation increases are estimated based on historical and expected increases in the future. Increases in estimated compensation increases would result in higher pension expense while decreases would lower pension expense. Discount rates are selected based upon rates of return on high quality fixed income investments currently available and expected to be available during the period to maturity of the pension benefit. A decrease in the discount rate would result in greater pension expense while an increase in the discount rate would decrease pension expense.

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 sheets.

In December 2008, the FASB issued new accounting guidance entitled, "Employers' Disclosures about Postretirement Benefit Plan Assets". The new guidance requires additional disclosures about plan assets for sponsors of defined benefit pension and postretirement plans including expanded information regarding investment strategies, major categories of plan assets, and concentrations of risk within plan assets. Additionally, this guidance requires disclosures similar to those required under the fair value accounting principles with respect to the fair value of plan assets such as the inputs and valuation techniques used to measure fair value and information with respect to classification of plan assets in terms of the hierarchy of the source of information used to determine their value. These disclosures are required for the period covered by this report and are included in Note 10.

#### Recent Accounting Pronouncements

In April 2010, the FASB codified the consensus reached in Emerging Issues Task Force Issue No. 08-09, "Milestone Method of Revenue Recognition." FASB ASU No. 2010-17 provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research and development transactions. FASB ASU No. 2010-17 is effective for fiscal years beginning on or after June 15, 2010 (Fiscal year ending September 30, 2011 for the Company), and is effective on a prospective basis for milestones achieved after the adoption date. The Company does not expect this ASU will have a material impact on its financial position or results of operations when it adopts this update on October 1, 2010.

Management does not anticipate that other recently issued accounting pronouncements will have a material impact on the Company's financial statements.

#### Inflation and Changing Prices

Management does not believe that inflation and changing prices had significant impact on sales, revenues or income (loss) during fiscal 2010 or 2009. There is no assurance that the Company's business will not be materially and adversely affected by inflation and changing prices in the future.

Item 8. Financial Statements and Supplementary Data

The consolidated financial statements are included herein.

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| Report of Independent Registered Public Accounting Firm   | 38   |
| Consolidated Balance Sheets as of September 30, 2010 and 2009   | 39   |
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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Controls and Procedures

**Disclosure Controls and Procedures.** The Company evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2010. Our chief executive officer, our chief financial officer and other members of our senior management team supervised and participated in this evaluation. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2010, the Company’s chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective.

**Management’s Report on Internal Control over Financial Reporting.** The Company’s management is responsible for establishing and maintaining adequate internal control over financial reporting. As defined in Rule 13a-15(f) under the Exchange Act, internal control over financial reporting is a process designed by or under the supervision of a company’s principal executive and principal financial officers and effected by a company’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. It includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of a company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of a company are being made only in accordance with authorizations of management and the board of directors of a company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company’s assets that could have a material effect on its financial statements.

Management has assessed the effectiveness of the Company’s internal control over financial reporting as of September 30, 2010. In making its assessment of internal control, management used the criteria described in “Internal Control—Integrated Framework” issued by the Committee of Sponsoring Organizations (“COSO”) of the Treadway Commission.

As a result of its assessment, management has concluded that the Company’s internal control over financial reporting was effective as of September 30, 2010.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

This Annual Report on Form 10-K does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's assessment of the effectiveness of the Company's internal control over financial reporting as of September 30, 2010 was not subject to attestation by the Company's independent registered public accounting firm pursuant to rules of the SEC that call for the Company to provide only management's report in this Annual Report on Form 10-K.

Changes in Internal Control over Financial Reporting.

During the quarter ended September 30, 2010, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting other than those discussed above.

Item 9B.

Other Information

None.

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## PART III

## Item 10. Directors, Executive Officers and Corporate Governance

We incorporate the information required by this item by reference to the sections captioned “Nominees for Election”, “Our Board of Directors”, “Our Executive Officers”, “Section 16(a) Beneficial Ownership Reporting Compliance” and “Corporate Governance” in our Schedule 14A Proxy Statement for our 2011 Annual Meeting of Stockholders, to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2010.

## Item 11. Executive Compensation

We incorporate the information required by this item by reference to the sections captioned “Compensation of Executive Officers” and “Compensation of Non-Employee Directors” in our Schedule 14A Proxy Statement for our 2011 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2010.

## Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

## Securities Authorized for Issuance Under Equity Compensation Plans.

The equity compensation plans approved by our stockholders consist of the CSP, Inc. 1991 Incentive Stock Option Plan, 1997 Incentive Stock Option Plan, 2003 Stock Incentive Plan, 2007 Stock Incentive Plan and 1997 Employee Stock Purchase Plan (the “ESPP”). The equity compensation plan not approved by our stockholders is a stock option plan for certain employees of Modcomp. Stock options issued under this plan were granted at the fair market value of our common stock on the date of grant, have a term of ten years and vest at the rate of 25% per year starting one year from the date of grant. In fiscal 2009 and 2010, the Company granted certain officers including its Chief Executive Officer and non-employee directors shares of non-vested common stock instead of stock options. The vesting periods for the officers’, the Chief Executive Officer’s and the directors’ non-vested stock awards are four years, three years and one year, respectively. The following table sets forth information as of September 30, 2010 regarding the total number of securities outstanding under these stock option and stock purchase plans.

| Plan Category  | (a)<br>Number of securities to be issued upon exercise of outstanding options, warrants and rights, and non-vested shares issued | (b)<br>Weighted-average exercise price of outstanding options, warrants and rights | (c)<br>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|--|--|--|--|
| Equity compensation plans approved by security holders     | (1)(2) 289,075   | \$ 7.67  | 191,954 (3)  |
| Equity compensation plans not approved by security holders | 40,000   | \$ 2.70  | —  |
| Total  | 329,075  | \$ 6.95  | 191,954  |



- 
- (1) Does not include purchase rights under the ESPP, as the purchase price and number of shares to be purchased under the ESPP are not determined until the end of the relevant purchase period.
  - (2) Includes 54,300 non-vested shares issued.
  - (3) Includes 167,950 shares available for future issuance under the incentive stock and stock option plans and 24,044 under the ESPP.

We incorporate additional information required by this Item by reference to the section captioned “Security Ownership of Certain Beneficial Owners and Management” in our Schedule 14A Proxy Statement for our 2011 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2010.

Item 13. Certain Relationships and Related Transactions and Director Independence

We incorporate the information required by this item by reference to the section captioned “Corporate Governance” in our Schedule 14A Proxy Statement for our 2011 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2010.

Item 14. Principal Accountant Fees and Services

We incorporate the information required by this item by reference to the section captioned “Fees for Professional Services” and “Pre-approval Policies and Procedures” in our Schedule 14A Proxy Statement for our 2011 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2010.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) (1) Financial statements filed as part of this report:

Consolidated Balance Sheets as of September 30, 2010 and 2009

Consolidated Statements of Operations for the years ended September 30, 2010 and 2009

Consolidated Statements of Shareholders' Equity and Comprehensive income (loss) for the years ended September 30, 2010 and 2009

Consolidated Statements of Cash Flows for the years ended September 30, 2010 and 2009

Notes to Consolidated Financial Statements

(2) Financial Statement Schedules

All other financial statements and schedules not listed have been omitted since the required information is included in the consolidated financial statements or the notes thereto included in Item 8, or is not applicable, material or required.

## (3) Exhibits

| Exhibit No. | Description   | Filed with Incorporated by Reference |         |                   | Exhibit No. |
|-------------|---|--------------------------------------|---------|-------------------|-------------|
|             |   | this Form 10-K                       | Form    | Filing Date       |             |
| 3.1         | Articles of Organization and amendments thereto   |                                      | 10-K    | December 26, 2007 | 3.1         |
| 3.2         | By-laws, as amended January 8, 1998   |                                      | 10-K    | December 26, 2007 | 3.2         |
| 10.1        | Form of Employee Invention and Non-Disclosure Agreement   |                                      | 10-K    | November 22, 1996 | 10.3        |
| 10.2        | CSPI Supplemental Retirement Income Plan  |                                      | 10-K    | December 29, 2008 | 10.2        |
| 10.4*       | 1991 Incentive Stock Option Plan  |                                      | 10-K    | December 29, 2008 | 10.4        |
| 10.5*       | Employment Agreement with Alexander R. Lupinetti dated September 12, 1996                                   |                                      | 10-K    | November 27, 1996 | 10.14       |
| 10.6*       | 1997 Incentive Stock Option Plan, as amended  |                                      | DEF 14A | December 1, 1997  | A           |
| 10.7*       | 1997 Employee Stock Purchase Plan   |                                      | DEF 14A | December 1, 1997  | B           |
| 10.8*       | 2003 Stock Incentive Plan   |                                      | DEF 14A | December 23, 2003 | B           |
| 10.9*       | 2007 Stock Incentive Plan   |                                      | DEF 14A | March 30, 2007    | B           |
| 10.10*      | 2011 Variable Compensation (Executive Bonus) and Base Programs dated November 9, 2010                       | X                                    |         |                   |             |
| 10.11*      | Form of Change of Control Agreement with Alexander R. Lupinetti dated January 11, 2008                      | X                                    |         |                   |             |
| 10.12*      | Form of Change of Control Agreement with Gary W. Levine and William E. Bent Jr. each dated January 11, 2008 |                                      |         |                   |             |
| 10.13*      | Form of Change of Control Agreement with Robert A. Stellato dated January 11, 2008                          | X                                    |         |                   |             |
| 10.14*      | Employment Agreement with Victor Dellovo dated April 11, 2003   | X                                    |         |                   |             |
| 21.1        | Subsidiaries  | X                                    |         |                   |             |
| 23.1        | Consent of McGladrey & Pullen, LLP, Independent Registered Public Accounting Firm                           | X                                    |         |                   |             |
| 31.1        |   | X                                    |         |                   |             |

Certification of Chief Executive Officer pursuant to  
Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer pursuant to X  
Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to X  
Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer pursuant to X  
Section 906 of the Sarbanes-Oxley Act of 2002

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\*Management contract or compensatory plan.

SIGNATURES

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

CSP INC.

Date: December 22, 2010

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

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

| Name   | Title  | Date              |
|--|--|-------------------|
| /s/ ALEXANDER R. LUPINETTI<br>Alexander R. Lupinetti | Chief Executive Officer,<br>President and Chairman       | December 22, 2010 |
| /s/ GARY W. LEVINE<br>Gary W. Levine                 | Chief Financial Officer<br>(Principal Financial Officer) | December 22, 2010 |
| /s/ ROBERT A. STELLATO<br>Robert A. Stellato         | Vice President of Finance<br>(Chief Accounting Officer)  | December 22, 2010 |
| /s/ J. DAVID LYONS<br>J. David Lyons                 | Director   | December 22, 2010 |
| /s/ C. SHELTON JAMES<br>C. Shelton James             | Director   | December 22, 2010 |
| /s/ ROBERT M. WILLIAMS<br>Robert M. Williams         | Director   | December 22, 2010 |
| /s/ CHRISTOPHER J. HALL<br>Christopher J. Hall       | Director   | December 22, 2010 |

CSP INC.

ANNUAL REPORT ON FORM 10-K

Item 8

Financial Statements

Years Ended September 30, 2010 and 2009

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
CSP Inc.

We have audited the accompanying consolidated balance sheets of CSP, Inc. and subsidiaries as of September 30, 2010 and 2009, and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss), and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of CSP, Inc. and subsidiaries as of September 30, 2010 and 2009, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statements, CSP, Inc. and subsidiaries has changed its method of recognizing certain revenues in 2010 due to the adoption of Accounting Standards Update ("ASU") 2009-13 – Multiple-Deliverable Revenue Arrangements-a Consensus of the FASB Emerging Issues Task Force and ASU 2009-14 – Certain Revenue Arrangements that Contain Software Elements.

/s/ McGladrey & Pullen, LLP

Boston, Massachusetts  
December 22, 2010



## CSP INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS  
(Amounts in thousands, except par value)

|   | September 30,<br>2010 | September 30,<br>2009 |
|---|-----------------------|-----------------------|
| <b>ASSETS</b>   |                       |                       |
| Current assets:   |                       |                       |
| Cash and cash equivalents   | \$ 15,531             | \$ 18,904             |
| Accounts receivable, net of allowance for doubtful accounts<br>of \$288 in 2010 and \$298 in 2009 | 12,190                | 7,410                 |
| Inventories   | 5,862                 | 5,935                 |
| Refundable income taxes   | 721                   | 1,160                 |
| Deferred income taxes   | 124                   | 633                   |
| Other current assets  | 1,523                 | 1,824                 |
| <b>Total current assets</b>   | <b>35,951</b>         | <b>35,866</b>         |
| Property, equipment and improvements, net   | 873                   | 832                   |
| Other assets:   |                       |                       |
| Intangibles, net  | 687                   | 800                   |
| Deferred income taxes   | 880                   | 275                   |
| Cash surrender value of life insurance  | 2,689                 | 2,460                 |
| Other assets  | 299                   | 253                   |
| <b>Total other assets</b>   | <b>4,555</b>          | <b>3,788</b>          |
| <b>Total assets</b>   | <b>\$ 41,379</b>      | <b>\$ 40,486</b>      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                       |                       |
| Current liabilities:  |                       |                       |
| Accounts payable and accrued expenses   | \$ 10,049             | \$ 10,530             |
| Deferred revenue  | 3,078                 | 2,059                 |
| Pension and retirement plans  | 441                   | 447                   |
| Deferred income taxes   | —                     | 96                    |
| Income taxes payable  | 380                   | 25                    |
| <b>Total current liabilities</b>  | <b>13,948</b>         | <b>13,157</b>         |
| Pension and retirement plans  | 8,928                 | 8,120                 |
| Deferred income taxes   | —                     | 146                   |
| Capital lease obligation  | 24                    | 48                    |
| Other long term liabilities   | —                     | 320                   |
| <b>Total liabilities</b>  | <b>22,900</b>         | <b>21,791</b>         |
| Commitments and contingencies   |                       |                       |
| Shareholders' equity:   |                       |                       |

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|   |                  |                  |
|---|------------------|------------------|
| Common stock, \$.01 par; authorized, 7,500 shares; issued and<br>outstanding 3,520 and 3,542 shares, respectively | 35               | 36               |
| Additional paid-in capital  | 11,280           | 11,325           |
| Retained earnings   | 12,516           | 11,602           |
| Accumulated other comprehensive loss  | (5,352 )         | (4,268 )         |
| <b>Total shareholders' equity</b>   | <b>18,479</b>    | <b>18,695</b>    |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 41,379</b> | <b>\$ 40,486</b> |

See accompanying notes to consolidated financial statements.

## CSP INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS  
(Amounts in thousands, except for per share data)

|  | Years ended September 30, |                   |
|--|---------------------------|-------------------|
|  | 2010                      | 2009              |
| <b>Sales:</b>  |                           |                   |
| Product  | \$78,743                  | \$67,237          |
| Services   | 16,275                    | 16,120            |
| <b>Total sales</b>   | <b>95,018</b>             | <b>83,357</b>     |
| <b>Cost of sales:</b>  |                           |                   |
| Product  | 67,385                    | 56,609            |
| Services   | 10,442                    | 11,797            |
| <b>Total cost of sales</b>                                   | <b>77,827</b>             | <b>68,406</b>     |
| <b>Gross profit</b>  | <b>17,191</b>             | <b>14,951</b>     |
| <b>Operating expenses:</b>                                   |                           |                   |
| Engineering and development                                  | 1,953                     | 1,970             |
| Selling, general and administrative                          | 14,096                    | 13,969            |
| Goodwill impairment  | —                         | 3,941             |
| <b>Total operating expenses</b>                              | <b>16,049</b>             | <b>19,880</b>     |
| <b>Operating income (loss)</b>                               | <b>1,142</b>              | <b>(4,929 )</b>   |
| <b>Other income (expense):</b>                               |                           |                   |
| Interest income  | 61                        | 225               |
| Interest expense   | (90 )                     | (112 )            |
| Foreign exchange loss  | (1 )                      | (104 )            |
| Other income (expense), net                                  | 37                        | (36 )             |
| <b>Total other income (expense), net</b>                     | <b>7</b>                  | <b>(27 )</b>      |
| <b>Income (loss) before income tax</b>                       | <b>1,149</b>              | <b>(4,956 )</b>   |
| <b>Income tax expense (benefit)</b>                          | <b>235</b>                | <b>(1,173 )</b>   |
| <b>Net income (loss)</b>                                     | <b>\$914</b>              | <b>\$(3,783 )</b> |
| <b>Net income (loss) attributable to common stockholders</b> | <b>\$905</b>              | <b>\$(3,765 )</b> |
| <b>Net income (loss) per share-basic</b>                     | <b>\$0.26</b>             | <b>\$(1.05 )</b>  |
| <b>Weighted average shares outstanding-basic</b>             | <b>3,538</b>              | <b>3,577</b>      |

|   |        |           |
|---|--------|-----------|
| Net income (loss) per share-diluted         | \$0.25 | \$(1.05 ) |
| Weighted average shares outstanding-diluted | 3,567  | 3,577     |

See accompanying notes to consolidated financial statements.

## CSP INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
AND COMPREHENSIVE INCOME (LOSS)

Years ended September 30, 2010 and 2009

(Amounts in thousands)

|   | Shares | Amount | Additional<br>paid-in<br>Capital | Retained<br>Earnings | Accum-<br>ulated<br>other<br>compre-<br>hensive<br>loss | Total<br>Share-<br>holders'<br>Equity | Compre-hensive<br>loss |
|---|--------|--------|----------------------------------|----------------------|---|---------------------------------------|------------------------|
| Balance September 30,<br>2008                               | 3,758  | \$ 38  | \$ 11,812                        | \$ 15,385            | \$ (3,287 )   | \$ 23,948                             |                        |
| Comprehensive loss:   |        |        |                                  |                      |   |                                       |                        |
| Net loss  | —      | —      | —                                | (3,783 )             | —   | (3,783 )                              | \$ (3,783 )            |
| Other comprehensive loss:                                   |        |        |                                  |                      |   |                                       |                        |
| Effect of foreign currency<br>translation                   | —      | —      | —                                | —                    | (302 )  | (302 )                                | (302 )                 |
| Increase in minimum<br>pension liability                    | —      | —      | —                                | —                    | (679 )  | (679 )                                | (679 )                 |
| Total comprehensive loss                                    |        |        |                                  |                      |   |                                       | \$ (4,764 )            |
| Stock-based compensation                                    | —      | —      | 243                              | —                    | —   | 243                                   |                        |
| Issuance of shares under<br>employee stock<br>purchase plan | 65     | 1      | 179                              | —                    | —   | 180                                   |                        |
| Restricted stock shares<br>issued                           | 23     | —      | 22                               | —                    | —   | 22                                    |                        |
| Purchase of common<br>stock                                 | (304 ) | (3 )   | (931 )                           | —                    | —   | (934 )                                |                        |
| Balance September 30,<br>2009                               | 3,542  | \$ 36  | \$ 11,325                        | \$ 11,602            | \$ (4,268 )   | \$ 18,695                             |                        |
| Comprehensive loss:   |        |        |                                  |                      |   |                                       |                        |
| Net income  | —      | —      | —                                | 914                  | —   | 914                                   | \$ 914                 |
| Other comprehensive loss:                                   |        |        |                                  |                      |   |                                       |                        |
| Effect of foreign currency<br>translation                   | —      | —      | —                                | —                    | (282 )  | (282 )                                | (282 )                 |
| Increase in minimum<br>pension liability                    | —      | —      | —                                | —                    | (802 )  | (802 )                                | (802 )                 |
| Total comprehensive loss                                    |        |        |                                  |                      |   |                                       | \$ (170 )              |
| Stock-based compensation                                    | —      | —      | 154                              | —                    | —   | 154                                   |                        |
| Issuance of shares under<br>employee stock                  | 42     | —      | 114                              | —                    | —   | 114                                   |                        |

| purchase plan                  |       |       |           |           |             |           |
|--------------------------------|-------|-------|-----------|-----------|-------------|-----------|
| Restricted stock shares issued | 31    | —     | 69        | —         | —           | 69        |
| Purchase of common stock       | (95 ) | (1 )  | (382 )    | —         | —           | (383 )    |
| Balance September 30, 2010     | 3,520 | \$ 35 | \$ 11,280 | \$ 12,516 | \$ (5,352 ) | \$ 18,479 |

See accompanying notes to consolidated financial statements.

## CSP INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Amounts in thousands)

|  | Years ended September 30, |                 |
|--|---------------------------|-----------------|
|  | 2010                      | 2009            |
| <b>Cash flows from operating activities:</b>   |                           |                 |
| Net income (loss)  | \$914                     | \$(3,783 )      |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                           |                 |
| Depreciation and amortization  | 399                       | 466             |
| Amortization of intangibles  | 113                       | 113             |
| Loss on disposal of property, net  | 12                        | 119             |
| Foreign exchange loss  | 1                         | 104             |
| Goodwill impairment charge   | —                         | 3,941           |
| Non-cash changes in accounts receivable  | (8 )                      | 127             |
| Deferred income taxes  | (360 )                    | (964 )          |
| Increase in cash surrender value life insurance  | (104 )                    | (86 )           |
| Stock based compensation expense   | 223                       | 265             |
| Changes in operating assets and liabilities:   |                           |                 |
| Decrease (increase) in accounts receivable   | (4,914 )                  | 3,863           |
| Decrease (increase) in inventories   | 58                        | 2,175           |
| Decrease (increase) in refundable income taxes   | 405                       | 534             |
| Decrease (increase) in other current assets  | 235                       | (458 )          |
| Decrease (increase) in other assets  | (45 )                     | 147             |
| Increase (decrease) in accounts payable and accrued expenses                                       | (183 )                    | (834 )          |
| Increase (decrease) in deferred revenue  | 1,108                     | (1,621 )        |
| Increase (decrease) in pension and retirement plans  | 230                       | (34 )           |
| Increase (decrease) in income taxes payable  | 350                       | (709 )          |
| Increase (decrease) in other liabilities   | (365 )                    | —               |
| <b>Net cash provided by (used in) operating activities</b>   | <b>(1,931 )</b>           | <b>3,365</b>    |
| <b>Cash flows from investing activities:</b>   |                           |                 |
| Purchases of investments   | (1,100 )                  | —               |
| Sale of investments  | 1,100                     | 5,000           |
| Life insurance premiums paid   | (124 )                    | (124 )          |
| Purchases of property, equipment and improvements  | (483 )                    | (402 )          |
| <b>Net cash provided by (used in) investing activities</b>   | <b>(607 )</b>             | <b>4,474</b>    |
| <b>Cash flows from financing activities:</b>   |                           |                 |
| Proceeds (payments) on short-term borrowings   | —                         | (1,501 )        |
| Proceeds from issuance of shares under employee stock purchase plan                                | 114                       | 180             |
| Purchase of common stock   | (383 )                    | (934 )          |
| <b>Net cash used in financing activities</b>   | <b>(269 )</b>             | <b>(2,255 )</b> |

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|  |           |   |           |   |
|--|-----------|---|-----------|---|
| Effects of exchange rate on cash                     | (566      | ) | (174      | ) |
| Net increase (decrease) in cash and cash equivalents | (3,373    | ) | 5,410     |   |
| Cash and cash equivalents, beginning of year         | 18,904    |   | 13,494    |   |
| Cash and cash equivalents, end of year               | \$ 15,531 |   | \$ 18,904 |   |
| Supplementary cash flow information:                 |           |   |           |   |
| Cash paid for income taxes                           | \$(535    | ) | \$(613    | ) |
| Cash paid for interest                               | \$(89     | ) | \$(105    | ) |

See accompanying notes to consolidated financial statements.



CSP INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
YEARS ENDED SEPTEMBER 30, 2010 and 2009

Organization and Business

CSP Inc. (“CSPI” or “the Company” or “we” or “our”) was founded in 1968 and is based in Billerica, Massachusetts. To meet the diverse requirements of its industrial, commercial 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. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant inter-company accounts and transactions have been eliminated.

Foreign Currency Translation

The U.S. Dollar is the reporting currency for all periods presented. The financial information for entities outside the United States is measured using the local currency as the functional currency. Assets and liabilities of the Company’s foreign operations are translated into U.S. dollars at the exchange rates in effect at the balance sheet date. Revenue and expenses are translated at average rates in effect during the period. The resulting translation adjustment is reflected as accumulated other comprehensive income (loss), a separate component of shareholders’ equity on the consolidated balance sheets. The translation adjustment for intercompany foreign currency loans that are of a long-term-investment nature is also reflected as accumulated other comprehensive income (loss). Currency transaction gains and losses are recorded as other income (expense) in the statements of operations.

Cash Equivalents

For purposes of the consolidated statement of cash flows, highly liquid investments with original maturities of three months or less at the time of acquisition are considered cash equivalents.

Fair Value Measurements

We follow current accounting standards for fair value measurements, which define fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date” and establish a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument’s categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. There are three levels of inputs that may be used to measure fair value:

Level 1

Level 1 applies to assets or liabilities for which there are quoted prices in active markets for identical assets or liabilities.

Level 2

Level 2 applies to assets or liabilities for which there are inputs other than quoted prices included within Level 1 that are observable for the asset or liability such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which significant inputs are observable or can be derived principally from, or corroborated by, observable market data.

Level 3

Level 3 applies to assets or liabilities for which there are unobservable inputs to the valuation methodology that are significant to the measurement of the fair value of the assets or liabilities.

## Investments

The Company classifies its investments at the time of purchase as either held-to-maturity or available-for-sale. Held-to-maturity securities are those investments that the Company has the ability and intent to hold until maturity. Held-to-maturity securities are recorded at cost, adjusted for the amortization of premiums and discounts, which approximates market value at the purchase date. Available-for-sale securities are recorded at fair value. Unrealized gains and losses net of the related tax effect, if any, on available-for-sale securities is reported in accumulated other comprehensive income (loss), a component of shareholders' equity, until realized. The fair value of available-for-sale investments are measured based on quoted market prices as of the end of the reporting period (ie., Level 1 inputs.)

Interest income is accrued as earned. Dividend income is recognized as income on the date the stock trades "ex-dividend." The cost of marketable securities sold is determined by the specific identification method and realized gains or losses are reflected in income.

## Impairment of Long-Lived Assets

The Company reviews its long-lived assets (other than goodwill) for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Management assesses the recoverability of the long-lived assets (other than goodwill) by comparing the estimated undiscounted cash flows associated with the related asset or group of assets against their respective carrying amounts. The amount of impairment, if any, is calculated based on the excess of the carrying amount over the fair value of those assets.

## Goodwill and Intangible Assets

We test goodwill annually for impairment and more frequently if events and circumstances indicate that the asset might be impaired. We recognize impairment losses to the extent that the carrying amount of goodwill exceeds its fair value. The impairment determination is made at the reporting unit level and consists of two steps. First, the Company determines the fair value of the reporting unit and compares it to its carrying amount. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. The Company's policy is to perform its annual impairment testing for all reporting units as of the end of each fiscal year. For the year ended September 30, 2009, we recorded a goodwill impairment charge for approximately \$3.9 million. There was no impairment of goodwill for the year ended September 30, 2010. All goodwill was written off in the prior year.

Intangible assets other than goodwill that are not subject to amortization are also required to be tested annually, or more frequently if events or circumstances indicate that the asset may be impaired. We did not have intangible assets with indefinite lives other than goodwill at any time during the two years ended September 30, 2010. Intangible assets subject to amortization are amortized over their estimated useful lives, generally three to ten years, and are carried at cost, less accumulated amortization. The remaining useful lives of intangible assets are evaluated on an annual basis. Intangible assets subject to amortization are also tested for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. If the fair value of an intangible asset subject to amortization is determined to be less than its carrying value, then an impairment charge is recorded to write down that asset to its fair value.

## Inventories

Inventories are stated at the lower of cost or market, with cost determined using the first-in, first-out method. The recoverability of inventories is based upon the types and levels of inventories held, forecasted demand, pricing, competition and changes in technology. We write down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

#### Property, Equipment and Improvements

The components of property, equipment and improvements are stated at cost. The Company provides for depreciation by use of the straight-line method over the estimated useful lives of the related assets (three to seven years). Leasehold improvements are amortized by use of the straight-line method over the lesser of the estimated useful life of the asset or the lease term. Repairs and maintenance costs are expensed as incurred. Property, equipment and improvements are tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. If the fair value of property, equipment and improvements is determined to be less than their carrying value, then an impairment charge is recorded to write down that asset to its fair value.

### Trade Accounts Receivable and Allowance for Doubtful Accounts

Trade accounts receivable are stated at amounts that have been billed to customers less an allowance for doubtful accounts. Allowances for doubtful accounts are recorded for the estimated losses resulting from the inability of our customers to make required payments. The estimates for allowance for doubtful accounts are based on the length of time the receivables are past due, current business environment and our historical experience. If the financial condition of our customers were to deteriorate, resulting in impairment of their ability to make payments, additional allowances may be required.

### Pension and Retirement Plans

The funded status of pension and other postretirement benefit plans is recognized prospectively on the balance sheet. Gains and losses, prior service costs and credits and any remaining transition amounts that have not yet been recognized through pension expense will be recognized in accumulated other comprehensive income, net of tax, until they are amortized as a component of net periodic pension/postretirement benefits expense. Additionally, plan assets and obligations are measured as of our fiscal year-end balance sheet date (September 30).

We have defined benefit and defined contribution plans in the United Kingdom (the "U.K."), Germany and in the U.S. In the U.K. and Germany, the Company provides defined benefit pension plans for certain employees and former employees and defined contribution plans for the majority of the employees. The defined benefit plans in both the U.K. and Germany are closed to newly hired employees and have been for the two years ended September 30, 2010. In the U.S., the Company also provides defined contribution plans that cover most employees and supplementary retirement plans to certain employees and former employees who are now retired. These supplementary retirement plans are also closed to newly hired employees and have been for the two years ended September 30, 2010. These supplemental plans are funded through whole life insurance policies. The Company expects to recover all insurance premiums paid under these policies in the future, through the cash surrender value of the policies and any death benefits or portions thereof to be paid upon the death of the participant. These whole life insurance policies are carried on the balance sheet at their cash surrender values as they are owned by the Company and not assets of the defined benefit plans. In the U.S., the Company also provides for officer death benefits and post-retirement health insurance benefits through supplemental post-retirement plans to certain officers. The Company also funds these supplemental plans' obligations through whole life insurance policies on the officers.

Pension expense is based on an actuarial computation of current future benefits using estimates for expected return on assets, expected compensation increases and applicable discount rates. Management has reviewed the discount rates with our consulting actuaries and investment advisor and concluded they were reasonable. A decrease in the expected return on pension assets would increase pension expense. Expected compensation increases are estimated based on historical and expected increases in the future. Increases in estimated compensation increases would result in higher pension expense while decreases would lower pension expense. Discount rates are selected based upon rates of return on high quality fixed income investments currently available and expected to be available during the period to maturity of the pension benefit. A decrease in the discount rate would result in greater pension expense while an increase in the discount rate would decrease pension expense.

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.

In December 2008, the FASB issued new accounting guidance entitled, "Employers' Disclosures about Postretirement Benefit Plan Assets". The new guidance requires additional disclosures about plan assets for sponsors of defined benefit pension and postretirement plans including expanded information regarding investment strategies, major

categories of plan assets, and concentrations of risk within plan assets. Additionally, this guidance requires disclosures similar to those required under the fair value accounting principles with respect to the fair value of plan assets such as the inputs and valuation techniques used to measure fair value and information with respect to classification of plan assets in terms of the hierarchy of the source of information used to determine their value. These disclosures are required for the period covered by this report and are included in Note 10.

#### Revenue Recognition

The Company recognizes product revenue from customers at the time of transfer of title and risk of loss which is generally at the time of shipment, provided that persuasive evidence of an arrangement exists, the price is fixed or determinable and collectability of sales proceeds is reasonably assured. We include freight billed to our customers as sales and the related freight costs as cost of sales. The Company reduces revenue for estimated customer returns.

The Company recognizes revenue from software licenses when persuasive evidence of an arrangement exists, delivery of the product has occurred and the fee is fixed or determinable and collectability is probable. When delivery of services accompany software sales, and vendor specific objective evidence does not exist, and the only undelivered element is services that do not involve significant modification, or customization, of software, then the entire fee is recognized as the services are performed. If no pattern of performance is discernable, the fee is recognized straight line over the service period.

The Company also offers training, maintenance agreements and support services. The Company has established fair value on its training, maintenance and support services based on prices charged in separate sales to customers at prices established and published in its standard price lists. These prices are not discounted. Revenue from these service obligations under maintenance contracts is deferred and recognized on a straight-line basis over the contractual period, which is typically three to twelve months, if all other revenue recognition criteria have been met. Support services provided on a time and material basis are recognized as provided if all of the revenue recognition criteria have been met for that element and the support services have been provided. Training revenue is recognized when performed.

In certain multiple-element revenue arrangements, the Company is obligated to deliver to its customers multiple products and/or services (“multiple elements”). In these transactions, the Company allocates the total revenue to be earned under the arrangement among the various elements based on the Company’s best estimate of the standalone selling price. The allocation is based on vendor specific objective evidence, third party evidence or estimated selling price when that element is sold separately. The Company recognizes revenue related to the delivered products or services only if the above revenue recognition criteria are met and the delivered element has standalone value.

In October 2009, the FASB issued Accounting Standards Update (“ASU”) 2009-13 - “Multiple-Deliverable Revenue Arrangements—a Consensus of the FASB Emerging Issues Task Force” (“ASU 2009-13”) and ASU 2009-14 – “Certain Revenue Arrangements that Contain Software Elements.” (“ASU 2009-14”). ASU 2009-13 amends existing revenue recognition accounting principles regarding multiple-deliverable revenue arrangements. The consensus provides accounting principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and how the consideration should be allocated. This guidance eliminates the requirement to establish verifiable, objective evidence of the fair value of undelivered products and services and also eliminates the residual method of allocating arrangement consideration. The new guidance provides for separate revenue recognition based upon management’s estimate of the selling price for an undelivered item when there is no other means to determine the fair value of that undelivered item. Under the previous guidance, if the fair value of all of the elements in the arrangement was not determinable, then revenue was deferred until all of the items were delivered or fair value was determined. This pronouncement is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted.

ASU 2009-14 removes the sale of tangible products containing software components and non-software components that function together to deliver the tangible product’s essential functionality from the scope of software revenue recognition guidance.

Adoption of the new revenue recognition guidance has had an impact on the pattern and timing of revenue recognition. In some cases, revenue that would have been deferred pursuant to the previously existing multiple-element revenue recognition guidance, has been recognized pursuant to the newly issued guidance. This is because in some cases we are not able to determine VSOE or third-party evidence of the service element in our arrangements. Under the new guidance, because the requirement to determine fair value of undelivered elements has been eliminated, and we may use estimated selling price to allocate revenue to elements in an arrangement, we are now more likely to be able to separate arrangements into separate units of accounting, and thereby recognize the delivered elements (typically product revenue) without having delivered the other elements in the arrangements (typically services). The impact of adopting this new accounting guidance on revenue for year ended September 30, 2010 was that \$3.5 million in additional revenue was recognized under the newly adopted guidance that wouldn’t have been recognized had we not adopted the new standards. The impact of adopting this new accounting guidance on net income and EPS was an increase to net income of \$284 thousand for the year ended September 30, 2010, and an increase of \$0.08, to both basic and fully diluted earnings per share for the year ended September 30, 2010.

The Company has adopted these standards as of October 1, 2009.

Description of multiple-deliverable arrangements and Software Elements

In many cases, our multiple-deliverable arrangements involve initial shipment of hardware (including tangible products that include software and non-software elements), software products and subsequent delivery of services which add value to the products that have been shipped. In some instances, services are performed prior to product shipment, but more typically services are performed subsequent to shipment of the hardware products. The timing of the delivery and performance of deliverables may vary case-by-case. We evaluate whether we can determine vendor-specific objective evidence (“VSOE”) or third-party evidence to allocate revenue among the various elements in an arrangement. When VSOE or third-party evidence cannot be determined, we use estimated selling prices to allocate revenue to the various elements. Estimated selling prices are determined using the targeted gross margin for each element and calculating the gross revenue for each element that would have been required to achieve the targeted gross margin, and allocating revenue to each element based on those relative values.

Typically, product revenue which may consist of hardware (including tangible products that include software and non-software elements) and/or software elements are recognized upon shipment, or when risk of loss passes to the customer. Services elements are typically recognized upon completion for fixed-price service arrangements, and as services are performed for time and materials service arrangements. For software elements that include services that do not involve significant production, modification or customization, and VSOE does not exist, the entire fee allocable to that element is recognized as the services are performed. If no pattern of performance is discernable, the fee is recognized straight line over the service period. The period over which services are delivered typically ranges from approximately sixty to ninety days, or longer in some cases.



For tangible products containing software components and non-software components, we determine whether these elements function together to deliver the tangible product essential functionality. If the software and non-software components of the tangible product function together to deliver the tangible product's essential functionality, software revenue recognition guidance is not applied, but rather other appropriate revenue recognition guidance as described above.

The following policies are applicable to the Company's major categories of segment revenue transactions:

#### Systems Segment Revenue

Revenue in the Systems Segment consists of product and service revenue. Generally, product revenue is recognized when product is shipped, provided that all revenue recognition criteria are met. Service revenue consists principally of royalty revenue related to the licensing of certain of the Company's proprietary system technology and repair services. The Company recognizes royalty revenues upon notification by the customer of shipment of the systems produced pursuant to the royalty agreement. Repair service revenue is generally based upon a fixed price and is recognized upon completion of the repair.

From time to time we enter into multiple element arrangements in the Systems Segment. We follow the accounting policies described above for such arrangements.

The Company's standard sales agreements generally do not include customer acceptance provisions. However, in certain instances when arrangements include a customer acceptance provision or there is uncertainty about customer acceptance, revenue is deferred until the Company has evidence of customer acceptance. Customers generally do not have the right of return, once customer acceptance has occurred.

#### Service and System Integration Segment Revenue

Revenue in the Service and System Integration Segment consists of product and service revenue.

Revenue from the sale of third-party hardware and third-party software is recognized when the revenue recognition criteria are met. The Company's standard sales agreements generally do not include customer acceptance provisions. However, in certain instances when arrangements include a customer acceptance provision or there is uncertainty about customer acceptance, revenue is deferred until the Company has evidence of customer acceptance. Customers do not have the right of return.

Service revenue is comprised of information technology consulting development, installation, implementation and maintenance services. We follow the accounting policies described above for service transactions. For arrangements that include a customer acceptance provision, or if there is uncertainty about customer acceptance of services rendered, revenue is deferred until the Company has evidence of customer acceptance.

For sales that are financed by customers through leases with a third party when risk of loss does not pass to the customer until the lease is executed, revenue is recognized upon cash receipt and execution of the lease.

We sell certain third party service contracts, which are evaluated to determine whether the sale of such service revenue should be recorded as gross sales or net sales in accordance with the sales recognition criteria as required by U.S. Generally Accepted Accounting Principles ("GAAP"). We must determine whether we act as a principal in the transaction and assume the risks and reward of ownership or if we are simply acting as an agent or broker. Under gross sales recognition, the entire selling price is recorded in sales and our cost to the third-party service provider or vendor is recorded in cost of goods sold. Under net sales recognition, the cost to the third-party service provider or

vendor is recorded as a reduction to sales resulting in net sales equal to the gross profit on the transaction and there are no costs of goods sold. We use the gross sales recognition method for the third party service contracts that we sell, as we have determined that we act as a principal in these sales transactions.

#### Product Warranty Accrual

Our product sales generally include a 90-day to one-year hardware warranty. At time of product shipment, we accrue for the estimated cost to repair or replace potentially defective products. Estimated warranty costs are based upon prior actual warranty costs for substantially similar products.

### Engineering and Development Expenses

Engineering and development expenses include payroll, employee benefits, stock-based compensation and other headcount-related expenses associated with product development. Engineering and development expenses also include third-party development and programming costs. We consider technological feasibility for our software products to be reached upon the release of the software, accordingly, no internal software development costs have been capitalized.

### Income Taxes

We use the asset and liability method of accounting for income taxes whereby deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. We also reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods. This methodology requires estimates and judgments in the determination of the recoverability of deferred tax assets and in the calculation of certain tax liabilities. Valuation allowances are recorded against the gross deferred tax assets that management believes, after considering all available positive and negative objective evidence, historical and prospective, with greater weight given to historical evidence, that it is more likely than not that these assets will not be realized.

In addition, we are required to recognize in the consolidated financial statements, 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.

In addition, the calculation of the Company's tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions. The Company records liabilities for estimated tax obligations in the U.S. and other tax jurisdictions. These estimated tax liabilities include the provision for taxes that may become payable in the future.

### Earnings per Share of Common Stock

In June 2008, the FASB issued new accounting guidance entitled, "Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities." Under the new guidance, non-vested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are participating securities and, therefore, are included in computing earnings per share ("EPS") pursuant to the two-class method. The two-class method determines EPS for each class of common stock and participating securities according to dividends or dividend equivalents and their respective participation rights in undistributed earnings. The new guidance is effective for fiscal years beginning after December 15, 2008 (fiscal year ending September 30, 2010 for the Company). The new disclosures required pursuant to this new guidance are included below.

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.

In accordance with new accounting guidance as described above, we are required to present EPS utilizing the two class method because we had outstanding, non-vested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents, which are considered participating securities.

Basic and diluted earnings (loss) per share computations for the Company's reported net income attributable to common stock holders are as follows:

|  | For the year ended                           |               |
|--|--|---------------|
|  | September                                    | September 30, |
|  | 30,  | 2009          |
|  | 2010   |               |
|  | (Amounts in thousands except per share data) |               |
| Net income (loss)  | \$914  | \$ (3,783 )   |
| Less: Net income attributable to nonvested common stock  | 9  | (18 )         |
| Net income (loss) attributable to common stockholders  | \$905  | \$ (3,765 )   |
| Weighted average shares outstanding – basic  | 3,574  | 3,594         |
| Less: weighted average non-vested shares outstanding   | 36   | 17            |
| Weighted average number of common shares outstanding – basic                                   | 3,538  | 3,577         |
| Potential common shares from non-vested stock awards and the assumed exercise of stock options | 29   | -             |
| Weighted average common shares outstanding – diluted   | 3,567  | 3,577         |
| Net income (loss) per share – basic  | \$0.26                                       | \$ (1.05 )    |
| Net income (loss) per share – diluted  | \$0.25                                       | \$ (1.05 )    |

For the year ended September 30, 2010, basic and diluted earnings per share attributable to unvested shares were \$0.26 and \$0.25 per share, respectively. For the year ended September 30, 2009, the loss per share attributable to unvested shares was \$1.05 per share.

All anti-dilutive securities, including stock options, are excluded from the diluted income per share computation. For the year ended September 30, 2010, 240 thousand options were excluded from the diluted income per share calculation because their inclusion would have been anti-dilutive. For the year ended September 30, 2009, approximately 348 thousand options were excluded from the diluted income per share calculation because their inclusion would have been anti-dilutive.

#### 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.

#### Stock-Based Compensation

We measure and recognize compensation expense for all stock-based payment awards made to employees and directors including stock options and nonvested shares of common stock based on estimated fair values of stock-based payment awards on the date of grant. The Company uses the Black-Scholes option-pricing model to calculate the fair value of stock option grants. The fair value of nonvested share awards is equal to the quoted market price of our common stock as quoted on the Nasdaq Global Market on the date of grant. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statement of Operations.

Because stock-based compensation expense recognized in the Consolidated Statements of Operations for the fiscal years ended September 30, 2010 and 2009 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures and will be revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Stock-based compensation expense recognized for the fiscal years ended September 30, 2010 and 2009 consisted of stock-based compensation expense related to options and nonvested stock granted pursuant to the Company's stock incentive and employee stock purchase plans of approximately \$223 thousand and \$265 thousand, respectively.

#### Concentrations of Credit Risk

Cash and cash equivalents are maintained with several financial institutions. Deposits held with banks may exceed the amount of insurance on such deposits. Generally, these deposits may be redeemed upon demand. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash and cash equivalents.

#### Subsequent Events

The Company recognizes in the consolidated financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the statement of financial position, including the estimates inherent in the process of preparing financial statements.

New Accounting Pronouncements

In April 2010, the FASB codified the consensus reached in Emerging Issues Task Force Issue No. 08-09, “Milestone Method of Revenue Recognition.” FASB ASU No. 2010-17 provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research and development transactions. FASB ASU No. 2010-17 is effective for fiscal years beginning on or after June 15, 2010 (Fiscal year ending September 30, 2011 for the Company), and is effective on a prospective basis for milestones achieved after the adoption date. The Company does not expect this ASU will have a material impact on its financial position or results of operations when it adopts this update on October 1, 2010.

Management does not anticipate other recently issued accounting pronouncements will have any impact on the Company's financial statements.

## 2. Inventories

Inventories consist of the following:

|                 | September 30,          |                |
|-----------------|------------------------|----------------|
|                 | 2010                   | 2009           |
|                 | (Amounts in thousands) |                |
| Raw materials   | \$ 1,029               | \$ 1,285       |
| Work-in-process | 439                    | 871            |
| Finished goods  | 4,394                  | 3,779          |
| <b>Total</b>    | <b>\$5,862</b>         | <b>\$5,935</b> |

Finished goods includes inventory that has been shipped, but for which all revenue recognition criteria has not been met of approximately \$2.4 million and \$1.4 as of September 30, 2010 and 2009, respectively.

Total inventory balances in the table above are shown net of reserves for obsolescence of approximately \$4.1 million and \$4.6 million as of September 30, 2010 and 2009, respectively.

## 3. Accumulated Other Comprehensive Loss

The components of Accumulated Other Comprehensive Loss are as follows:

|                                | Effect of<br>Foreign<br>Currency<br>Translation | Minimum<br>Pension<br>Liability | Accumulated<br>Other<br>Comprehensive<br>Loss |
|--------------------------------|---|---------------------------------|---|
|                                | (Amounts in thousands)                          |                                 |   |
| Balance September 30, 2008     | \$(1,549 )                                      | \$(1,738 )                      | \$ (3,287 )                                   |
| Change in period               | (302 )  | (711 )                          | (1,013 )                                      |
| Tax effect of change in period | —   | 32                              | 32  |
| Balance September 30, 2009     | \$(1,851 )                                      | \$(2,417 )                      | \$ (4,268 )                                   |
| Change in period               | (282 )  | (995 )                          | (1,277 )                                      |
| Tax effect of change in period | —   | 193                             | 193   |
| Balance September 30, 2010     | \$(2,133 )                                      | \$(3,219 )                      | \$ (5,352 )                                   |

The changes in the minimum pension liability are net of amortization of net (gain) loss of \$137 thousand in 2010 and \$(39) thousand in 2009 included in net periodic pension cost.

## 4. Income Taxes:

The components of income (loss) before income tax and income tax expense (benefit) are comprised of the following:

|   | Years Ended September 30, |            |
|---|---------------------------|------------|
|   | 2010                      | 2009       |
|   | (Amounts in thousands)    |            |
| <b>Income (loss) before income tax:</b> |                           |            |
| U.S.                                    | \$1,448                   | \$(4,197 ) |
| Foreign                                 | (299 )                    | (759 )     |
|   | \$1,149                   | \$(4,956 ) |
| <b>Income tax expense (benefit):</b>    |                           |            |
| <b>Current:</b>                         |                           |            |
| Federal                                 | \$410                     | \$28       |
| State                                   | 51                        | 31         |
| Foreign                                 | (158 )                    | (519 )     |
|   | 303                       | (460 )     |
| <b>Deferred:</b>                        |                           |            |
| Federal                                 | (59 )                     | (625 )     |
| State                                   | (9 )                      | (91 )      |
| Foreign                                 | --                        | 3          |
|   | (68 )                     | (713 )     |
|   | \$235                     | \$(1,173 ) |

Reconciliation of “expected” income tax expense (benefit) to “actual” income tax expense (benefit) is as follows:

|  | Years Ended September 30,     |             |          |                   |              |           |
|--|-------------------------------|-------------|----------|-------------------|--------------|-----------|
|  | 2010                          |             | 2009     |                   |              |           |
|  | (Dollar amounts in thousands) |             |          |                   |              |           |
| Computed “expected” tax expense (benefit)              | \$391                         | 34.0        | %        | \$(1,685 )        | (34.0        | )%        |
| <b>Increases (reductions) in taxes resulting from:</b> |                               |             |          |                   |              |           |
| State income taxes, net of federal tax benefit         | 28                            | 2.4         | %        | (40 )             | (0.8         | )%        |
| Foreign operations                                     | (57 )                         | (5.0        | )%       | (258 )            | (5.2         | )%        |
| Change in valuation allowance                          | 70                            | 6.1         | %        | 900               | 18.2         | %         |
| Permanent differences                                  | 4                             | 0.4         | %        | 19                | 0.4          | %         |
| Inventory  | --                            | --          |          | (76 )             | (1.5         | )%        |
| Stock-based compensation                               | 34                            | 3.0         | %        | 49                | 1.0          | %         |
| Federal net operating loss                             | --                            | --          |          | (106 )            | (2.1         | )%        |
| Uncertain tax liability adjustment                     | (320 )                        | (27.8       | )%       | 28                | 0.5          | %         |
| Tax refund adjustment                                  | 79                            | 6.9         | %        | --                | --           |           |
| Other items  | 6                             | 0.5         | %        | (4 )              | (0.2         | )%        |
| <b>Income tax expense (benefit)</b>                    | <b>\$235</b>                  | <b>20.5</b> | <b>%</b> | <b>\$(1,173 )</b> | <b>(23.7</b> | <b>)%</b> |



The Company recorded a consolidated income tax expense of \$235 thousand in fiscal year 2010 reflecting an effective tax rate of 20.5% compared to a tax benefit of \$1.2 million in fiscal year 2009 with an effective tax rate of (23.7)%. We utilized approximately \$359 thousand of our net operating loss carryovers which were applied against our 2009 U.S. taxable income.

For the years ended September 30, 2010 and 2009, temporary differences, which give rise to deferred tax assets (liabilities), are as follows:

|  | September 30,<br>2010  | September 30,<br>2009 |
|--|------------------------|-----------------------|
|  | (Amounts in thousands) |                       |
| <b>Deferred tax assets:</b>                        |                        |                       |
| Pension  | \$2,502                | \$ 2,199              |
| Goodwill   | 954                    | 1,052                 |
| Other reserves and accruals                        | 409                    | 273                   |
| Inventory reserves and other                       | 618                    | 519                   |
| State credits, net of federal benefit              | 485                    | 219                   |
| Federal and state net operating loss carryforwards | 132                    | 297                   |
| Foreign net operating loss carryforwards           | 2,874                  | 2,847                 |
| Foreign tax credits                                | 7                      | 44                    |
| Depreciation and amortization                      | 228                    | 203                   |
| Gross deferred tax assets                          | 8,209                  | 7,653                 |
| Less: valuation allowance                          | (7,205 )               | (6,745 )              |
| Realizable deferred tax asset                      | 1,004                  | 908                   |
| <b>Deferred tax liabilities:</b>                   |                        |                       |
| Pension  | —                      | (146 )                |
| Reserves   | —                      | (96 )                 |
| Gross deferred tax liabilities                     | —                      | (242 )                |
| Net deferred tax assets                            | \$1,004                | \$ 666                |

The deferred tax valuation allowance increased by \$460 thousand, from \$6.7 million at September 30, 2009, to \$7.2 million at September 30, 2010. In assessing the realizability of deferred tax assets, the Company considers its taxable future earnings and the expected timing of the reversal of temporary differences. Accordingly, the Company has recorded a valuation allowance which reduces the gross deferred tax asset to an amount which management believes will more likely than not be realized. The valuation allowance was determined, by assessing both positive and negative evidence, whether it is more likely than not that deferred tax assets are realizable. Such assessment is done on a jurisdiction-by-jurisdiction basis. The Company's inability to project future profitability beyond fiscal year 2012 in the U.S. and the cumulative losses incurred in recent years in the U.K. represent sufficient negative evidence to record a valuation allowance against certain deferred tax assets.

As of September 30, 2010 and 2009, the Company had U.S. net operating loss carryforwards for state tax purposes of approximately \$1.9 million and \$4.2 million, respectively which are available to offset future taxable income through 2028.

As of September 30, 2010, the Company had U.K. net operating loss carryforwards of approximately \$8.6 million that have an indefinite life with no expiration.

Undistributed earnings of the Company's foreign subsidiaries amounted to approximately \$3.7 million and \$3.1 million at September 30, 2010 and 2009, respectively. The Company's policy is that its undistributed foreign earnings are indefinitely reinvested and, accordingly, no U.S. federal and state deferred tax liabilities have been recorded.

In addition, the calculation of the Company's tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions. The Company records liabilities for estimated tax obligations in the U.S. and other tax jurisdictions. These estimated tax liabilities include the provision for taxes that may become payable in the future.

As of October 1, 2007, the total amount of uncertain tax liabilities was \$260 thousand, 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.

A reconciliation of the beginning and ending balances of the total amounts of gross unrecognized tax benefits is as follows:

|  | Year Ended<br>September 30,<br>2010 | Year Ended<br>September 30,<br>2009 |
|--|-------------------------------------|-------------------------------------|
|  | (Amounts in thousands)              |                                     |
| Balance, beginning of year                       | \$320                               | \$ 291                              |
| Increases in tax positions in the current year   | —                                   | —                                   |
| Settlements                                      | —                                   | —                                   |
| Accrued penalties and interest                   | 14                                  | 29                                  |
| Decrease in current and prior year tax positions | (334 )                              | —                                   |
| Balance, end of year                             | \$—                                 | \$ 320                              |

We file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. During 2010, the Company closed its most recent IRS audit. The Company has reviewed the tax positions taken on returns filed domestically and in its foreign jurisdictions for all open years, generally 2007 through 2010, and believes that tax adjustments in any audited year will not be material.

#### 5. Property, Equipment and Improvements, Net

Property, equipment and improvements, net consist of the following:

|  | September 30,<br>2010  | September 30,<br>2009 |
|--|------------------------|-----------------------|
|  | (Amounts in thousands) |                       |
| Leasehold improvements                         | \$305                  | \$ 300                |
| Equipment                                      | 6,993                  | 7,960                 |
| Automobiles                                    | 118                    | 84                    |
|  | 7,416                  | 8,344                 |
| Less accumulated depreciation and amortization | (6,543 )               | (7,512 )              |
| Property, equipment and improvements, net      | \$873                  | \$ 832                |

The Company uses the straight-line method over the estimated useful lives of the assets to record depreciation expense. Depreciation expense was \$399 thousand and \$466 thousand for the years ended September 30, 2010 and 2009, respectively.

#### 6. Goodwill and Other Intangible Assets

##### Goodwill

The following table summarizes our goodwill as of September 30, 2010 and 2009 and the changes thereto for the years ended September 30, 2010 and 2009:

|                                    | September 30,<br>2010  | September 30,<br>2009 |
|------------------------------------|------------------------|-----------------------|
|                                    | (Amounts in thousands) |                       |
| Goodwill balance beginning of year | \$—                    | \$ 3,941              |
| Impairment charge                  | —                      | (3,941 )              |

|                              |     |      |
|------------------------------|-----|------|
| Goodwill balance end of year | \$— | \$ — |
|------------------------------|-----|------|

The goodwill balance as of October 1, 2008 consisted of \$2.8 million recognized in connection with the purchase of certain assets of Technisource Hardware, Inc. (“Technisource”) on May 30, 2003 and approximately \$1.1 million recognized in connection with the purchase of substantially all the assets of R2 Technology Services, Inc. on September 25, 2008. The goodwill balance was within the Service and System Integration segment. The reporting unit for purposes of evaluating goodwill impairment was the Modcomp U.S. Systems and Solutions division.

As required by GAAP, we test goodwill for impairment annually and/or more frequently if events occur that indicate the impairment conditions may be present, to determine whether there has been an impairment to the fair value of our reporting unit that includes goodwill. The estimated fair value of the reporting unit with goodwill is based on a combination of discounted projected cash flows and observable market price-to-earnings multiples of relevant, comparable peer companies. Based upon the results of our appraisal and valuation activities in connection with our annual goodwill impairment test, we determined that the reporting unit's estimated fair value was below its carrying value. We then calculated the implied fair value of goodwill by determining the fair value of all the assets and liabilities of the reporting unit. As a result of this process, we determined that the fair value of goodwill was \$0 as of September 30, 2009. The carrying value of goodwill prior to any impairment charges was approximately \$3.9 million. Accordingly, we recorded an impairment charge of approximately \$3.9 million as shown in the table above, for the year ended September 30, 2009.

The global economic downturn led to significant market volatility and a reduction in the Company's profitability in the second half of fiscal 2009. These changes to market and business conditions caused lower multiples and resulted in our lowering our projected forecast for 2010. The fair value of our Systems and Solutions reporting unit declined due to these deteriorating market and business conditions, which ultimately resulted in a \$3.9 million non-cash impairment charge to our goodwill for the year ended September 30, 2009.

#### Intangible Assets

The Company acquired intangible assets in connection with the acquisition of R2 on September 25, 2008 (see Note 2). As of September 30, 2010 and 2009 intangible assets is as follows:

|                        | September 30, 2010   |        |                                       |        | September 30, 2009   |        |                                       |        |
|------------------------|--|--------|---------------------------------------|--------|--|--------|---------------------------------------|--------|
|                        | Weighted<br>Average<br>Remaining<br>Amortization<br>Period | Gross  | Accum-<br>ulated<br>Amor-<br>tization | Net    | Weighted<br>Average<br>Remaining<br>Amortization<br>Period | Gross  | Accum-<br>ulated<br>Amor-<br>tization | Net    |
| (Amounts in thousands) |  |        |                                       |        |  |        |                                       |        |
| Customer list          | 8 years  | \$ 820 | \$ 164                                | \$ 656 | 9 years  | \$ 820 | \$ 82                                 | \$ 738 |
| Non-Compete agreements | 1 year   | 93     | 62                                    | 31     | 2 years  | 93     | 31                                    | 62     |
| Total                  | 7.7 years  | \$ 913 | \$ 226                                | \$ 687 | 8.5 years  | \$ 913 | \$ 113                                | \$ 800 |

Amortization expense on these intangible assets was \$113 thousand and \$113 thousand for fiscal 2010 and 2009, respectively.

Annual amortization expense related to intangible assets for each of the following successive fiscal years is as follows:

| Fiscal year ending September 30: | (Amounts in<br>thousands) |
|----------------------------------|---------------------------|
| 2011                             | \$113                     |
| 2012                             | 82                        |
| 2013                             | 82                        |
| 2014                             | 82                        |
| 2015                             | 82                        |
| Thereafter                       | 246                       |

|       |       |
|-------|-------|
| Total | \$687 |
|-------|-------|

## 7. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consist of the following:

|   | September 30,          |          |
|---|------------------------|----------|
|   | 2010                   | 2009     |
|   | (Amounts in thousands) |          |
| Accounts payable                                    | \$6,349                | \$6,901  |
| Commissions   | 186                    | 128      |
| Compensation and fringe benefits                    | 1,827                  | 1,428    |
| Professional fees and shareholders' reporting costs | 513                    | 645      |
| Taxes, other than income                            | 633                    | 368      |
| Warranty  | 143                    | 157      |
| Current portion of capital lease                    | 55                     | 16       |
| Other   | 343                    | 887      |
|   | \$10,049               | \$10,530 |

## 8. Stock Options and Awards

In 1991, the Company adopted the 1991 Stock Option Plan (the “1991 Plan”), and authorized 332,750 shares of common stock to be reserved for issuance pursuant to the 1991 Plan. The 1991 Plan expired on October 23, 2001. In 1997, the Company adopted the 1997 Stock Option Plan (the “1997 Plan”), and authorized 199,650 shares of common stock to be reserved for issuance pursuant to the 1997 Plan. The 1997 plan expired in 2007. Because the 1991 Plan and the 1997 Plan have expired, no further awards will be issued under these plans. In 2003, the Company adopted the 2003 Stock Incentive Plan (the “2003 Plan”) and authorized 200,000 shares of common stock to be reserved for issuance pursuant to the 2003 Plan. As of September 30, 2010, there were 20,000 shares available to be granted under the 2003 Plan. In 2007, the Company adopted the 2007 Stock Incentive Plan (the “2007 Plan”) and authorized 250,000 shares of common stock to be reserved for issuance pursuant to the 2007 Plan. As of September 30, 2010, there were 147,950 shares available to be granted under the 2007 Plan. In 2003, the Company issued non-qualified stock options to non-officer employees hired as part of the Technisource acquisition. These options were granted at their fair value on the date of grant. These options vested over a period of four years and expire ten years from the date of grant. Under all of the stock incentive plans, both incentive stock options and non-qualified stock options may be granted to officers, key employees and other persons providing services to the Company. The 2003 Plan and 2007 Plan also provide for awards of nonvested shares of common stock. All of the Company’s stock incentive plans have a ten year life. The total number of available shares under all plans for future awards was 167,950 as of September 30, 2010.

Options issued under any of the stock option plans are not affected by termination of the plan. The Company issues stock options at their fair market value on the date of grant. Vesting of stock options granted pursuant to the Company’s stock incentive plans is determined by the Company’s compensation committee. Generally, options granted to employees vest over four years and expire ten years from the date of grant. Options granted to non-employee directors, have historically been cliff vesting after six months from the date of grant and expire three years from the date of grant. In fiscal 2009 and 2010, the Company granted certain officers including its Chief Executive Officer and non-employee directors shares of nonvested common stock instead of stock options. The vesting periods for the officers’, the Chief Executive Officer’s and the directors’ nonvested stock awards are four years, three years and one year, respectively.

We measure and recognize compensation expense for all stock-based payment awards made to employees and directors including employee stock options and awards of nonvested stock based on estimated fair values, as described in note 1. Stock-based compensation expense incurred and recognized for the years ended September 30, 2010 and 2009 related to stock options and nonvested stock granted to employees and non-employee directors under the Company’s stock incentive and employee stock purchase plans totaled approximately \$223 thousand and \$265 thousand, respectively. The classification of the cost of share-based compensation, in the statements of operations, is consistent with the nature of the services being rendered in exchange for the share based payment. The following table summarizes stock-based compensation expense in the Company’s consolidated statements of operations:

|                                     | Years ended            |                       |
|-------------------------------------|------------------------|-----------------------|
|                                     | September 30,<br>2010  | September 30,<br>2009 |
|                                     | (Amounts in thousands) |                       |
| Cost of sales                       | \$ 1                   | \$ 9                  |
| Engineering and development         | 28                     | 35                    |
| Selling, general and administrative | 194                    | 221                   |
| <b>Total</b>                        | <b>\$223</b>           | <b>\$ 265</b>         |



For the year ended September 30, 2010, the Company granted 2,250 share options to certain key employees, 21,000 nonvested shares to certain officers including the Chief Executive Officer and 10,000 nonvested shares to its non-employee directors. For the year ended September 30, 2009, the Company granted 12,250 share options to certain key employees, 13,300 nonvested shares to its Chief Executive Officer and 10,000 nonvested shares to its non-employee directors.

The Company measures the fair value of nonvested stock awards based upon the market price of its common stock as of the date of grant. The Company uses the Black-Scholes option-pricing model to value stock options. The Black-Scholes model requires the use of a number of assumptions including volatility of the Company's stock price, the weighted average risk-free interest rate and the weighted average expected life of the options, at the time of grant. Because the Company does not pay dividends, the dividend rate variable in the Black-Scholes model is zero. The table below summarizes the assumptions used to value these options:

|                          | Years ended           |                       |
|--------------------------|-----------------------|-----------------------|
|                          | September 30,<br>2010 | September 30,<br>2009 |
| Expected volatility      | 59 %                  | 57 %                  |
| Expected dividend yield  | —                     | —                     |
| Risk-free interest rate  | 2.72%-3.08 %          | 1.55%-1.73 %          |
| Expected term (in years) | 6.1-7.6               | 6.1-7.6               |

The volatility assumption is based on the historical weekly price data of the Company's stock over a period equivalent to the weighted average expected life of the Company's options. Management evaluated whether there were factors during those periods which would distort the volatility figures if used to estimate future volatility and concluded that there were no such factors.

The risk-free interest rate assumptions are based on U.S. Treasury rates determined at the date of option grant.

The expected terms of employee stock options represent weighted-average periods that the stock options are expected to remain outstanding. They are based upon the historical average of the actual terms that stock options were outstanding, or are expected to be outstanding. Management believes this historical data is representative of the expected term of options granted for the years ended September 30, 2010 and 2009.

As stock-based compensation expense recognized in the consolidated statements of operations is based on awards ultimately expected to vest, expense for grants beginning upon adoption on October 1, 2005 has been reduced for estimated forfeitures. Forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The forfeiture rates for the years ended September 30, 2010 and 2009 were based on actual forfeitures.

No cash was used to settle equity instruments granted under share-base payment arrangements in any of the years in the two-year period ended September 30, 2010.

The following tables provide summary data of stock option award activity:

|                                   | Number<br>of Shares | Weighted<br>average<br>exercise<br>price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|-----------------------------------|---------------------|--|---|---|
| Outstanding at September 30, 2008 | 437,682             | \$6.69                                   | —   | —   |
| Granted                           | 12,250              | \$2.99                                   | —   | —   |
| Expired                           | (78,970 )           | \$6.50                                   | —   | —   |
| Forfeited                         | —                   | —  | —   | —   |
| Exercised                         | —                   | —  | —   | —   |
| Outstanding at September 30, 2009 | 370,962             | \$6.61                                   | —   | —   |
| Granted                           | 2,250               | \$3.85                                   | —   | —   |
| Expired                           | (98,437 )           | \$5.61                                   | —   | —   |
| Forfeited                         | —                   | —  | —   | —   |
| Exercised                         | —                   | —  | —   | —   |

|   |         |        |            |       |
|---|---------|--------|------------|-------|
| Outstanding at September 30, 2010                 | 274,775 | \$6.95 | 4.92 Years | \$ 82 |
| Exercisable at September 30, 2010                 | 235,398 | \$7.14 | 4.47 Years | \$ 69 |
| Vested and expected to vest at September 30, 2010 | 274,775 | \$6.95 | 4.92 Years | \$ 82 |

The weighted average grant date fair value of share options granted during the years ended September 30, 2010 and 2009 was \$2.32 and \$1.71, respectively. The aggregate intrinsic value of stock options exercised during the years ended September 30, 2010 and 2009 was zero (there were no stock options exercised in fiscal 2010 and 2009).

The following table provides summary data of nonvested stock award activity:

|  | Number of<br>nonvested<br>shares | Weighted<br>Average<br>grant date<br>Fair<br>Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|--|----------------------------------|--|---|---|
| Nonvested shares outstanding at September 30, 2009 | 23,300                           | \$3.17   | —   | —   |
| Activity in 2010                                   |                                  |  |   |   |
| Granted  | 31,000                           | \$3.79   | —   | —   |
| Vested   | (14,434 )                        | \$3.28   | —   | —   |
| Forfeited  | —                                | —  | —   | —   |
| Nonvested shares outstanding at September 30, 2010 | 39,866                           | \$3.61   | 1.65 Years  | \$ 171  |
| Vested at September 30, 2010                       | 14,434                           | \$3.28   | 0.37 Years  | 62  |
| Vested and expected to vest at September 30, 2010  | 54,300                           | \$3.52   | 1.31 Years  | \$ 233  |

As of September 30, 2010 there was \$192 thousand of total unrecognized compensation cost related to nonvested share-based compensation arrangements (including share option and nonvested share awards) granted under the company's stock incentive plans. This cost is expected to be expensed over a weighted average period of approximately 1.66 years. The total fair value of shares vested during the years ended September 30, 2010 and 2009 was \$169 thousand and \$194 thousand, respectively.

#### 9. Stock Purchase Plan

In October 1997, the Board of Directors of the Company adopted an Employee Stock Purchase Plan (the "1997 Purchase Plan"), which was ratified by the shareholders. There are 332,750 shares of common stock reserved for issuance under the 1997 Purchase Plan. Under the 1997 Purchase Plan, the Company's employees may purchase shares of common stock at a price per share that is 85% of the lesser of the fair market value as of the beginning or end of semi-annual option periods. Compensation expense recorded for shares issued pursuant to the 1997 Purchase Plan for the years ended September 30, 2010 and 2009 was approximately \$46 thousand and \$75 thousand, respectively. For the years ended September 30, 2010 and 2009, 42,121 and 64,888 shares were issued pursuant to the 1997 Purchase Plan, respectively. Since inception of the plan, 308,746 shares have been issued and there are 24,004 shares available for future issuance under the 1997 Purchase Plan as of September 30, 2010.

#### 10. Pension and Retirement Plans

We have defined benefit and defined contribution plans in the U.K., Germany and in the U.S. In the U.K. and Germany, the Company provides defined benefit pension plans for certain employees and former employees and defined contribution plans for the majority of the employees. The defined benefit plans in both the U.K. and Germany are closed to newly hired employees and have been for the two years ended September 30, 2010. In the U.S., the Company also provides defined contribution plans that cover most employees and supplementary retirement plans to certain employees and former employees who are now retired. These supplementary retirement plans are also closed to newly hired employees and have been for the two years ended September 30, 2010. These supplemental plans are funded through whole life insurance policies. The Company expects to recover all insurance premiums paid under these policies in the future, through the cash surrender value of the policies and any death benefits or portions thereof to be paid upon the death of the participant. These whole life insurance policies are carried on the balance sheet at their cash surrender values as they are owned by the Company and not assets of the defined benefit plans. In the U.S., the Company also provides for officer death benefits and post-retirement health insurance benefits through

supplemental post-retirement plans to certain officers. The Company also funds these supplemental plans' obligations through whole life insurance policies on the officers.

#### Defined Benefit Plans

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

The German Plan does not have any assets and therefore all costs and benefits of the plan are funded annually with cash flow from operations.

The domestic supplemental retirement plans have life insurance policies which are not considered plan assets but were purchased by the Company as a vehicle to fund the costs of the plan. These insurance policies are included in the balance sheet at their cash surrender value, net of policy loans, aggregating \$1.8 million and \$1.7 million as of September 30, 2010 and 2009, respectively. The loans against the policies have been taken out by the Company to pay the premiums. The costs and benefit payments for these plans are paid through operating cash flows of the Company to the extent that they can not be funded through the use of the cash values in the insurance policies. The Company expects that the recorded value of the insurance policies will be sufficient to fund all of the Company's obligations under these plans.

## Assumptions:

The following table provides the weighted average actuarial assumptions used to determine the actuarial present value of projected benefit obligations at:

|                                 | Domestic<br>September 30, |        | International<br>September 30, |        |
|---------------------------------|---------------------------|--------|--------------------------------|--------|
|                                 | 2010                      | 2009   | 2010                           | 2009   |
| Discount rate:                  | 5.25                      | % 5.75 | % 4.66                         | % 5.63 |
| Expected return on plan assets: | —                         | % —    | % 6.20                         | % 6.20 |
| Rate of compensation increase:  | —                         | % —    | % 1.20                         | % 1.17 |

The following table provides the weighted average actuarial assumptions used to determine net periodic benefit cost for years ended:

|                                 | Domestic<br>September 30, |        | International<br>September 30, |        |
|---------------------------------|---------------------------|--------|--------------------------------|--------|
|                                 | 2010                      | 2009   | 2010                           | 2009   |
| Discount rate:                  | 5.75                      | % 7.50 | % 5.63                         | % 6.66 |
| Expected return on plan assets: | —                         | % —    | % 6.20                         | % 7.10 |
| Rate of compensation increase:  | —                         | % —    | % 1.17                         | % 1.62 |

For domestic plans, the discount rate was determined by comparison against the Citigroup Pension Discount Curve and Liability Index for AA rated corporate instruments with lives approximating the pension benefit. The Company monitors other indices to assure that the pension obligations are fairly reported on a consistent basis. The international discount rates were determined by comparison against country specific AA corporate indices, adjusted for duration of the obligation.

The periodic benefit cost and the actuarial present value of projected benefit obligations are based on actuarial assumptions that are reviewed on an annual basis. The Company revises these assumptions based on an annual evaluation of long-term trends, as well as market conditions that may have an impact on the cost of providing retirement benefits.

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

|  | Years Ended September 30 |               |               |               |               |               |
|--|--------------------------|---------------|---------------|---------------|---------------|---------------|
|  | Foreign                  | 2010<br>U.S.  | Total         | Foreign       | 2009<br>U.S.  | Total         |
| (amounts in thousands)   |                          |               |               |               |               |               |
| <b>Pension:</b>  |                          |               |               |               |               |               |
| Service cost   | \$ 58                    | \$ 9          | \$ 67         | \$ 54         | \$ 7          | \$ 61         |
| Interest cost  | 669                      | 116           | 785           | 689           | 147           | 836           |
| Expected return on plan assets   | (448 )                   | —             | (448 )        | (456 )        | —             | (456 )        |
| <b>Amortization of:</b>  |                          |               |               |               |               |               |
| Prior service gains  | —                        | —             | —             | —             | —             | —             |
| Amortization of net (gain)/loss  | 42                       | 30            | 72            | 9             | (30 )         | (21 )         |
| <b>Net periodic benefit cost</b>   | <b>\$ 321</b>            | <b>\$ 155</b> | <b>\$ 476</b> | <b>\$ 296</b> | <b>\$ 124</b> | <b>\$ 420</b> |
| <b>Post Retirement:</b>  |                          |               |               |               |               |               |
| Service cost   | \$ —                     | \$ 18         | \$ 18         | \$ —          | \$ 13         | \$ 13         |
| Interest cost  | —                        | 69            | 69            | —             | 66            | 66            |
| Expected return on plan assets   | —                        | —             | —             | —             | —             | —             |
| <b>Amortization of:</b>  |                          |               |               |               |               |               |
| Prior service costs/(gains)  | —                        | —             | —             | —             | —             | —             |
| Amortization of net (gain)/loss  | —                        | 65            | 65            | —             | (18 )         | (18 )         |
| <b>Net periodic benefit cost</b>   | <b>\$ —</b>              | <b>\$ 152</b> | <b>\$ 152</b> | <b>\$ —</b>   | <b>\$ 61</b>  | <b>\$ 61</b>  |
| <b>Pension:</b>  |                          |               |               |               |               |               |
| Increase in minimum liability included in other comprehensive income (loss)            | \$ 1,048                 | \$ 2          | \$ 1,050      | \$ 277        | \$ 182        | \$ 459        |
| <b>Post Retirement:</b>  |                          |               |               |               |               |               |
| Increase (decrease) in minimum liability included in other comprehensive income (loss) | —                        | (55 )         | (55 )         | —             | 252           | 252           |
| <b>Total:</b>  |                          |               |               |               |               |               |
| Increase (decrease) in minimum liability included in other comprehensive income (loss) | \$ 1,048                 | \$ (53 )      | \$ 995        | \$ 277        | \$ 434        | \$ 711        |

The following table presents an analysis of the changes in 2010 and 2009 of the benefit obligation, the plan assets and the funded status of the plans:

|   | Years Ended September 30 |              |             |             |              |             |
|---|--------------------------|--------------|-------------|-------------|--------------|-------------|
|   | Foreign                  | 2010<br>U.S. | Total       | Foreign     | 2009<br>U.S. | Total       |
| <b>Pension:</b>                                 |                          |              |             |             |              |             |
| Change in projected benefit obligation ("PBO")  |                          |              |             |             |              |             |
| Balance beginning of year                       | \$ 12,769                | \$ 2,011     | \$ 14,780   | \$ 12,371   | \$ 1,966     | \$ 14,337   |
| Service cost                                    | 58                       | 9            | 67          | 54          | 7            | 61          |
| Interest cost                                   | 669                      | 116          | 785         | 689         | 147          | 836         |
| Changes in actuarial assumptions                | 1,248                    | 32           | 1,280       | 854         | 151          | 1,005       |
| Foreign exchange impact                         | (357 )                   | —            | (357 )      | (808 )      | —            | (808 )      |
| Benefits paid                                   | (269 )                   | (273 )       | (542 )      | (391 )      | (260 )       | (651 )      |
| Projected benefit obligation at end of year     | \$ 14,118                | \$ 1,895     | \$ 16,013   | \$ 12,769   | \$ 2,011     | \$ 14,780   |
| Changes in fair value of plan assets:           |                          |              |             |             |              |             |
| Fair value of plan assets at beginning of year  | \$ 7,410                 | \$ —         | \$ 7,410    | \$ 7,444    | \$ —         | \$ 7,444    |
| Actual gain on plan assets                      | 606                      | —            | 606         | 796         | —            | 796         |
| Company contributions                           | 306                      | 273          | 579         | 289         | 260          | 549         |
| Foreign exchange impact                         | (117 )                   | —            | (117 )      | (729 )      | —            | (729 )      |
| Benefits paid                                   | (268 )                   | (273 )       | (541 )      | (390 )      | (260 )       | (650 )      |
| Fair value of plan assets at end of year        | \$ 7,937                 | \$ —         | \$ 7,937    | \$ 7,410    | \$ —         | \$ 7,410    |
| Funded status                                   | \$ (6,181 )              | \$ (1,895 )  | \$ (8,076 ) | \$ (5,359 ) | \$ (2,011 )  | \$ (7,370 ) |
| Unamortized net loss                            | —                        | —            | —           | —           | —            | —           |
| Net amount recognized                           | \$ (6,181 )              | \$ (1,895 )  | \$ (8,076 ) | \$ (5,359 ) | \$ (2,011 )  | \$ (7,370 ) |
| <b>Post Retirement:</b>                         |                          |              |             |             |              |             |
| Change in projected benefit obligation ("PBO"): |                          |              |             |             |              |             |
| Balance beginning of year                       | \$ —                     | \$ 1,197     | \$ 1,197    | \$ —        | \$ 885       | \$ 885      |
| Service cost                                    | —                        | 18           | 18          | —           | 13           | 13          |
| Interest cost                                   | —                        | 68           | 68          | —           | 66           | 66          |
| Changes in actuarial assumptions                | —                        | 10           | 10          | —           | 233          | 233         |
| Foreign exchange impact                         | —                        | —            | —           | —           | —            | —           |
| Benefits paid                                   | —                        | —            | —           | —           | —            | —           |



|  |      |             |             |      |             |             |
|--|------|-------------|-------------|------|-------------|-------------|
| Projected benefit obligation at end of year    | \$ — | \$ 1,293    | \$ 1,293    | \$ — | \$ 1,197    | \$ 1,197    |
| Changes in fair value of plan assets:          |      |             |             |      |             |             |
| Fair value of plan assets at beginning of year | —    | —           | —           | —    | —           | —           |
| Actual gain/(loss) on plan assets              | —    | —           | —           | —    | —           | —           |
| Company contributions                          | —    | —           | —           | —    | —           | —           |
| Foreign exchange impact                        | —    | —           | —           | —    | —           | —           |
| Benefits paid from plan assets                 | —    | —           | —           | —    | —           | —           |
| Fair value of plan assets at end of year       | \$ — | \$ —        | \$ —        | \$ — | \$ —        | \$ —        |
| Funded status                                  | \$ — | \$ (1,293 ) | \$ (1,293 ) | \$ — | \$ (1,197 ) | \$ (1,197 ) |
| Unamortized net loss                           | —    | —           | —           | —    | —           | —           |
| Net amount recognized                          | \$ — | \$ (1,293 ) | \$ (1,293 ) | \$ — | \$ (1,197 ) | \$ (1,197 ) |

The amounts recognized in the consolidated balance sheet consist of:

|   | Years Ended September 30 |              |              |              |              |              |
|---|--------------------------|--------------|--------------|--------------|--------------|--------------|
|   | Foreign                  | 2010<br>U.S. | Total        | Foreign      | 2009<br>U.S. | Total        |
| <b>Pension:</b>                           |                          |              |              |              |              |              |
| Accrued benefit liability                 | \$ (6,181 )              | \$ (1,895 )  | \$ (8,076 )  | \$ (5,359 )  | \$ (2,011 )  | \$ (7,370 )  |
| Deferred tax                              | 48                       | —            | 48           | (145 )       | —            | (145 )       |
| Accumulated other comprehensive income    | 2,985                    | 92           | 3,077        | 2,131        | 90           | 2,221        |
| Net amount recognized                     | \$ (3,148 )              | \$ (1,803 )  | \$ (4,951 )  | \$ (3,373 )  | \$ (1,921 )  | \$ (5,294 )  |
| <b>Post Retirement:</b>                   |                          |              |              |              |              |              |
| Accrued benefit liability                 | \$ —                     | \$ (1,293 )  | \$ (1,293 )  | \$ —         | \$ (1,197 )  | \$ (1,197 )  |
| Deferred tax                              | —                        | —            | —            | —            | —            | —            |
| Accumulated other comprehensive income    | —                        | 142          | 142          | —            | 196          | 196          |
| Net amount recognized                     | \$ —                     | \$ (1,151 )  | \$ (1,151 )  | \$ —         | \$ (1,001 )  | \$ (1,001 )  |
| <b>Total pension and post retirement:</b> |                          |              |              |              |              |              |
| Accrued benefit liability                 | \$ (6,181 )              | \$ (3,188 )  | \$ (9,369 )  | \$ (5,359 )  | \$ (3,208 )  | \$ (8,567 )  |
| Deferred tax                              | 48                       | —            | 48           | (145 )       | —            | (145 )       |
| Accumulated other comprehensive income    | 2,985                    | 234          | 3,219        | 2,131        | 286          | 2,417        |
| Net amount recognized                     | \$ (3,148 )              | \$ (2,954 )  | \$ (6,102 )  | \$ (3,373 )  | \$ (2,922 )  | \$ (6,295 )  |
| <b>Accumulated Benefit Obligation:</b>    |                          |              |              |              |              |              |
| Pension                                   | \$ (14,006 )             | \$ (1,895 )  | \$ (15,901 ) | \$ (12,677 ) | \$ (2,011 )  | \$ (14,688 ) |
| Post Retirement                           | —                        | (1,293 )     | (1,293 )     | —            | (1,197 )     | (1,197 )     |
| Total accumulated benefit obligation      | \$ (14,006 )             | \$ (3,188 )  | \$ (17,194 ) | \$ (12,677 ) | \$ (3,208 )  | \$ (15,885 ) |

Plans with projected benefit obligations in excess of plan assets are attributable to unfunded domestic supplemental retirement plans, our German plans which are legally not required to be funded and our U.K. retirement plan.

Accrued benefit liability reported as:

|                                      | September 30, |       |
|--------------------------------------|---------------|-------|
|                                      | 2010          | 2009  |
| <b>(Amounts in thousands)</b>        |               |       |
| Current accrued benefit liability    | \$441         | \$447 |
| Noncurrent accrued benefit liability | 8,928         | 8,120 |

|                                 |         |         |
|---------------------------------|---------|---------|
| Total accrued benefit liability | \$9,369 | \$8,567 |
|---------------------------------|---------|---------|

As of September 30, 2010 and 2009 the amounts included in accumulated other comprehensive income, consisted of deferred net losses totaling approximately \$3.2 million and \$2.4 million, respectively.

The amount of net deferred loss expected to be recognized as a component of net periodic benefit cost for the year ending September 30, 2011, is approximately \$146 thousand.

#### Contributions

The Company expects to contribute \$441 thousand to its pension plans for fiscal 2011.

#### Estimated Future Benefit Payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (amounts in thousands):

| Fiscal year ending September 30: | (Amounts in thousands) |
|----------------------------------|------------------------|
| 2011                             | \$572                  |
| 2012                             | 643                    |
| 2013                             | 647                    |
| 2014                             | 754                    |
| 2015                             | 797                    |
| Thereafter                       | 4,384                  |

## Plan Assets

At September 30, 2010, our pension plan in the U.K. was the only plan with assets, holding investments of approximately \$7.9 million. Pension plan assets are managed by a fiduciary committee. The Company's investment strategy for pension plan assets is to maximize the long-term rate of return on plan assets within an acceptable level of risk while maintaining adequate funding levels. Local regulations, local funding rules, and local financial and tax considerations are part of the funding and investment process. In deciding on the investments to be held, the trustees take into account the risk of possible fluctuations in income from, and market values of, the assets as well as the risk of departing from an asset profile which broadly matches the liability profile. The committee has invested the plan assets in a single pooled fund with an authorized investment company. The fund selected by the trustees is consistent with the plan's overall investment principles and strategy described herein. There are no specific targets as to asset allocation other than those contained within the pooled fund that is managed by the authorized investment company.

The fair value of the assets held by the UK pension plan, by asset category, are as follows:

| (Thousands)<br>Asset Category | Fair Value at<br>September<br>30, 2010 | Fair Value Measurements Using Inputs<br>Considered as |          |           |
|-------------------------------|--|---|----------|-----------|
|                               |  | Level I   | Level II | Level III |
| Cash on deposit               | \$389                                  | \$389   | \$—      | —         |
| Pooled Funds                  | 7,548                                  | —   | 7,548    | —         |
| Total Plan Assets             | \$7,937                                | \$389   | \$7,548  | —         |

The expected long-term rates of return on plan assets are equal to the yields to maturity of appropriate indices for government and corporate bonds and by adding a premium to the government bond return for equities. The expected rate of return on cash is the Bank of England base rate in force at the effective date.

## Defined Contribution Plans

The Company has defined contribution plans in domestic and international locations under which the Company matches a portion of the employee's contributions and may make discretionary contributions to the plans. The Company's contributions were \$141 thousand and \$178 thousand for the years ended September 30, 2010 and 2009, respectively.

## 11. Lines of Credit

As of September 30, 2010 and September 30, 2009, the Company maintained lines of credit notes that allow for borrowings of up to \$2.5 million. Availability under these facilities is reduced by outstanding borrowings thereunder. The interest rates on outstanding borrowings range from 2.5% over the London Inter-Bank Offer Rate ("LIBOR") with a floor of 4% to Prime plus 1%. Borrowings under the credit agreements are required to be repaid on demand by the lender in some cases, upon termination of the agreements or may be prepaid by the Company without penalty. The credit agreements contain various covenants including financial covenants which require the Company to maintain various financial ratios at prescribed levels. The Company is in compliance with all covenants as of September 30, 2010.

The Company had no borrowings outstanding under its lines of credit as of September 30, 2010 and September 30, 2009.

## 12. Commitments and Contingencies

### Leases

The Company occupies office space under lease agreements expiring at various dates during the next five years. The leases are classified as operating leases and provide for the payment of real estate taxes, insurance, utilities and maintenance.

The Company was obligated under non-cancelable operating leases as follows:

| Fiscal year ending September 30: | (Amounts<br>in thousands) |
|----------------------------------|---------------------------|
| 2011                             | 1,020                     |
| 2012                             | 698                       |
| 2013                             | 562                       |
| 2014                             | 497                       |
| 2015                             | 219                       |
| Thereafter                       | 9                         |
|                                  | \$ 3,005                  |

Occupancy expenses under the operating leases approximated \$1.4 million in 2010 and \$1.6 million in 2009.

### Common Stock Repurchase

On February 3, 2009, the Board of Directors authorized the Company to purchase up to 350 thousand additional shares of the Company's outstanding common stock at market price. Pursuant to the aforementioned authorization and an authorization by our board of directors on November 13, 2007 to purchase 250 thousand shares, the Company repurchased approximately 95 thousand shares of its outstanding common stock during the year ended September 30, 2010. As of September 30, 2010, approximately 145 thousand shares remain authorized to repurchase under its stock repurchase program.

### 13. Segment and Geographical Information

The following table presents certain operating segment information.

| Years Ended September 30,     | Systems Segment | Service and System Integration Segment |              |               |               | Consolidated Total |
|-------------------------------|-----------------|--|--------------|---------------|---------------|--------------------|
|                               |                 | Germany                                | UK           | US            | Total         |                    |
| (Amounts in thousands)        |                 |  |              |               |               |                    |
| <b>2010</b>                   |                 |  |              |               |               |                    |
| Sales:                        |                 |  |              |               |               |                    |
| Product                       | \$ 4,888        | \$ 15,369                              | \$ 50        | \$ 58,436     | \$ 73,855     | \$ 78,743          |
| Service                       | 3,423           | 8,582                                  | 1,585        | 2,685         | 12,852        | 16,275             |
| <b>Total sales</b>            | <b>8,311</b>    | <b>23,951</b>                          | <b>1,635</b> | <b>61,121</b> | <b>86,707</b> | <b>95,018</b>      |
| Profit (loss) from operations | (316 )          | (153 )                                 | (81 )        | 1,692         | 1,458         | 1,142              |
| Assets                        | 13,400          | 11,565                                 | 3,667        | 12,747        | 27,979        | 41,379             |
| Capital expenditures          | 78              | 260                                    | 30           | 115           | 405           | 483                |
| Depreciation and amortization | 114             | 171                                    | 27           | 200           | 398           | 512                |
| <b>2009</b>                   |                 |  |              |               |               |                    |
| Sales:                        |                 |  |              |               |               |                    |
| Product                       | \$ 6,055        | \$ 15,588                              | \$ 153       | \$ 45,441     | \$ 61,182     | \$ 67,237          |
| Service                       | 1,932           | 9,339                                  | 2,048        | 2,801         | 14,188        | 16,120             |
| <b>Total sales</b>            | <b>7,987</b>    | <b>24,927</b>                          | <b>2,201</b> | <b>48,242</b> | <b>75,370</b> | <b>83,357</b>      |
| Profit (loss) from operations | (684 )          | (728 )                                 | 112          | (3,629 )      | (4,245 )      | (4,929 )           |
| Assets                        | 13,564          | 11,953                                 | 4,163        | 10,806        | 26,922        | 40,486             |
| Capital expenditures          | 61              | 249                                    | 13           | 79            | 341           | 402                |
| Depreciation and amortization | 182             | 124                                    | 27           | 246           | 397           | 579                |

Profit (loss) from operations is sales less cost of sales, engineering and development, 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 interest income/expense and foreign exchange gain/loss.

All intercompany transactions have been eliminated.



The following table details the Company's sales by operating segment for fiscal years September 30, 2010 and 2009. The Company's sales by geographic area based on the location of where the products were shipped or services rendered are as follows:

| 2010                           | Americas        | Europe          | Asia           | Total           | % of Total |          |
|--------------------------------|-----------------|-----------------|----------------|-----------------|------------|----------|
| (Amounts in thousands)         |                 |                 |                |                 |            |          |
| Systems                        | \$7,239         | \$—             | \$1,072        | \$8,311         | 9          | %        |
| Service and System Integration | 60,555          | 26,118          | 34             | 86,707          | 91         | %        |
| <b>Total</b>                   | <b>\$67,794</b> | <b>\$26,118</b> | <b>\$1,106</b> | <b>\$95,018</b> | <b>100</b> | <b>%</b> |
| % of Total                     | 71              | % 28            | % 1            | % 100           | %          |          |
|                                |                 |                 |                |                 |            |          |
| 2009                           | Americas        | Europe          | Asia           | Total           | % of Total |          |
| (Amounts in thousands)         |                 |                 |                |                 |            |          |
| Systems                        | \$5,799         | \$—             | \$2,188        | \$7,987         | 10         | %        |
| Service and System Integration | 47,949          | 27,387          | 34             | 75,370          | 90         | %        |
| <b>Total</b>                   | <b>\$53,748</b> | <b>\$27,387</b> | <b>\$2,222</b> | <b>\$83,357</b> | <b>100</b> | <b>%</b> |
| % of Total                     | 64              | % 33            | % 3            | % 100           | %          |          |

Substantially all Americas amounts are United States.



Long-lived assets by geographic location at September 30, 2010 and 2009 were as follows:

|               | September 30,<br>2010  | September 30,<br>2009 |
|---------------|------------------------|-----------------------|
|               | (Amounts in thousands) |                       |
| North America | \$985                  | \$ 1,116              |
| Europe        | 575                    | 516                   |
| Totals        | \$1,560                | \$ 1,632              |

Deferred tax assets by geographic location at September 30, 2010 and 2009 were as follows:

|               | September 30,<br>2010  | September 30,<br>2009 |
|---------------|------------------------|-----------------------|
|               | (Amounts in thousands) |                       |
| North America | \$377                  | \$ 400                |
| Europe        | 627                    | 508                   |
| Totals        | \$1,004                | \$ 908                |

The Company had one customer from which we derived revenues in excess of 10% of total revenues for the years ended September 30, 2010 and 2009, listed below.

|       | Years Ended                   |                    |         |                  |
|-------|-------------------------------|--------------------|---------|------------------|
|       | September 30, 2010            | September 30, 2009 |         |                  |
|       | Amount                        | % of<br>Revenues   | Amount  | % of<br>Revenues |
|       | (Dollar amounts in thousands) |                    |         |                  |
| Verio | \$22.5                        | 24                 | % \$8.1 | 10               |

#### 14. Restructuring Expense

In connection with reductions in workforce in the German and U.K. divisions of Modcomp, the Company accrued a restructuring charge of approximately \$268 thousand in the fourth quarter of fiscal 2009, which was charged to services cost of sales expense. This amount consists of termination payments to affected employees.

#### 15. Loss Contingency

We record estimated loss contingencies when information is available that indicates that it is probable that a material loss has been incurred or an asset has been impaired and the amount of the loss can be reasonably estimated. We disclose if the assessment indicates that a potentially material loss contingency is not probable but is reasonably possible, or is probable but cannot be estimated, or if an exposure to loss exists in excess of the amount accrued. Loss contingencies considered remote are generally not disclosed. Determining the likelihood of incurring a liability and estimating the amount of the liability involves judgment by management. If the event results in an outcome that has greater adverse consequences to us than management expects, then we may have to record additional charges in future periods.

The Company's U.S. Modcomp division ("Modcomp U.S."), which is part of the Service and System Integration segment, had a pricing dispute (the "Dispute") with one of its largest hardware manufacturers (the "Hardware

Manufacturer”). The Dispute arose through the discovery that Modcomp U.S. was buying some products from the Hardware Manufacturer’s distributors at incorrect prices. The prices that were incorrect arose from Modcomp U.S. and three of the Hardware Manufacturer’s distributors misapplying discounts that were available for specific products for certain customers to customers for whom these discounts were not available.

In July 2009, the Company settled with the Hardware Manufacturer with respect to a portion of the transactions in which incorrect discounts were used. However, there are additional affected transactions, which are subject to further review by the Hardware Manufacturer which must be resolved before we will be able to agree on a final settlement with respect to these remaining transactions.

For the year ended September 30, 2009, we accrued approximately \$337 thousand in additional cost of sales, approximately \$174 thousand of which was paid to the Hardware Manufacturer under the settlement referred to above. We also reduced commissions and income tax expense by approximately \$98 thousand and \$103 thousand, for a net impact of approximately \$137 thousand of additional net loss, for the year ended September 30, 2009, in connection with the Dispute. These amounts represented our best estimates of the liability associated with the Dispute for all transactions involved, whether settled or still under review. This estimate was based on the assumption that all of the transactions that were still under review would be resolved in substantially the same manner that the settled transactions had been, because management believed that the facts and circumstances of the transactions still under review are the same as for the transactions that had been settled. However, the Hardware Manufacturer had advised us that they needed more time to review the remaining affected transactions, and accordingly had not yet agreed to resolve the remaining transactions in the same manner as the previously settled transactions. Accordingly, there was a contingent liability with respect to the unsettled transactions, because the Hardware Manufacturer could assert a claim for amounts in excess of the estimates that we accrued in connection with the Dispute. The Company had assessed that an additional contingent loss related to the Dispute was reasonably possible, but not probable. Therefore, an accrual had not been recorded for the loss contingency as of September 30, 2009. For loss contingencies assessed at the reasonably possible level, the loss contingency must be disclosed and an estimate or range of possible loss must also be disclosed in the event that a reasonable estimate can be made. Accordingly, as of September 30, 2009, we estimated the range of the loss contingency associated with the Dispute was between \$0 and \$389 thousand.

In July 2010, the Hardware Manufacturer informed us that they had calculated an additional assessment in connection with the Dispute of approximately \$306 thousand. As a result of this new information, we reevaluated the likelihood of the loss, and we determined that the loss was probable and estimable. Although we were still negotiating a final settlement with the Hardware Manufacturer, we determined that the amount that had been provided to us by the Hardware Manufacturer of approximately \$306 thousand, was the best estimate of the loss, at that time. Accordingly, we accrued an additional \$306 thousand as cost of sales for the nine months ended June 30, 2010.

In August 2010, we completed our negotiations with the Hardware Manufacturer. As a result of these negotiations, the final settlement agreed to between the Company and the Hardware manufacturer was approximately \$47 thousand less than the amount referred to above of \$306 thousand, which was our best estimate of the contingent loss as of June 30, 2010. Accordingly, we reduced our accrual for this contingent loss by approximately \$47 thousand, resulting in a final increase to cost of sales as a result of this settlement of approximately \$259 thousand for the year ended September 30, 2010. This amount was paid to the Hardware manufacturer during the final quarter of fiscal 2010.

## 16. Fair Value Measures

Assets and Liabilities measured at fair value on a recurring basis are as follows:

|                    | Fair Value Measurements Using  |   |   |                  | Gain<br>or<br>(loss) |
|--------------------|--|---|---|------------------|----------------------|
|                    | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Instruments<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Input<br>(Level 3) | Total<br>Balance |                      |
|                    | As of September 30, 2010   |   |   |                  |                      |
|                    | (Amounts in thousands)   |   |   |                  |                      |
| Assets:            |  |   |   |                  |                      |
| Money Market funds | \$3,482  | \$—   | \$—   | \$3,482          | \$—                  |

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|  |         |     |     |         |     |
|--|---------|-----|-----|---------|-----|
| Total assets measured at fair value                | \$3,482 | \$— | \$— | \$3,482 | \$— |
| As of September 30, 2009<br>(Amounts in thousands) |         |     |     |         |     |
| Assets:  |         |     |     |         |     |
| Money Market funds                                 | \$6,840 | \$— | \$— | \$6,840 | \$— |
| Total assets measured at fair value                | \$6,840 | \$— | \$— | \$6,840 | \$— |

These assets are included in cash and cash equivalents in the accompanying consolidated balance sheets. All other monetary assets and liabilities are short-term in nature and approximate their fair value.

The Company had no liabilities measured at fair value as of September 30, 2010. The Company had no assets or liabilities measured at fair value on a non recurring basis as of September 30, 2010.

Corporate Information

| Board of Directors  | Officers   |
|---|--|
| Alexander R. Lupinetti<br>Chairman of the Board,<br>President and Chief Executive Officer<br>CSP Inc. | Alexander R. Lupinetti<br>Chairman of the Board,<br>President and Chief Executive Officer<br>CSP Inc.  |
| Christopher J. Hall<br>Municipal Bond Investor<br>(Self Employed)                                     | Gary W. Levine<br>Chief Financial Officer, Clerk and Treasurer<br>CSP Inc.   |
| C. Shelton James<br>Principal<br>C. Shelton James Associates  | William E. Bent, Jr.<br>Vice President and General Manager<br>MultiComputer Division<br>CSP Inc.   |
| J. David Lyons<br>Retired Managing Director<br>The Carter Group, L.L.C.                               | Robert A. Stellato<br>Vice President of Finance<br>Chief Accounting Officer<br>CSP Inc.  |
| Robert M. Williams<br>Retired Vice President<br>IBM Corporation                                       | Victor Dellovo<br>Vice President and General Manager<br>Modcomp Division<br>CSP, Inc.  |
| General Counsel   | Annual Meeting of Stockholders   |
| Foley Hoag LLP<br>Boston, MA  | All interested parties are cordially invited to attend the Annual Meeting of Stockholders on Tuesday, February 8, 2010 at 9:00 a.m. at the Company's corporate offices at 43 Manning Road, Billerica, MA 01821   |
| Auditors  | Investor Relations   |
| McGladrey & Pullen, LLP<br>Boston, MA   | To obtain additional copies of the Company's Annual Report for the Fiscal Year 2010, including Form 10-K as filed with the Securities and Exchange Commission, contact the Vice President of Finance at CSP Inc. |
| Transfer Agent  |  |
| American Stock Transfer Company<br>New York, NY   | Financial data may also be accessed online at <a href="http://www.cspi.com">www.cspi.com</a>   |