

Results of operations

Twelve months ended September 30, 2008 compared to September 30, 2007

Results of operations for the twelve months ended September 30, 2008 compared to September 30, 2007 are as follows:

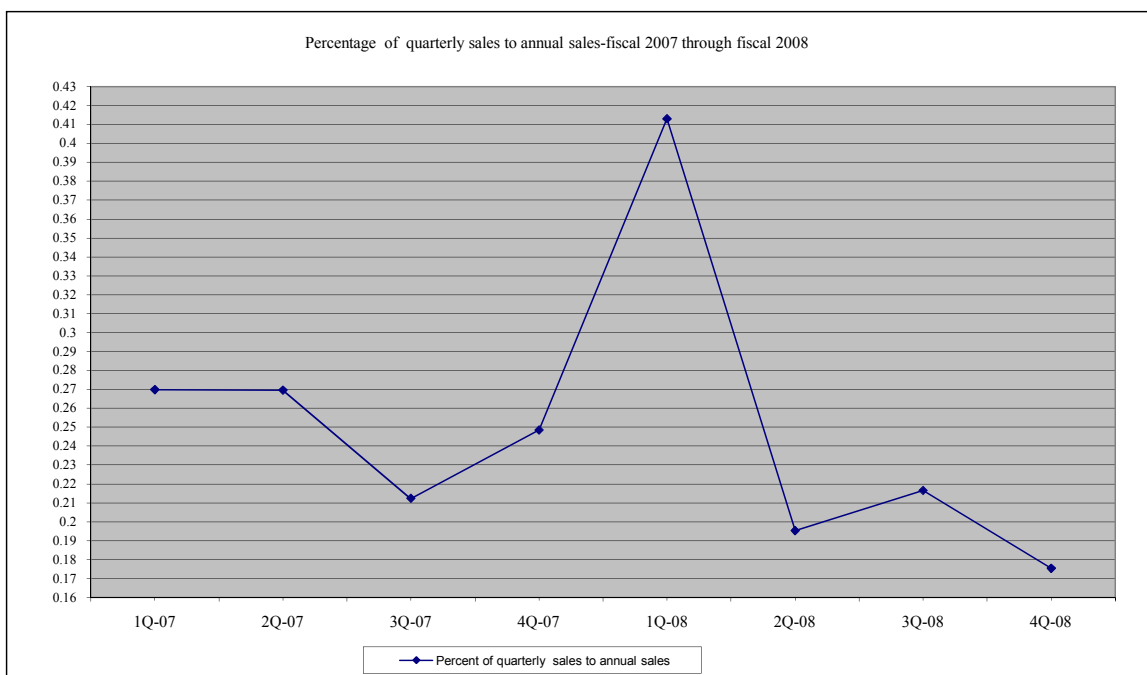
	Twelve Months Ended 9/30/08	Twelve Months Ended 9/30/07	Variance \$	Percentage of sales		
				2008	2007	Variance
Net Sales	\$ 89,701,028	\$ 110,896,010	\$ (21,194,982)	100.00%	100.00%	-
Cost of sales	72,019,046	88,651,881	(16,632,835)	80.29%	79.94%	0.35%
Gross Profit	17,681,982	22,244,129	(4,562,147)	19.71%	20.06%	-0.35%
Gross Profit %	19.71%	20.06%	-0.35%			
Expenses:						
Sales & marketing	11,630,853	10,132,587	1,498,266	12.97%	9.14%	3.83%
Technical support	578,815	600,074	(21,259)	0.65%	0.54%	0.10%
General & administrative	4,421,012	3,618,813	802,199	4.93%	3.26%	1.67%
Selling, general and administrative stock compensation expense	522,168	316,292	205,876	0.58%	0.29%	0.30%
Total Selling, general and administrative expense	17,152,848	14,667,766	2,485,082	19.13%	13.23%	5.90%
Research and development	3,610,003	3,294,441	315,562	4.02%	2.97%	1.05%
Research and development stock compensation expense	273,744	185,576	88,168	0.31%	0.17%	0.14%
Total expenses	21,036,595	18,147,783	2,888,812	23.46%	16.37%	7.09%
Net operating income (loss)	(3,354,613)	4,096,346	(7,450,959)	-3.75%	3.69%	-7.44%
Other income:						
Interest income	43,989	43,135	854	0.05%	0.04%	0.01%
Foreign currency	(15,138)	(31,676)	16,538	-0.02%	-0.03%	0.01%
Total other income	28,851	11,459	17,392	0.03%	0.01%	0.02%
Income before taxes (benefit) on income	(3,325,762)	4,107,805	(7,433,567)	-3.72%	3.70%	-7.42%
Income tax provision (benefit)	(237,573)	(1,197,579)	960,006	-0.26%	-1.08%	-0.82%
Net income (loss)	\$ (3,088,189)	\$ 5,305,384	\$ (8,393,573)	-3.46%	4.78%	-8.24%

Net sales for the twelve months ended September 30, 2008 decreased \$21,194,982 compared to the twelve months ended September 30, 2007 as shown on the table below.

Location	Twelve Months Ended 9/30/08	Twelve Months Ended 9/30/07	Increase (decrease) Dollar Variance	Increase (decrease) Variance %	Percentage of sales by Geographic region	
					2008	2007
Domestic	\$ 42,964,592	\$ 62,649,883	\$ (19,685,291)	(31)%	48%	56%
Europe	43,810,431	45,585,721	(1,775,290)	(4)%	49%	42%
Asia	2,926,005	2,660,406	265,599	10%	3%	2%
Total	\$ 89,701,028	\$ 110,896,010	\$ (21,194,982)	-19%	100%	100%

Net sales to domestic customers were 48% of net sales for the fiscal year ended September 30, 2008 and 56% of net sales for the fiscal year ended September 30, 2007. Net sales to European customers were 49% of net sales for the fiscal year ended September 30, 2008 and 42% of net sales for the fiscal year ended September 30, 2007. Net sales to Asian customers were 3% of net sales for the fiscal year ended September 30, 2008 and 2% of net sales for the fiscal year ended September 30, 2007. We experienced a decrease in unit sales of about 7.86% while changes in sales mix lowered the average sales price by about 12.22%. Sales were impacted by the closing of CompUSA and a lower product purchases by PC manufacturers due to poor retail economic conditions and a reduction in the marketing programs of TV tuner boards.

Seasonal nature of sales



As the chart above indicates, there is a seasonal pattern to our quarterly sales. Listed below are the primary causes of our seasonal sales:

- We primarily sell through a sales channel which consists of retailers, PC manufacturers and distributors. Spurred on by the holiday spending, our sales during our first fiscal quarter, which encompasses the holiday season, have historically been either the highest or the second highest of our fiscal year.
- Post holiday sales, mid year school computer purchases, gift certificates, holiday cash gifts and disposable income generated from year end bonuses fuel the sales of our second quarter and have historically resulted in sales for our second quarter being either the highest or second highest of our fiscal year.
- For each of the fiscal years ended September 30, 2008 and 2007 at least 40% of our sales were generated by our European subsidiary. We typically experience a slowdown due to the summer holiday period in Europe starting with the second half of our fiscal third quarter and into the first half of our fiscal fourth quarter. We also experience decreased sales in the U.S. during the summer holiday months. This has historically caused sales for the last six months of our fiscal year to be lower than the first six months of our fiscal year. As the chart above indicates, our sales for the first six months of fiscal 2007 and fiscal 2008 accounted for 54% and 61% of sales, respectively, and our sales for the last six months of fiscal 2007 and 2008 accounted for 46% and 39% of sales, respectively.

Although our strategy has been to diversify our sales to minimize the seasonal nature of our business, we anticipate similar seasonal trends for the near term future.

Gross profit

Gross profit decreased \$4,562,147 for the twelve months ended September 30, 2008 compared to the twelve months ended September 30, 2007.

The decrease in the gross profit is detailed below:

	Increase (decrease)
Decrease in sales	\$ (5,795,068)
Increase in inventory obsolescence reserve	(930,000)
Gross profit on sales mix	1,242,193
Software licensing accrual adjustment	1,190,000
Production and production related costs	<u>(269,272)</u>
Total decrease in gross profit	<u>\$ (4,562,147)</u>

Gross profit percentage for the twelve months ended September 30, 2008 was 19.71% compared to 20.06% for the twelve months ended September 30, 2007, a decrease of 0.35%.

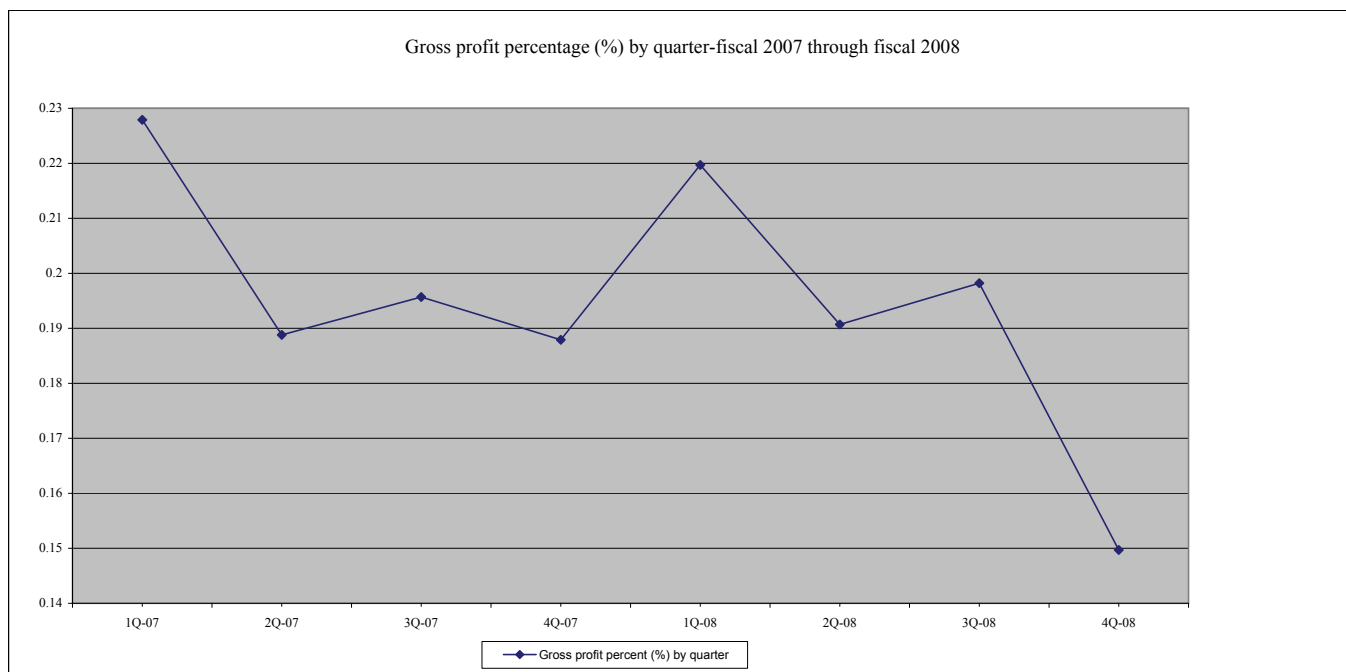
The increases and (decreases) in the gross profit percent are detailed below:

	Increase (decrease)
Gross profit on sales mix	1.38%
Increase in inventory obsolescence reserve	-1.04%
Production and production related costs	-2.02%
Software licensing accrual adjustment	1.33%
Net increase in gross profit percent	<u>-0.35%</u>

The increase in the gross profit percent for the twelve months ended September 30, 2008 compared to the twelve months ended September 30, 2007 was primarily due to:

- A greater sales mix of higher gross profit margin products contributed to the increase in gross profit.
- Due to the decrease in sales, certain fixed and semi-fixed expenses, such as building overhead, production labor and shipping labor increased as a percentage of sales.
- Due to an expected loss in a customer program and continued decrease in the analog market the inventory obsolescence reserve was increased.
- Due to a current year change in estimate and correction of an error the Company’s accrued software licensing fee was decreased in the current year

Volatility of gross profit percentage:



The chart above indicates the quarterly fluctuations in gross profit percent. Over the eight quarters ended with the fourth quarter of fiscal 2008, the gross profit percent has ranged from a low of 14.97% to a high of 22.79%.

Factors affecting the volatility of our gross profit percentages are:

- Mix of product-gross profit percentages vary within our retail family of products as well as for products sold to manufacturers. Varying sales mix of these different product lines affect the quarterly gross profit percentage.
- Fluctuating quarterly sales caused by seasonal trends-included in cost of sales are certain fixed costs, mainly for production labor, warehouse labor and the overhead cost of our Ireland distribution facility. Due to this, when unit and dollar sales decline due to seasonal sales trends these fixed costs get spread over lower unit and dollar sales, which increase the product unit costs and increase the fixed costs as a percentage of sales.
- Competitive pressures-our market is constantly changing with new competitors joining our established competitors. These competitive pressures from time to time result in a lowering of our average sales prices which can reduce gross profit.
- Supply of component parts-in times when component parts are in short supply we have to manage price increases. Conversely, when component parts’ supply is high we may be able to secure price decreases.

- Sales volume-as unit sales volume increases we have more leverage in negotiating volume price decreases with our component suppliers and our contract manufacturers.
- Cost reductions-we evaluate the pricing we receive from our suppliers and our contract manufacturers and we often seek to achieve component part and contract manufacturer cost reductions.
- Mix of sales that impact the Company's obligation to pay certain licensing costs
- Volatility of fuel prices-increases in fuel costs are reflected in the amounts we pay for the delivery of product from our suppliers and the amounts we pay for deliveries to our customers. Therefore increasing fuel prices increase our freight costs and negatively impact our gross profit.

Managing product mix through market strategy and new products, moderating seasonal trends, efficiently managing shipments and achieving cost reductions are a Company priority and are critical to our competitive position in the market. Although our goal is to optimize gross profit and minimize gross profit fluctuations, in light of the dynamics of our market we anticipate the continuance of gross profit percentage fluctuations.

Selling, general and administrative expenses

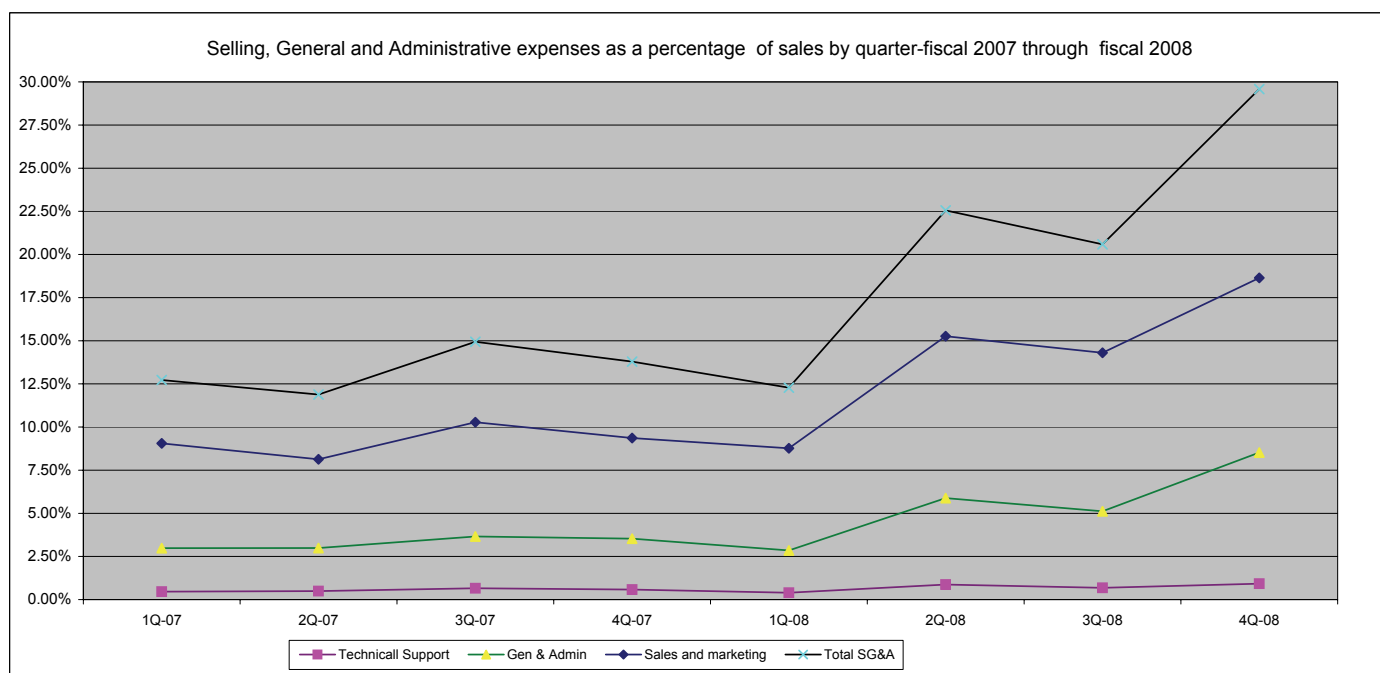
The chart below illustrates the components of Selling, general and administrative expenses.

	Twelve months ended September 30,					
	Dollar Costs			Percentage of Sales		
	2008	2007	Increase (Decrease)	2008	2007	Increase (Decrease)
Sales and marketing.	\$ 11,630,853	\$ 10,132,587	\$ 1,498,266	12.97%	9.14%	3.83%
Technical support	578,815	600,074	(21,259)	0.65%	0.54%	0.11%
General and administrative.	4,421,012	3,618,813	802,199	4.93%	3.26%	1.67%
Selling and general administrative stock compensation expense	522,168	316,292	205,876	0.58%	0.29%	0.29%
Total	<u>\$ 17,152,848</u>	<u>\$ 14,667,766</u>	<u>\$ 2,485,082</u>	<u>19.13%</u>	<u>13.23%</u>	<u>5.90%</u>

Selling, general and administrative expenses increased \$2,485,082 from the prior fiscal year. Of the \$1,498,266 increase in sales and marketing expense, \$854,211 was due to the increase in the Euro rate compared to the U.S. dollar. The average Euro rate for fiscal 2008 was \$1.5031 to 1 Euro compared to \$1.3314 to 1 Euro for fiscal 2007. Excluding the increase due the exchange rate, sales and marketing expenses increased \$644,055. The increases were due to higher sales compensation expense of \$372,949 and higher UK, France and German sales office expense of \$399,686 due to a combination of personnel additions and higher office occupancy costs, offset by lower commission expense of \$116,962 due to lower sales and lower advertising expense of \$116,962 due to lower sales related marketing development expense.

The increase in general and administrative expense of \$802,199 was primarily due to higher director expenses of \$171,363 related to the issuance of stock in lieu of stock options during fiscal 2008, higher legal fees of \$78,722 for certain labor related issues, higher rent expense of \$47,328 due rent increases and expanded office space, increase in bad debt expense of \$430,000 related to the liquidation of CompUSA and the chapter 11 filing of Circuit City and a \$53,641 increase in depreciation expense. The increase in stock compensation expense is due to stock options issued during fiscal 2007 and fiscal 2008.

Selling general and administrative expenses as a percentage of sales



The chart above indicates the quarterly fluctuations for technical support, general and administrative, sales and marketing and total selling, general and administrative expenses. Due to fixed costs which fluctuate minimally with changes in sales coupled with the seasonal nature of our business, selling, general and administrative expenses as a percentage of sales are sensitive to seasonal sales fluctuations. Over the eight quarters ending with the fourth quarter of fiscal 2008, the pattern of selling, general and administrative expenses as a percentage of sales has resulted in the following trends:

- Due to our first and second quarters yielding the highest quarterly sales levels of our fiscal year, our total selling, general and administrative expenses as a percentage of sales have typically been the lowest during our first quarter and second quarter. As reflected in the chart, selling, general and administrative expense as a percentage of sales were the lowest in the first quarters of fiscal 2007 and 2008.
- Reflecting the seasonal trend in which our third and fourth quarters yield the lowest quarterly sales of our fiscal year, our total selling, general and administrative expenses for the third and fourth quarters are the highest as a percentage of sales. As reflected in the chart, total selling, general and administrative expense as a percentage of sales were the highest in the third quarter of fiscal 2007 and fourth quarter of fiscal 2008.
- Reflecting the decline in sales, total selling, general and administrative expenses as a percent of sales for the twelve months ended September 30, 2008 increased to the highest level of the 2007 and 2008 fiscal years.

With the expectation that the seasonal nature of sales will continue for the near future, we expect selling, general and administrative expenses as a percentage of sales to reflect a future trend that is similar to the historical trends we have experienced over the prior two fiscal years.

Research and development expenses

Research and development expenses increased \$315,562. The increase was mainly due to the hiring of additional engineering personnel of \$346,967 offset by lower program development expenses of \$89,289.

Other income

Other income for the twelve months ended September 30, 2008 was \$28,851 compared to other income of \$11,459 for the twelve months ended September 30, 2007 as detailed below:

	<u>Twelve months ended September 30, 2008</u>	<u>Twelve months ended September 30, 2007</u>
Interest income	\$ 43,989	\$ 43,135
Foreign currency transaction gains (losses)	<u>(15,138)</u>	<u>(31,676)</u>
Total other income (expense)	<u>\$ 28,851</u>	<u>\$ 11,459</u>

Accumulated other comprehensive income (loss)

Accumulated other comprehensive income (loss) consists of two components: translation gains and losses and FAS 133 mark to market gains and losses on our open foreign exchange contracts.

During fiscal 2008, we recorded on our balance sheet in the equity section under "Accumulated other comprehensive (loss)" a loss of \$2,036,899, which consisted of translation losses of \$2,088,408 and a gain of \$51,509 due to the mark to market differences between the value of the Company's open forward exchange contracts versus the same contracts valued at the period ending forward rate. The table below details the gains and losses that make up the accumulated other comprehensive loss of \$3,362,870 recorded on our balance sheet as of September 30, 2008:

	<u>Balance as of Sept 30, 2007</u>	<u>Oct 2007 to Sept 2008 gain (loss)</u>	<u>Balance as of Sept 30, 2008</u>
Accumulated Other Comprehensive Income (Loss)			
Fiscal 2008 activity	\$ (1,257,918)	\$ (2,088,408)	\$ (3,346,326)
Translation gains and losses	<u>(68,053)</u>	<u>51,509</u>	<u>(16,544)</u>
FAS 133 mark to market adjustment	<u>\$ (1,325,971)</u>	<u>\$ (2,036,899)</u>	<u>\$ (3,362,870)</u>

Tax provision

Our net tax provision for the year ended September 30, 2008 and 2007 is as follows:

	<u>Twelve months ended September 30, 2008</u>	<u>Twelve months ended September 30, 2007</u>
AMT Tax attributable to U.S. operations	\$ -	\$ 108,343
Income tax benefit due to change in deferred taxes	(529,995)	(1,490,689)
Tax expense European operations	267,422	146,767
State taxes	<u>25,000</u>	<u>38,000</u>
Net tax (benefit) provision	<u>\$ (237,573)</u>	<u>\$ (1,197,579)</u>

The deferred tax assets and the offsetting tax valuation allowance is attributable to our domestic operations. For the last three fiscal years our domestic operation has had taxable income. As of September 30, 2007, we evaluated the future realization of our deferred tax assets and the corresponding valuation allowance. We took into consideration:

- the taxable income of our domestic operations for the last three fiscal years ended September 30, 2007, 2006 and 2005
- the utilization in fiscal 2007 of the remainder of our net operating loss carry forward

After evaluating the circumstances listed above, it was our opinion to reduce the deferred tax valuation allowance by \$3,010,253, resulting in a tax benefit for fiscal 2007 of \$1,490,689.

As a result of all of the above items mentioned in the Management's Discussion and Analysis of Financial Condition and Results of Operations, we had a net loss of \$3,088,189 for the twelve months ended September 30, 2008, which resulted in basic and diluted net loss per share of \$0.31 on weighted average basic and diluted shares of 9,969,939, compared to net income of \$5,305,384 for the twelve months ended September 30, 2007, which resulted in basic net income per share of \$0.54 and diluted net income per share of \$0.51 on weighted average basic and diluted shares of 9,862,655 and 10,367,775, respectively.

Options to purchase 1,767,744, 540,250 and 193,856 shares of Common Stock at prices ranging \$1.05 to \$8.75, \$4.67 to \$8.75 and 4.13 to \$8.75, respectively, were outstanding as of September 30, 2008, 2007 and 2006, respectively, but were not included in the computation of diluted net income per share of Common Stock because they were anti-dilutive.

Results of operations**Twelve months ended September 30, 2007 compared to September 30, 2006.**

Results of operations for the twelve months ended September 30, 2007 compared to September 30, 2006 are as follows:

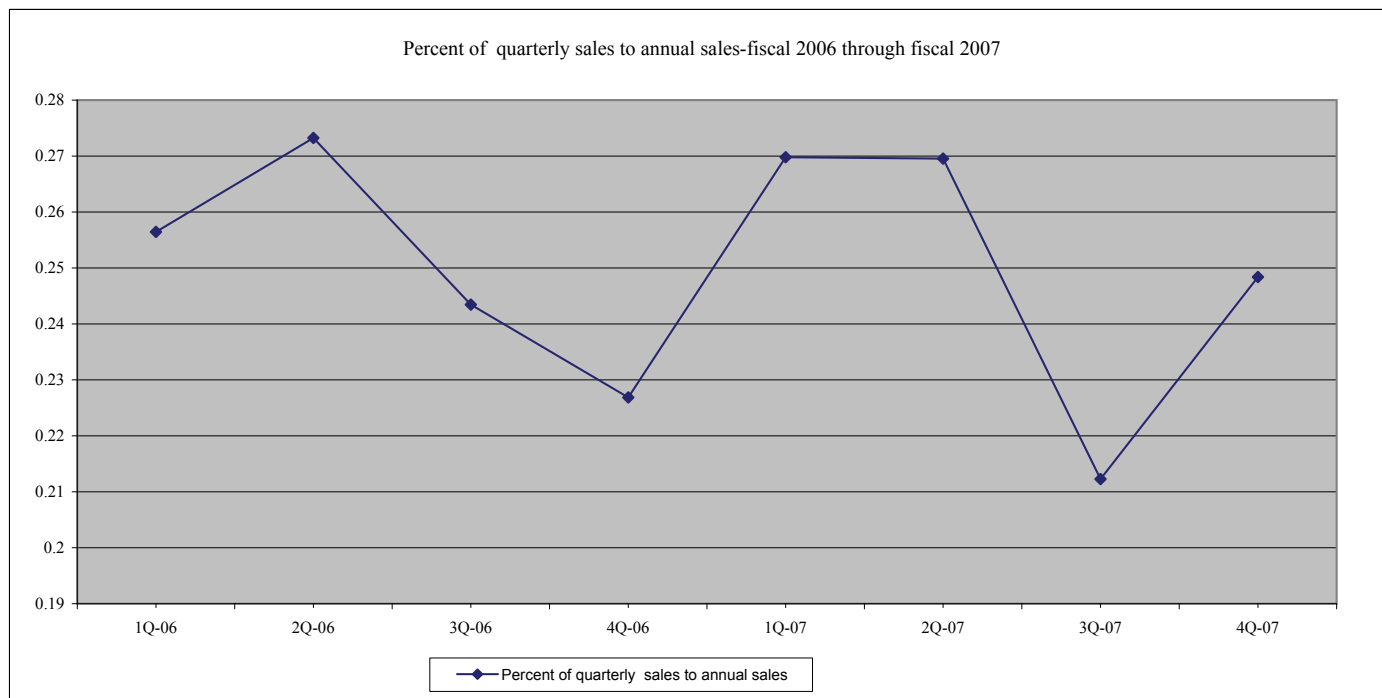
	Twelve Months Ended 9/30/07	Twelve Months Ended 9/30/06	Variance \$	Percentage of sales 2007	Percentage of sales 2006	Variance
Net Sales	\$ 110,896,010	\$ 97,662,326	\$ 13,233,684	100.00%	100.00%	-
Cost of sales	<u>88,651,881</u>	<u>77,817,275</u>	<u>10,834,606</u>	<u>79.94%</u>	<u>79.68%</u>	<u>0.26%</u>
Gross Profit	22,244,129	19,845,051	2,399,078	20.06%	20.32%	-0.26%
Gross Profit %	20.06%	20.32%	-0.26%			
Expenses:						
Sales & marketing	10,132,587	9,565,730	566,857	9.14%	9.79%	-0.65%
Technical support	600,074	556,865	43,209	0.54%	0.57%	-0.03%
General & administrative	3,618,813	3,730,031	(111,218)	3.26%	3.82%	-0.56%
Selling, general and administrative stock compensation expense	<u>316,292</u>	<u>263,363</u>	<u>52,929</u>	<u>0.29%</u>	<u>0.27%</u>	<u>0.02%</u>
Total Selling, general and administrative expense . . .	14,667,766	14,115,989	551,777	13.23%	14.45%	-1.22%
Research and development	3,294,441	3,072,001	222,440	2.97%	3.15%	-0.18%
Research and development stock compensation expense	<u>185,576</u>	<u>92,923</u>	<u>92,653</u>	<u>0.17%</u>	<u>0.10%</u>	<u>0.07%</u>
Total expenses	18,147,783	17,280,913	866,870	16.37%	17.70%	-1.33%
Net operating income	4,096,346	2,564,138	1,532,208	3.69%	2.62%	1.07%
Other income:						
Interest income	43,135	28,422	14,713	0.04%	0.03%	0.01%
Foreign currency	<u>(31,676)</u>	<u>7,292</u>	<u>(38,968)</u>	<u>-0.03%</u>	<u>0.01%</u>	<u>-0.04%</u>
Total other income	<u>11,459</u>	<u>35,714</u>	<u>(24,255)</u>	<u>0.01%</u>	<u>0.04%</u>	<u>-0.03%</u>
Income before taxes (benefit) on income	4,107,805	2,599,852	1,507,953	3.70%	2.66%	1.04%
Income tax provision (benefit)	<u>(1,197,579)</u>	<u>190,240</u>	<u>(1,387,819)</u>	<u>-1.08%</u>	<u>0.19%</u>	<u>-1.27%</u>
Net income	<u>\$ 5,305,384</u>	<u>\$ 2,409,612</u>	<u>\$ 2,895,772</u>	<u>4.78%</u>	<u>2.47%</u>	<u>2.31%</u>

Net sales for the twelve months ended September 30, 2007 increased \$13,233,684 compared to the twelve months ended September 30, 2006 as shown on the table below.

Location:	Twelve Months ended 9/30/07	Twelve Months ended 9/30/06	Increase (Decrease) Dollar Variance	Increase (Decrease) Variance %	Percentage of sales by Geographic region	
					2007	2006
Domestic	62,649,883	45,231,986	17,417,897	39%	56%	46%
Europe	45,585,721	49,803,392	(4,217,671)	-8%	42%	51%
Asia	<u>2,660,406</u>	<u>2,626,948</u>	<u>33,458</u>	<u>1%</u>	<u>2%</u>	<u>3%</u>
Total	<u>\$ 110,896,010</u>	<u>\$ 97,662,326</u>	<u>\$ 13,233,684</u>	<u>14%</u>	<u>100%</u>	<u>100%</u>

Net sales to domestic customers were 56% of net sales for the fiscal year ended September 30, 2007 and 46% of net sales for the fiscal year ended September 30, 2006. Net sales to European customers were 42% of net sales for the fiscal year ended September 30, 2007 and 51% of net sales for the fiscal year ended September 30, 2006. Net sales to Asian customers were 2% of net sales for the fiscal year ended September 30, 2007 and 3% of net sales for the fiscal year ended September 30, 2006. We experienced an increase in unit sales of about 22% while the dynamics of new production and changes in sales mix lowered the average sales price by about 7%.

Seasonal nature of sales



As the chart above indicates, there is a seasonal pattern to our quarterly sales. Listed below are the primary causes of our seasonal sales:

- We primarily sell through a sales channel which consists of retailers, PC manufacturers and distributors. Spurred on by the holiday spending, our sales during our first fiscal quarter, which encompasses the holiday season, have historically been either the highest or the second highest of our fiscal year.
- Post holiday sales, mid year school computer purchases, gift certificates, holiday cash gifts and disposable income generated from year end bonuses fuel the sales of our second quarter and have historically resulted in sales for our second quarter being either the highest or second highest of our fiscal year.
- For each of the fiscal years ended September 30, 2007 and 2006 at least 40% of our sales were generated by our European subsidiary. During our fiscal third quarter and into the first half of our fiscal fourth quarter, we typically experience a slowdown due to the summer holiday period in Europe. We also see decreased spending in the U.S. during the summer months. This has historically caused sales for the last six months of our fiscal year to be lower than the first six months of our fiscal year. As the chart above indicates our sales for the last six months of fiscal 2006 and 2007 were lower than the sales for the first six months of fiscal 2006 and fiscal 2007.

Although our strategy has been to diversify our sales to minimize the seasonal nature of our business, we anticipate similar seasonal trends for the near term future.

Gross profit

Gross profit increased \$2,399,078 for the twelve months ended September 30, 2007 compared to the twelve months ended September 30, 2006.

The increases and (decreases) in the gross profit are detailed below:

	Increase (Decrease)
Due to increased sales.	\$ 3,726,900
Lower gross profit on sales mix.	(909,934)
Production and production related costs	(417,888)
Total increase in gross profit.	<u>\$ 2,399,078</u>

Gross profit percentage for the twelve months ended September 30, 2007 was 20.06% compared to 20.32% for the twelve months ended September 30, 2006, a decrease of 0.26%.

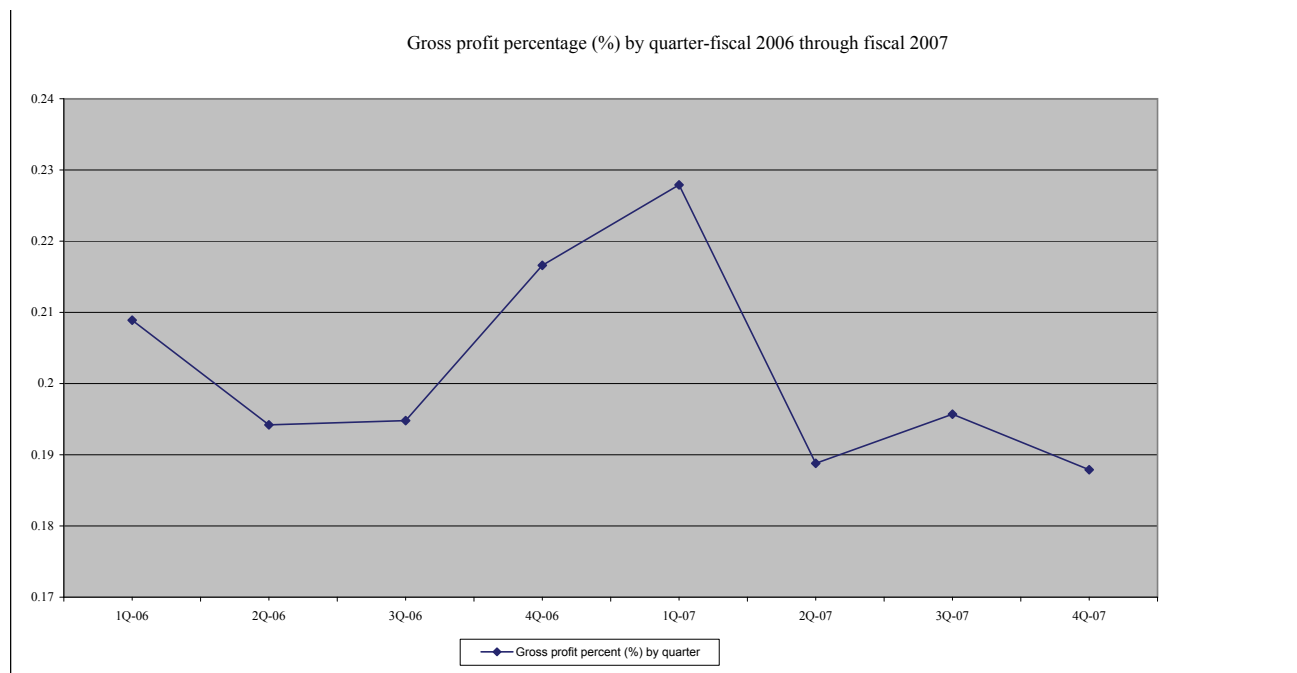
The increases and (decreases) in the gross profit percent are detailed below:

	Increase (Decrease)
Lower gross profit on sales mix	(0.82)%
Production and production related costs	0.56%
Net decrease in gross profit percent	<u>(0.26)%</u>

The decrease in the gross profit percent of 0.26 % for the twelve months ended September 30, 2007 compared to the twelve months ended September 30, 2006 was primarily due to:

- A higher percentage of lower gross profit margin products contributed to a 0.82% decrease in gross profit.
- Production and production related costs declined as a percentage of sales which contributed to a 0.56% increase in gross profit percent. The increase in net sales was about 14% while the increase in production and production related costs was about 5%.

Volatility of gross profit percentage:



The chart above indicates the quarterly fluctuations in gross profit percent. Over the eight quarters ended with the fourth quarter of fiscal 2007, the gross profit percent has ranged from a low of 18.79% to a high of 22.79%.

Factors affecting the volatility of our gross profit percentages are:

- Mix of product. Gross profit percentages vary within our retail family of products as well as for products sold to manufacturers. Varying sales mix of these different product lines affect the quarterly gross profit percentage.
- Fluctuating quarterly sales caused by seasonal trends. Included in cost of sales are certain fixed costs, mainly for production labor, warehouse labor and the overhead cost of our Ireland distribution facility. Due to this, when unit and dollar sales decline due to seasonal sales trends these fixed costs get spread over lower unit and dollar sales, which increase the product unit costs and increase the fixed costs as a percentage of sales.
- Competitive pressures. Our market is constantly changing with new competitors joining our established competitors. These competitive pressures from time to time result in a lowering of our average sales prices which can reduce gross profit.
- Supply of component parts. In times when component parts are in short supply we have to manage price increases. Conversely, when component parts' supply is high we may be able to secure price decreases.
- Sales volume. As unit sales volume increases we have more leverage in negotiating volume price decreases with our component suppliers and our contract manufacturers.
- Cost reductions. We evaluate the pricing we receive from our suppliers and our contract manufacturers and we often seek to achieve component part and contract manufacturer cost reductions.
- Volatility of fuel prices. Increases in fuel costs are reflected in the amounts we pay for the delivery of product from our suppliers and the amounts we pay for deliveries to our customers. Therefore increasing fuel prices increase our freight costs and negatively impact our gross profit.

Managing product mix through market strategy and new products, moderating seasonal trends, efficiently managing shipments and achieving cost reductions are a company priority and are critical to our competitive position in the market. Although our goal is to optimize gross profit and minimize gross profit fluctuations, in light of the dynamics of our market we anticipate the continuance of gross profit percentage fluctuations.

Selling, general and administrative expenses

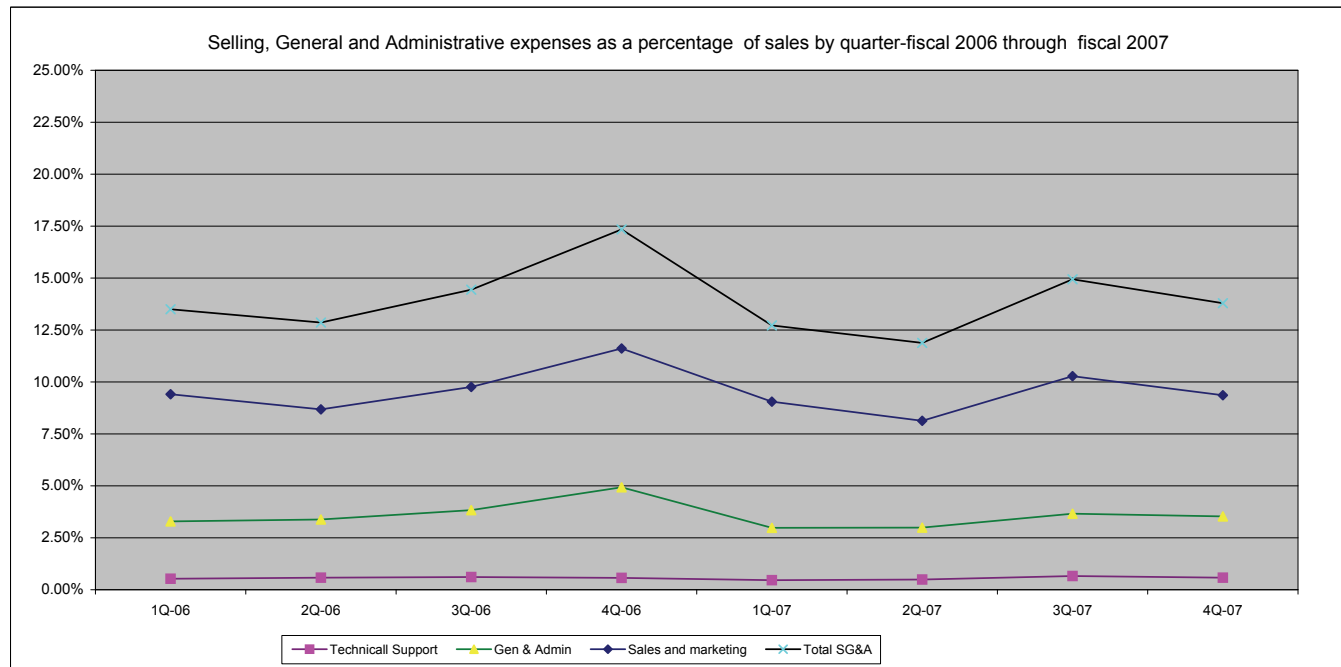
The chart below illustrates the components of Selling, general and administrative expenses.

	Twelve months ended September 30,			Percentage of Sales		
	Dollar Costs		Increase (Decrease)			
	2007	2006		2007	2006	(Decrease)
Sales and marketing	\$ 10,132,587	\$ 9,565,730	\$ 566,857	9.14%	9.79%	-0.65%
Technical support	600,074	556,865	43,209	0.54%	0.57%	-0.03%
General and administrative	3,618,813	3,730,031	(111,218)	3.26%	3.82%	-0.56%
Selling and general administrative stock compensation expense	316,292	263,363	52,929	0.29%	0.27%	0.02%
Total	<u>\$ 14,667,766</u>	<u>\$ 14,115,989</u>	<u>\$ 551,777</u>	<u>13.23%</u>	<u>14.45%</u>	<u>-1.22%</u>

Selling, general and administrative expenses increased \$551,777 from the prior fiscal year. As a percentage of sales, Selling, general and administrative expenses decreased by 1.22% when compared to the twelve months ended September 30, 2006. The increase in sales and marketing expense of \$566,857 was mainly due to increased commission expense due to higher sales and higher sales compensation expense due to sales personnel increases. The increase in technical support expenses of \$43,209 was primarily due to higher compensation expenses in Asia and Europe due to increased personnel. The decrease in general and administrative expenses of \$111,218 was primarily due to lower rent expense due to a rent reduction negotiated under a new lease, lower professional fees due lower usage of outside consultants and lower bank and credit card processing fees.

Stock compensation expense related to SG&A personnel was \$52,929 higher than in fiscal 2006. During fiscal 2006, we had run out of options authorized in our stock option plan. Accordingly, we did not issue as many options as we would have in fiscal 2006 had there been additional shares authorized. At our October 2006 Annual Meeting of Stockholders, our stockholders approved the addition of 1 million shares of Common Stock to our 2003 Performance and Equity Incentive Plan. As a result, we were able to grant more options in fiscal 2007 than fiscal 2006, thus increasing the stock compensation expense recorded in fiscal 2007.

Selling, general and administrative expenses as a percentage of sales



The chart above indicates the quarterly fluctuations for technical support, general and administrative, sales and marketing and total selling, general and administrative expenses. Due to fixed costs which fluctuate minimally with changes in sales coupled with the seasonal nature of our business, selling, general and administrative expenses as a percentage of sales are sensitive to seasonal sales fluctuations. Over the eight quarters ending with the fourth quarter of fiscal 2007, the pattern of selling general and administrative expenses as a percentage of sales has resulted in the following trends:

- Due to our first and second quarters yielding the highest quarterly sales levels of our fiscal year, our selling, general and administrative expenses as a percentage of sales have typically been the lowest during our first quarter and second quarter. As reflected in the chart, selling, general and administrative expenses as a percentage of sales were the lowest in the first and second quarters of fiscal 2006 and 2007.
- Reflecting the seasonal trend in which our third and fourth quarters yield the lowest quarterly sales of our fiscal year, our selling, general and administrative expenses for the third and fourth quarters are the highest as a percentage of sales. As reflected in the chart, selling, general and administrative expenses as a percentage of sales were the highest in the third and fourth quarters of fiscal 2006 and 2007.
- Selling, general and administrative expenses as a percent of sales for the twelve months ended September 30, 2007 declined to its lowest level of the two fiscal years ended September 30, 2007, the result of sales percentage increases growing in excess of percentage increases in selling, general and administrative expenses.

With the expectation that the seasonal nature of sales will continue for the near future, we expect selling, general and administrative expenses as a percentage of sales to reflect a future trend that is similar to the historical trends we have experienced over the prior two fiscal years.

Research and development expenses

Research and development expenses increased \$315,093. The increase was mainly due to the hiring of additional engineering personnel and increased program development expenses due to higher volume of new product and product enhancement programs. Stock compensation expense related to research and development personnel was \$92,653 higher than fiscal 2006.

Other income

Other income for the twelve months ended September 30, 2007 was \$11,459 compared to other income of \$35,714 for the twelve months ended September 30, 2006 as detailed below:

	Twelve months ended September 30, 2007	Twelve months ended September 30, 2006
Interest income	\$ 43,135	\$ 28,422
Foreign currency transaction gains (losses)	(31,676)	7,292
Total other income (expense)	<u>\$ 11,459</u>	<u>\$ 35,714</u>

Accumulated other comprehensive income (loss)

Accumulated other comprehensive income (loss) consists of two components: translation gains and losses and FAS 133 mark to market gains and losses on our open foreign exchange contracts.

During fiscal 2007, we recorded on our balance sheet in the equity section under "Accumulated other comprehensive (loss)" a loss of \$816,652, which consisted of translation losses of \$726,629 and a loss of \$90,023 due to the mark to market differences between the value of the Company's open forward exchange contracts at the contract rates versus the same contracts valued at the period ending forward rate. The table below details the gains and losses that make up the accumulated other comprehensive loss of \$1,325,971 recorded on our balance sheet as of September 30, 2007:

Accumulated Other Comprehensive Income (Loss) Fiscal 2007 activity	Balance as of Sept. 30, 2006	Oct. 2006 to Sept. 2007 (losses)	Balance as of Sept. 30, 2007
Translation gains and losses	\$ (531,289)	\$ (726,629)	\$ (1,257,918)
FAS 133 mark to market adjustment	21,970	(90,023)	(68,053)
	<u>\$ (509,319)</u>	<u>\$ (816,652)</u>	<u>\$ (1,325,971)</u>

Tax provision

Our net tax provision for the year ended September 30, 2007 and 2006 is as follows:

	Twelve months ended September 30, 2007	Twelve months ended September 30, 2006
AMT Tax attributable to U.S. operations	\$ 108,343	\$ 60,000
Income tax benefit due reduction of valuation allowance	(1,490,689)	-
Tax expense European operations	146,767	110,240
State taxes	38,000	20,000
Net tax (benefit) provision	<u>\$ (1,197,579)</u>	<u>\$ 190,240</u>

The deferred tax assets and the offsetting tax valuation allowance is attributable to our domestic operations. For the last three fiscal years our domestic operation has had taxable income. As of September 30, 2007, we evaluated the future realization of our deferred tax assets and the corresponding valuation allowance. We took into consideration:

- the taxable income of our domestic operations for the last three fiscal years ended September 30, 2007, 2006 and 2005
- anticipated taxable income for fiscal 2008
- the utilization in fiscal 2007 of the remainder of our net operating loss carry forward

After evaluating the circumstances listed above, it was our opinion to reduce the deferred tax valuation allowance by \$3,010,253, resulting in a tax benefit for fiscal 2007 of \$1,490,689.

As a result of all of the above items mentioned in the Management's Discussion and Analysis of Financial Condition and Results of Operations, we had net income of \$5,305,384 for the twelve months ended September 30, 2007, which resulted in basic net income per share of \$0.54 and diluted net income per share of \$0.51 on weighted average basic and diluted shares of 9,862,655 and 10,367,775, respectively, compared to net income of \$2,409,612 for the twelve months ended September 30, 2006, which resulted in basic net income per share of \$0.25 and diluted net income per share of \$0.24 on weighted average basic and diluted shares of 9,593,050 and 10,019,514, respectively.

Options to purchase 540,250, 193,856 and 48,453 shares of Common Stock at prices ranging \$4.67 to \$ 8.75, \$4.13 to \$8.75 and 4.40 to \$8.75, respectively, were outstanding as of September 30, 2007, 2006 and 2005, respectively, but were not included in the computation of diluted net income per share of Common Stock because they were anti-dilutive.

Liquidity and Capital Resources

Our cash, working capital and stockholders' equity position is set forth below:

	As of September 30,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Cash	\$ 14,191,721	\$ 11,581,657	\$ 9,020,941
Working Capital	17,229,410	21,198,184	17,084,175
Stockholders' Equity	18,988,536	22,941,081	17,779,725

We had cash and cash equivalents as of September 30, 2008 of \$14,191,721, an increase of \$2,610,064 from September 30, 2007

The increase was due to:

Sources of cash:

Decrease in accounts receivable	\$ 13,969,369
Decrease in inventory	355,698
Proceeds from employee stock purchases	291,463
Less cash used for:	
Net loss adjusted for non cash items	(1,041,476)
Decrease in accounts payable and accrued expense	(8,305,403)
Increase in prepaid expenses and other current assets	(290,831)
Capital equipment purchases	(291,025)
Effect of exchange rates on cash	(2,036,899)
Purchase of treasury stock	(40,832)
Net cash increase	<u>\$ 2,610,064</u>

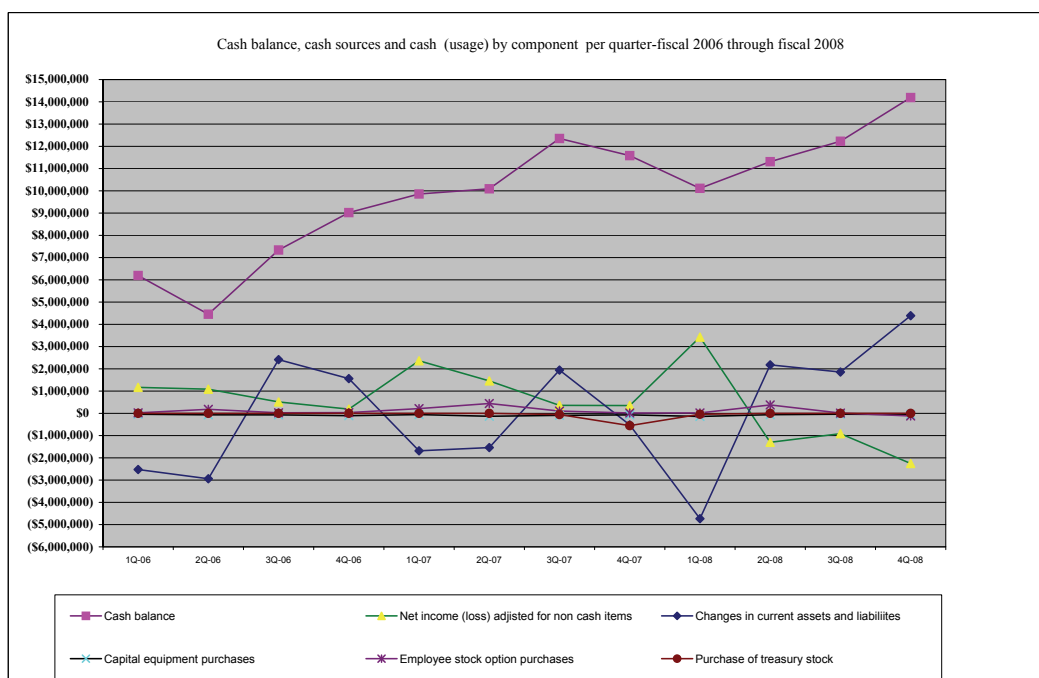
Net cash of \$4,687,357 generated from operating activities was due to a decrease in accounts receivable of \$13,969,369 and a decrease in inventory of \$355,698 offset by the net loss adjusted for non cash items of \$1,041,476, a decrease in accounts payable and accrued expenses of \$ 8,305,403 and an increase in prepaid expenses and other current assets of \$290,831. The decrease in accounts receivable was due to the 19% reduction in sales. Lower sales also resulted in less inventory purchased which was the driving force in the reduction of accounts payable and inventory.

Cash of \$291,025 was used to purchase fixed assets and \$40,832 in cash was used to purchase shares on the open market pursuant to our stock repurchase program. Proceeds from stock purchased by employees through the purchase of options and the employee stock purchase plan provided additional cash of \$291,463. The effect of exchange rates used cash of \$ 2,036,899.

On November 8, 1996, we approved a stock repurchase program. The program authorized us to repurchase up to 850,000 shares of our own stock. The stock repurchase program was extended by a resolution of our Board of Directors on December 17, 1997. At our August 3, 2007 Board meeting, our Board of Directors approved an increase in the number of shares which can be repurchased under the plan to 1,200,000. As of September 30, 2008, we held 759,579 treasury shares purchased for \$2,404,337 at an average purchase price of approximately \$3.17 per share.

Sources and (usage) of cash components

The chart below shows our cash balances, sources of cash and (usage) of cash for by quarter for fiscal 2006 through fiscal 2008.



Our sources and (usage) of cash primarily comes from the items listed below:

- Net income adjusted for non cash items
- Changes in the levels of current assets and current liabilities, primarily accounts receivable, inventories and accounts payable
- Employee purchases of stock options
- Purchase of capital equipment
- Purchase of treasury stock

Since accounts receivable, inventory and current liabilities make up the majority of our current asset and current liability levels, our cash balances are affected by the increase and decrease of these assets and liabilities. As noted in the above graph, in the quarters where cash was used to increase the current asset levels or decrease the current liability levels, there was usually a corresponding decrease or neutral position in the cash balances during those quarters.

Conversely, in the quarters when we generated cash by reducing the current asset levels or increasing the current liability levels, there was a corresponding increase in the cash balances during those quarters.

We expect for the near term future that our operating structure will remain similar to past years, therefore our investment and subsequent changes in our current assets and current liabilities required to fund our operating cycles will continue to have a material impact on our cash generation, cash usage and cash balances.

Line of Credit

On December 12, 2008, Hauppauge Computer Works, Inc. ("HCW"), a wholly-owned subsidiary of ours, executed a Fourth Amended and Restated Promissory Note (the "Fourth Amendment") to the order of JPMorgan Chase Bank, N.A. (the "Bank"). The Fourth Amendment modified the terms and conditions of that certain Promissory Note dated December 1, 2005, executed by HCW and made payable to the order of the Bank (the "Note"), as amended by an Amended and Restated Promissory Note dated March 31, 2006, as further amended by a Second Amended and Restated Promissory Note dated February 28, 2007 and as further amended by a Third Amended and Restated Promissory Note dated March 31, 2008. The Fourth Amendment, among other things, reduces the amount HCW is authorized to borrow from the Bank from a principal amount of up to Five Million Dollars (\$5,000,000) to a principal amount of up to Seven Hundred Thousand Dollars (\$700,000), based upon borrowings made under the Fourth Amendment which may be made from time to time by HCW (each, a "Loan"). The Fourth Amendment matures on March 31, 2009 (the "Maturity Date") and principal payments are due on the Maturity Date, and thereafter on demand. Until the Maturity Date, Loans made under the Amendment bear interest annually at HCW's option of (i) the Eurodollar Rate (as defined in the Fourth Amendment) (each, a "Eurodollar Loan") or (ii) the Prime Rate (as defined in the Fourth Amendment) minus one percent (1.0%) (each, a "Prime Loan"). Interest is payable with respect to each Eurodollar Loan at the end of one month after the date of such Loan (the "Interest Period"), provided that, upon the expiration of the first Interest Period and each Interest Period thereafter, each Eurodollar Loan will be automatically continued with an Interest Period of the same duration, unless HCW notifies the Bank that it intends to convert a Eurodollar Loan to a Prime Loan or if the Bank is prohibited from making Eurodollar Loans, and with respect to each Prime Loan the last day of each calendar month during the term of the Fourth Amendment and on the date on which a Prime Loan is converted to a Eurodollar Loan, until such Loan(s) shall be due and payable. Interest due after the Maturity Date shall be payable at a rate of three percent (3%) per annum over the Prime Rate.

In connection with the Fourth Amendment, we agreed that all of the terms and conditions of (i) our Guaranty as entered into with the Bank, dated as of December 1, 2005, and (ii) the Pledge Agreement by and among us, the Bank and HCW, dated as of December 1, 2005 (pursuant to which, among other things, we granted to the Bank a first priority right of pledge on approximately two-thirds of the outstanding capital shares of Hauppauge Digital Europe Sarl), each as amended, restated, supplemented or modified, from time to time and as entered into in connection with the Note, shall remain in full force and effect and apply to the terms and conditions of the Amendment.

Further, on December 12, 2008, in connection with the Fourth Amendment, HCW entered into a Pledge Security Agreement with the Bank (the "Pledge Security Agreement"), whereby HCW grants the Bank a security interest in its certificate of deposit account held with the Bank. The aggregate value of the Collateral (as defined in the Pledge Security Agreement) held pursuant to the Pledge Security Agreement shall not be less than Seven Hundred Thousand Dollars (\$700,000) at any given time.

There were no borrowings outstanding and no letters of credit outstanding as of the filing date of this Annual Report.

Our cash requirements during fiscal 2009 will include the cash required to finance the purchase the PCTV product line from Avid Technology, Inc. and the cash needed to fund the acquisition's working capital needs. With the proper execution of our operational and integration plan, we believe that our cash and cash equivalents as of September 30, 2008 and our internally generated cash flow will provide us with sufficient liquidity to meet our capital needs for the next twelve months. Failure to meet the operating and integration plan could require the need for additional sources of capital. In light of the current economic and credit conditions there can be no assurances that we will be able to find external sources of financing to fund our additional working capital needs.

Future Contractual Obligation

The following table shows our contractual obligations related to lease obligations as of September 30, 2008:

Contractual obligations	Payment due by period				
	Total	Less than 1 year	1-3 years	3 to 5 years	More than 5 years
Operating lease obligations	\$ 1,687,135	\$ 610,721	\$ 1,076,414	-	-

Effective December 24, 2008, pursuant to an Asset Purchase Agreement dated as of October 25, 2008, we acquired certain assets and properties of Avid Technology, Inc., Pinnacle Systems, Inc., Avid Technology GmbH, Avid Development GmbH, and Avid Technology International BV. The purchase price consisted of \$2,500,000 payable in cash and \$2,500,000 payable pursuant to Promissory Note made payable by us to Avid. The principal amount due pursuant to the Note is payable in 12 equal monthly installments of \$208,333.33. The first payment is due and payable on January 24, 2009. Interest on the outstanding principal amount of the Note is payable at a rate equal to (i) from December 24, 2008 until the Maturity Date, five percent (5%), (ii) from and after the Maturity Date, or during the continuance of an Event of Default, at seven percent (7%). Pursuant to the terms of the Note, we and our affiliates are prohibited from (i) declaring or paying any cash dividend, or making a distribution on, repurchasing, or redeeming, any class of stock or other equity or ownership interest in the Buyer or its affiliates, (ii) selling, leasing, transferring or otherwise disposing of any assets or property of the Buyer or any of its affiliates, or attempting to or contracting to do so, other than (a) the sale of inventory in the ordinary course of business and consistent with past practice, (b) the granting of non-exclusive licenses of intellectual property in the ordinary course of business and consistent with past practice and (c) the sale, lease, transfer or disposition of any assets or property (other than the Acquired Assets) with a value not to exceed \$500,000 in the aggregate, or (iii) dissolving or liquidating, or merging or consolidating with any other entity, or acquiring all or substantially all of the stock or assets of any other entity.

Critical Accounting Policies and Estimates

We believe the following critical accounting policies affect the significant judgments and estimates used in the preparation of our financial statements:

- Revenue Recognition
- Management's estimates
- Translation of assets and liabilities denominated in non-functional currencies on our European financial statements
- Inventory obsolescence and reserves
- Accounts receivable related reserves

Revenue Recognition

We sell through a sales channel which consists of retailers, PC manufacturers and distributors. The majority of our customers are granted lines of credit. The product is shipped on account with the majority of customers typically given 30 to 45 day payment terms. Those customers deemed as large credit risks either pay in advance or issue us a letter of credit.

We require the customer to submit a purchase order to us. The price of the product and payment terms are fixed per the terms of the purchase order. Upon shipment of the order to the customer, the title to the goods is passed to the customer. The customer is legally obligated to pay for the order within the payment terms stated on the customer's purchase order. The obligation to insure the boards and

the cost of any pilferage while in the customer's possession is the responsibility of the customer. We sell analog, hybrid video recorders or digital computer boards that are stocked on the shelves of retailers and are subject to the normal consumer traffic that retail stores attract. Aside from normal store promotions such as advertisements in the store's circular, we have no further obligation to assist in the resale of the products.

We offer some of our customers a right of return. Our accounting complies with SFAS 48 Revenue Recognition when Right of Return Exists, as typically at the end of every quarter we, based on historical data, evaluate our sales reserve level based on the previous six months sales. Due to the seasonal nature of the business coupled with the changing economic environment, management exercises some judgment with regard to the historical data to arrive at the reserve.

We offer mail-in rebates on certain products at certain times as we may determine. The rebates are recorded as a reduction to sales. We also participate in limited cooperative advertising programs with retailers and distributors and account for these in accordance with EITF 01-09, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)".

Management's Estimates

The 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 management to make estimates and judgments that affect the reported amounts of assets, liabilities and related disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts for revenues and expenses during the reporting period. On an ongoing basis, management evaluates estimates, including those related to sales provisions, as described above, income taxes, bad debts, inventory allowances and contingencies. We base our estimates on historical data, when available, experience, and on various other assumptions that are believed to be reasonable under the circumstances, the combined 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.

Translation of assets and liabilities denominated in non-functional currencies on our European financial statements

The functional currency of our European subsidiary is the Euro. In preparing our consolidated financial statements, we are required to translate assets and liabilities denominated in a non-functional currency, mainly U.S. Dollars, to Euros on the books of our European subsidiary. This process results in exchange gains and losses depending on the changes in the Euro to U.S. Dollar exchange rate. Under the relevant accounting guidance, with the exception of inter-company accounts which are considered long term in nature, we are obligated to include these gains and losses on our statement of operations, which we report in other income or expense under the caption "foreign currency".

The extent of these gains and losses can fluctuate greatly from month to month depending on the change in the exchange rate, causing results to vary widely. Due to the past volatility of the Euro, it is difficult to forecast the long term trend of these gains and losses.

Inventory obsolescence and reserves

The technology underlying our products and other products in the computer industry, in general, is subject to rapid change, including the potential introduction of new types of products and technologies. Due to this, we maintain a program in which we review on a regular basis our inventory forecasting, inventory purchasing and our inventory levels. We review our inventory realization and inventory reserves on a quarterly basis.

Accounts receivable and related reserves

On a daily basis we credit approve all orders scheduled for shipment. Customers who are over their credit limit or who have invoices that are past their due date are typically placed on credit hold until the credit problem is resolved. Credit reviews are performed on new customers. Existing customers who request an increased credit line are subject to a new credit review before increases in their credit line are approved.

Our reserve for bad debt is done using a specific identification method. On a quarterly basis we review the age and quality of our accounts receivable. We reserve amounts due us from companies that have gone bankrupt or companies that we evaluate are near bankrupt.

Our products are sold through a sales channel which consist of retailers, PC manufacturers and distributors. Our product is primarily a retail product sold to end user consumers. Similar to other companies in the computer industry our products are subject to returns by the end user. In recognition that product may be returned at a later date, at the end of every quarter, based on historical data, we evaluate our sales reserve level based on the previous six months sales and we adjust our sales reserve as required.

Inflation

While inflation has not had a material effect on our operations in the past, there can be no assurance that we will be able to continue to offset the effects of inflation on the costs of our products or services through price increases to our customers without experiencing a reduction in the demand for our products; or that inflation will not have an overall effect on the computer equipment market that would have a material affect on us.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin No 51" ("SFAS No. 160"). SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, changes in a parent's ownership of a noncontrolling interest, calculation and disclosure of the consolidated net income attributable to the parent and the noncontrolling interest, changes in a parent's ownership interest while the parent retains its controlling financial interest and fair value measurement of any retained noncontrolling equity investment. SFAS No. 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company must adopt these new requirements in its first quarter of fiscal 2010. Management does not expect SFAS No. 160 to have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB approved the issuance of SFAS No. 141 (revised 2007) "Business Combinations" ("SFAS No. 141R"). SFAS No. 141R establishes principles and requirements for how the acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The provisions for SFAS No. 141R are effective for fiscal years beginning after December 15, 2008 and are applied prospectively to business combinations completed on or after that date. Early adoption is not permitted. SFAS No. 141R is effective for the Company beginning in the first quarter of fiscal 2010. Management is currently evaluating the impact of SFAS No. 141R on our results of operations and financial condition.

In September 2006, the FASB issued Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurement," which defines fair value, establishes a framework for measuring fair value and expands disclosures regarding assets and liabilities measured at fair value. In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" (FSP 157-1) and FSP 157-2, "Effective Date of FASB Statement No. 157" (FSP 157-2). FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the Company's first quarter of fiscal 2010. The measurement and disclosure requirements related to financial assets and financial liabilities are effective for the Company's first quarter of fiscal 2009. The Company does not expect that the adoption of SFAS 157 will have a material impact on its consolidated financial position, results of operations or cash flows.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities— An Amendment of FASB Statement No. 133" ("SFAS No. 161"). SFAS 161 requires enhanced qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Management is currently evaluating the impact of SFAS 161 on our consolidated financial statements.

Quantitative and Qualitative Disclosures about Market Risks

For each of the three fiscal years ended September 30, 2008, at least 40% of our sales were generated by our European subsidiary and were invoiced and collected in local currency, which was primarily the Euro. On the supply side, since we predominantly deal with North American and Asian suppliers and contract manufacturers, approximately 90% of our inventory required to support our European sales are purchased and paid in U.S. Dollars.

The combination of sales billed in Euros supported by inventory purchased in U.S. Dollars results in an absence of a natural local currency hedge. Consequently, our financial results are subject to market risks resulting from the fluctuations in the Euro to U.S. Dollar exchange rates.

We attempt to reduce these risks by entering into foreign exchange forward contracts with financial institutions. The purpose of these forward contracts is to hedge the foreign currency market exposures underlying the U.S. Dollar denominated inventory purchases required to support our European sales. As of September 30, 2008, the Company had foreign currency contracts outstanding of approximately \$14,359,000 against the delivery of the Euro. These contracts expire each month through February 2009.

Our Common Stock trades on the Nasdaq Global Market under the symbol HAUP. The range of high and low sales prices for our Common Stock during the two fiscal years ended September 30, 2008, were as follows:

Year ended September 30, 2008	High	Low
First Quarter	5.08	3.55
Second Quarter	5.38	3.18
Third Quarter	4.11	1.50
Fourth Quarter	1.61	1.10
Year ended September 30, 2007	High	Low
First Quarter	7.46	4.82
Second Quarter	9.06	6.68
Third Quarter	7.27	4.89
Fourth Quarter	5.28	3.48

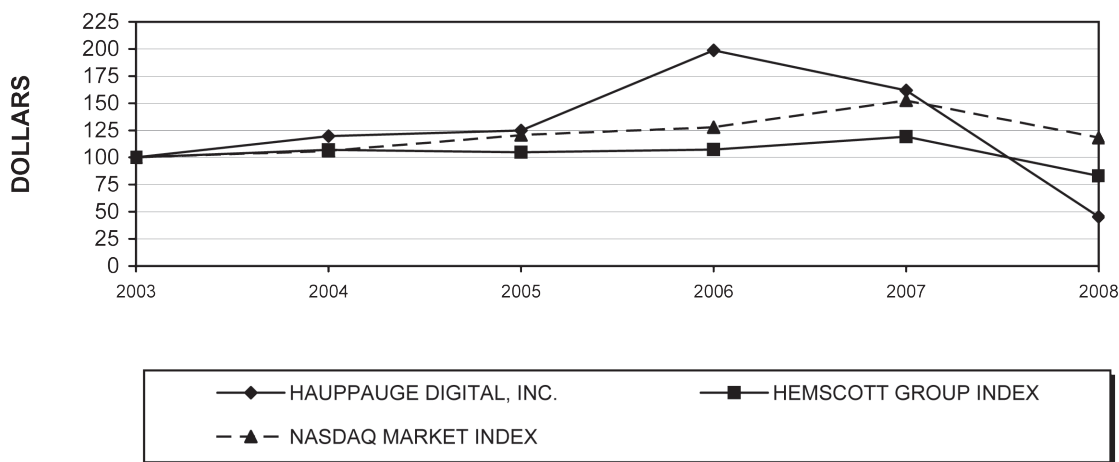
We have been advised by our transfer agent, Continental Stock Transfer & Trust Company that the approximate number of holders of record of our Common Stock as of September 30, 2008 was 156. We believe there are in excess of 4,000 beneficial holders of our Common Stock.

No cash dividends have been paid during the two fiscal years ended September 30, 2008. We have no present intention of paying any cash dividends in our foreseeable future and intend to use our net income, if any, in our operations.

On November 8, 1996, we approved a stock repurchase program. The program authorized us to repurchase up to 850,000 shares of our own stock. The stock repurchase program was extended by a resolution of our Board of Directors on December 17, 1997. At our August 3, 2007 Board meeting, our Board of Directors approved an increase in the number of shares which can be repurchased under the plan to 1,200,000.

The following graph shows a five year comparison of cumulative total stockholder return, calculated on a dividend reinvested basis, for us, the NASDAQ Market Index and the Hemscott Group (Computer Peripheral) Index (the “Hemscott Group Index”). The graph assumes \$100 was invested in each of our shares of Common Stock, the NASDAQ Market Index and the Hemscott Group Index on October 1, 2002 and that all dividends were reinvested. Data points on the graph are annual. Note that historic stock price performance is not necessarily indicative of future stock performance.

**COMPARISON OF 5-YEAR CUMULATIVE TOTAL RETURN
HAUPPAUGE DIGITAL INC.,
NASDAQ MARKET INDEX AND HEMSCOTT GROUP INDEX**



ASSUMES \$100 INVESTED ON OCT. 1, 2003
ASSUMES DIVIDEND REINVESTED

selected financial data

The following selected financial data with respect to our financial position and our results of operations for each of the five fiscal years in the period ended September 30, 2008 set forth below has been derived from our audited consolidated financial statements. The selected financial information presented below should be read in conjunction with the Consolidated Financial Statements and related notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations.

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Consolidated Statement of Operations Data					
(In thousands except for per share amounts)					
Net Sales	\$ 89,701	\$ 110,896	\$ 97,662	\$ 78,458	\$ 65,339
Cost of sales	<u>72,019</u>	<u>88,652</u>	<u>77,817</u>	<u>60,599</u>	<u>48,045</u>
Gross Profit	17,682	22,244	19,845	17,859	17,294
Selling, general and administrative expenses	17,153	14,668	14,116	13,903	12,320
Research and development expenses	3,884	3,480	3,165	2,494	2,021
Legal expenses related to arbitration and litigation proceedings	-	-	-	-	354
Arbitration proceeding	-	-	-	-	206
Litigation proceeding	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>427</u>
Income (loss) from operations	(3,355)	4,096	2,564	1,462	1,966
Other Income (Expense):					
Interest income	44	43	28	13	7
Foreign currency	<u>(15)</u>	<u>(31)</u>	<u>7</u>	<u>61</u>	<u>2</u>
Income (loss) before taxes	(3,326)	4,108	2,599	1,536	1,975
Income tax provision (benefit)	<u>(238)</u>	<u>(1,197)</u>	<u>190</u>	<u>149</u>	<u>150</u>
Net income (loss)	<u>\$ (3,088)</u>	<u>\$ 5,305</u>	<u>\$ 2,409</u>	<u>\$ 1,387</u>	<u>\$ 1,825</u>
Net income (loss) per share:					
Basic	\$ (0.31)	\$ 0.54	\$ 0.25	\$ 0.15	\$ 0.20
Diluted	<u>\$ (0.31)</u>	<u>\$ 0.51</u>	<u>\$ 0.24</u>	<u>\$ 0.14</u>	<u>\$ 0.19</u>
Weighted average shares outstanding:					
Basic	9,970	9,863	9,593	9,431	8,999
Diluted	9,970	10,368	10,019	9,988	9,668
Consolidated Balance Sheet Data (at period end):					
Working capital	\$ 17,229	\$ 21,198	\$ 17,084	\$ 15,335	\$ 13,760
Total assets	39,662	51,920	36,650	32,116	32,071
Stockholders' equity	18,989	22,941	17,780	15,971	14,327



To the Board of Directors and Stockholders of
Hauppauge Digital, Inc. and Subsidiaries
Hauppauge, New York

We have audited the accompanying consolidated balance sheets of Hauppauge Digital, Inc. and Subsidiaries as of September 30, 2008 and 2007 and the related consolidated statements of operations, other comprehensive income (loss), stockholders' equity and cash flows for each of the three years in the period ended September 30, 2008. These financial statements are the responsibility of the management of Hauppauge Digital, Inc. 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 audits 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 presentation of the financial statements. 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 Hauppauge Digital, Inc. and Subsidiaries as of September 30, 2008 and 2007 and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2008 in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

/s/ BDO Seidman, LLP

BDO Seidman, LLP

Melville, New York

January 9, 2009

consolidated balance sheets

Assets	<u>September 30, 2008</u>	<u>September 30, 2007</u>
Current Assets:		
Cash and cash equivalents	\$ 14,191,721	\$ 11,581,657
Accounts receivable, net of various allowances	6,932,400	15,038,751
Other non trade receivable	2,316,057	8,629,075
Inventories	12,236,166	13,521,864
Deferred tax asset-current	1,133,073	603,078
Prepaid expenses and other current assets	1,093,406	802,575
Total current assets	<u>37,902,823</u>	<u>50,177,000</u>
Property, plant and equipment, net	769,288	745,121
Security deposits and other non current assets	102,227	110,165
Deferred tax asset-non current	887,611	887,611
Total assets	<u>\$ 39,661,949</u>	<u>\$ 51,919,897</u>
Liabilities And Stockholders' Equity:		
Current Liabilities:		
Accounts payable	\$ 10,406,836	\$ 20,635,137
Accrued expenses – license fees	7,952,244	5,827,356
Accrued expenses	2,256,099	2,374,410
Income taxes payable	58,234	141,913
Total current liabilities	<u>20,673,413</u>	<u>28,978,816</u>
Commitments and contingencies	-	-
Stockholders' Equity		
Common stock \$.01 par value; 25,000,000 shares authorized, 10,784,717 and 10,597,002 issued, respectively	107,847	105,970
Additional paid-in capital	16,709,201	15,497,703
Retained earnings	7,938,695	11,026,884
Accumulated other comprehensive loss	(3,362,870)	(1,325,971)
Treasury Stock at cost, 759,579 and 749,579 shares, respectively	(2,404,337)	(2,363,505)
Total stockholders' equity	<u>18,988,536</u>	<u>22,941,081</u>
Total liabilities and stockholders' equity	<u>\$ 39,661,949</u>	<u>\$ 51,919,897</u>

See accompanying notes to consolidated financial statements

consolidated statements of operations

Years ended September 30,

	2008	2007	2006
Net sales	\$ 89,701,028	\$ 110,896,010	\$ 97,662,326
Cost of sales	72,019,046	88,651,881	77,817,275
Gross profit	17,681,982	22,244,129	19,845,051
Selling, general and administrative expenses	17,152,848	14,667,766	14,115,989
Research and development expenses	3,883,747	3,480,017	3,164,924
Income (loss) from operations	(3,354,613)	4,096,346	2,564,138
Other Income (expense):			
Interest income	43,989	43,135	28,422
Foreign currency	(15,138)	(31,676)	7,292
Total other income	28,851	11,459	35,714
Income (loss) before taxes (benefit) on income	(3,325,762)	4,107,805	2,599,852
Income tax provision (benefit)	(237,573)	(1,197,579)	190,240
Net income (loss)	<u>(\$ 3,088,189)</u>	<u>\$ 5,305,384</u>	<u>\$ 2,409,612</u>
Net income (loss) per share:			
Basic	(\$ 0.31)	\$ 0.54	\$ 0.25
Diluted	<u>(\$ 0.31)</u>	<u>\$ 0.51</u>	<u>\$ 0.24</u>

See accompanying notes to consolidated financial statements

consolidated statements of other comprehensive income (loss)

Years ended September 30,

	2008	2007	2006
Other comprehensive income (loss):			
Net income (loss)	(\$ 3,088,189)	\$ 5,305,384	\$ 2,409,612
Forward exchange contracts marked to market	51,509	(90,023)	(114,448)
Foreign currency translation (loss)	(2,088,408)	(726,629)	(1,077,641)
Other comprehensive income (loss)	<u>\$ (\$ 5,125,088)</u>	<u>\$ 4,488,732</u>	<u>\$ 1,094,012</u>

See accompanying notes to consolidated financial statement

consolidated statements of stockholders' equity

For the years ended September 30, 2008, 2007 and 2006

	Common Stock						
	Number Of Shares	Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (loss)	Treasury Stock	Total
BALANCE AT SEPTEMBER 30, 2005.	10,107,936	\$ 101,080	\$ 13,603,705	\$ 3,311,888	\$ 682,770	\$ (1,757,951)	\$ 15,941,492
Net income for the year ended September 30, 2006	-	-	-	2,409,612	-	-	2,409,612
Stock compensation	-	-	356,286	-	-	-	356,286
Exercise of stock options	131,597	1,316	199,818	-	-	-	201,134
Foreign currency translation loss	-	-	-	-	(1,077,641)	-	(1,077,641)
Change in fair value of forward contracts	-	-	-	-	(114,448)	-	(114,448)
Stock issued through Employee Stock Purchase plan	<u>20,931</u>	<u>209</u>	<u>63,081</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>63,290</u>
BALANCE AT SEPTEMBER 30, 2006.	10,260,464	\$ 102,605	\$ 14,222,890	\$ 5,721,500	\$ (509,319)	\$ (1,757,951)	\$ 17,779,725
Net income for the year ended September 30, 2007	-	-	-	5,305,384	-	-	5,305,384
Stock compensation	-	-	501,868	-	-	-	501,868
Purchase of treasury stock	-	-	-	-	-	(605,554)	(605,554)
Exercise of warrants	103,800	1,028	194,960	-	-	-	195,988
Exercise of Stock Options	220,425	2,215	526,135	-	-	-	528,350
Foreign currency translation loss	-	-	-	-	(726,629)	-	(726,629)
Change in fair value of forward contracts	-	-	-	-	(90,023)	-	(90,023)
Stock issued through Employee Stock Purchase plan	<u>12,313</u>	<u>122</u>	<u>51,850</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>51,972</u>
BALANCE AT SEPTEMBER 30, 2007.	10,597,002	\$ 105,970	\$ 15,497,703	\$ 11,026,884	\$ (1,325,971)	\$ (2,363,505)	\$ 22,941,081
Net (loss) for the year ended September 30, 2008	-	-	-	(3,088,189)	-	-	(3,088,189)
Stock compensation	-	-	795,912	-	-	-	795,912
Stock compensation-stock issued to directors	35,000	350	125,650	-	-	-	126,000
Purchase of treasury stock	-	-	-	-	-	(40,832)	(40,832)
Exercise of Stock Options	132,800	1,327	235,471	-	-	-	236,798
Foreign currency translation loss	-	-	-	-	(2,088,408)	-	(2,088,408)
Change in fair value of forward contracts	-	-	-	-	51,509	-	51,509
Stock issued through Employee Stock Purchase plan	<u>19,915</u>	<u>200</u>	<u>54,465</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>54,665</u>
BALANCE AT SEPTEMBER 30, 2008.	<u>10,784,717</u>	<u>\$ 107,847</u>	<u>\$ 16,709,201</u>	<u>\$ 7,938,695</u>	<u>\$ (3,362,870)</u>	<u>\$ (2,404,337)</u>	<u>\$ 18,988,536</u>

See accompanying notes to consolidated financial statements

consolidated statements of cash flows

	Years ended September 30,		
	2008	2007	2006
Cash Flows From Operating Activities:			
Net income (loss)	(\$ 3,088,189)	\$ 5,305,384	\$ 2,409,612
Adjustments to reconcile net income (loss) to net cash provided by (used in)			
operating activities:			
Depreciation and amortization	266,858	213,207	195,080
Inventory reserve	930,000	450,000	265,947
Bad debt reserve	450,000	20,000	120,000
Sales reserve-net	-	166,921	-
Stock compensation expense-employees	795,912	501,868	356,286
Stock compensation expense-directors	126,000	-	-
Deferred tax benefit	(529,995)	(1,490,689)	-
Other non cash items	7,938	(26,526)	(1,710)
Changes in current assets and liabilities:			
Accounts receivable and other non trade receivables	13,969,369	(8,443,712)	(3,204,852)
Inventories	355,698	(3,344,225)	(364,908)
Prepaid expenses and other current assets	(290,831)	92,648	192,230
Accounts payable	(10,228,301)	8,623,905	1,260,672
Accrued expenses and income taxes	1,922,898	1,484,248	1,435,139
Total adjustments	7,775,546	(1,752,355)	253,884
Net cash provided by operating activities	4,687,357	3,553,029	2,663,496
Cash Flows From Investing Activities:			
Purchases of property, plant and equipment	(291,025)	(346,417)	(282,283)
Net cash used in investing activities	(291,025)	(346,417)	(282,283)
Cash Flows From Financing Activities:			
Proceeds from employee stock purchases	291,463	776,310	264,424
Purchase of treasury stock	(40,832)	(605,554)	-
Net cash provided by financing activities	250,631	170,756	264,424
Effect of exchange rates on cash	(2,036,899)	(816,652)	(1,192,089)
Net increase in cash and cash equivalents	2,610,064	2,560,716	1,453,548
Cash and cash equivalents, beginning of year	11,581,657	9,020,941	7,567,393
Cash and cash equivalents, end of year	\$ 14,191,721	\$ 11,581,657	\$ 9,020,941
Supplemental disclosures:			
Income taxes paid	\$ 375,437	\$ 273,718	\$ 142,526

See accompanying notes to consolidated financial statements

1. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Hauppauge Digital, Inc. (the "Company") and its wholly-owned subsidiaries, Hauppauge Computer Works, Inc., HCW Distributing Corp., and Hauppauge Digital Europe Sarl, its branch Hauppauge Digital Europe Ireland and Hauppauge Digital Europe Sarl's wholly-owned subsidiaries, Hauppauge Digital Asia Pte Ltd, Hauppauge Computer Works, GmbH, Hauppauge Computer Works, Ltd., and Hauppauge Computer Works. All inter-company accounts and transactions have been eliminated.

Nature of Business

Hauppauge Digital, Inc. is a developer of analog and digital TV tuner products for the personal computer market. Through its Hauppauge Computer Works, Inc. and Hauppauge Digital Europe Sarl subsidiaries, the Company designs, develops, manufactures and markets analog, digital and other types of TV tuners that allow PC users to watch television on a PC screen in a resizable window, and enables the recording of TV shows to a PC's hard disk, digital video editing, video conferencing, and the display of digital media stored on a computer to a TV set via a home network. The Company, incorporated in Delaware in August 1994, is headquartered in Hauppauge, New York, with administrative offices in Luxembourg, Ireland and Singapore and with sales offices in Germany, London, Paris, The Netherlands, Sweden, Italy, Spain, Singapore, Taiwan and California.

The Company's products fall under three product categories:

- Analog TV tuners
- Digital TV tuners, and combination analog and digital TV tuners
- Other non TV tuner products

The Company's analog and digital TV tuner products enable, among other things, a PC user to watch TV in a resizable window on a PC.

The Company's other non TV tuner products enable, among other things, a PC user to video conference, watch and listen to PC based videos, music and pictures on a TV set through a home network, and record TV shows on a PC for playback on portable video players.

Product Segment and Geographic Information

The Company operates in one business segment, which is the development, marketing and manufacturing of analog and digital TV tuner products for the personal computer market. The products are similar in function and share commonality of component parts and manufacturing processes. The Company's products are either sold, or can be sold, by the same retailers and distributors in the Company's marketing channel. The Company also sells the Company's TV tuner products directly to PC manufacturers. The Company evaluates its product lines under the functional categories of analog TV tuners, digital TV and combination digital and analog TV tuners and other non TV tuner products. Sales by functional category are as follows:

	Twelve months ended September 30,		
	2008	2007	2006
Product line sales:			
Analog sales	\$ 10,561,536	\$ 45,571,132	\$ 62,767,575
Digital sales	74,371,847	63,385,218	33,075,913
Other non TV tuners products	4,767,645	1,939,660	1,818,838
Total sales	<u>\$ 89,701,028</u>	<u>\$ 110,896,010</u>	<u>\$ 97,662,326</u>

The Company sells its product through a domestic and international network of distributors and retailers. Net sales to international and domestic customers were approximately 52% and 48%, 44% and 56%, and 54% and 46% of total sales for the years ended September 30, 2008, 2007 and 2006, respectively.

Net sales to customers by geographic location consist of:

	Years ended September 30,		
	2008	2007	2006
Sales to:			
The Americas	48%	56%	46%
Northern Europe	9%	12%	18%
Southern Europe	14%	8%	9%
Central and Eastern Europe	26%	21%	24%
Asia	3%	3%	3%
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>

Net long lived assets located in the United States, Europe and Asia locations were approximately 74%, 16% and 10% of total net long lived assets, respectively, at September 30, 2008, and 75%, 15% and 10%, respectively, at September 30, 2007.

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, manage-

ment is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the 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. The Company reviews all significant estimates affecting the financial statements on a recurring basis and records the effect of any adjustments when necessary.

Cash and Cash Equivalents

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with an original maturity date of three months or less to be cash equivalents.

Concentrations of Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and accounts receivable. At times such cash in banks are in excess of the FDIC insurance limit. Concentration of credit risk with respect to accounts receivable exists because the Company operates in one industry (also see Note 8). Although the Company operates in one industry segment, it does not believe that it has a material concentration of credit risk either from an individual counter party or a group of counter parties, due to the large and diverse user group for its products. The Company performs ongoing credit notes to consolidated financial statements evaluations of its customers and generally does not require collateral. The Company maintains allowances to cover potential or anticipated losses for uncollectible amounts.

Shipping and Handling Costs

The Company records all shipping and handling charges in Cost of Sales.

Revenue Recognition

The Company sells through a sales channel which consist of retailers, PC manufacturers and distributors. The majority of the Company's customers are granted lines of credit. The product is shipped on account with the majority of customers typically given 30 to 45 day payment terms. Those customers deemed as large credit risks either pay in advance or issue the Company a letter of credit.

The Company requires the customer to submit a purchase order to the Company. The price of the product and payment terms are fixed per the terms of the purchase order. Upon shipment of the order to the customer, the title to the goods is passed to the customer. The customer is legally obligated to pay for the order within the payment terms stated on the customer's purchase order. The obligation to insure the boards and the cost of any pilferage while in the customer's possession is the responsibility of the customer. The Company sells analog, hybrid video recorders or digital computer boards that are stocked on the shelves of retailers and are subject to the normal consumer traffic that retail stores attract. Aside from normal store promotions such as advertisements in the store's circular, the Company has no further obligation to assist in the resale of the products.

The Company offers some of its customers a right of return. The Company's accounting complies with SFAS 48 Revenue Recognition when Right of Return Exists, as typically at the end of every quarter the Company, based on historical data, evaluates its sales reserve level based on the previous six months sales. Due to seasonal nature of the business coupled with the changing economic environment, management exercises some judgment with regard to the historical data when calculating the reserve.

The Company offers mail-in rebates on certain products at certain times as determined by the Company. The rebates are recorded as a reduction to sales. The Company also participates in limited cooperative advertising programs with retailers and distributors and accounts for these in accordance with EITF 01-09, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)".

Warranty Policy

The Company warrants that its products are free from defects in material and workmanship for a period of one year from the date of initial retail purchase. The warranty does not cover any losses or damage that occur as a result of improper installation, misuse or neglect and repair or modification by anyone other than the Company or its authorized repair agent. The Company accrues anticipated warranty costs based upon historical percentages of items returned for repair within one year of the initial sale. The Company's repair rate of product under warranty has been minimal and the warranty reserve has not been material.

Inventories

Inventories are valued at the lower of cost (principally average cost) or market. A reserve has been provided to reduce obsolete and/or excess inventory to its net realizable value.

Property, Plant and Equipment

Depreciation of office equipment and machinery and amortization of leasehold improvements is provided for using both accelerated and straight line methods over the estimated useful lives of the related assets as follows:

- Office Equipment and Machinery: 5 to 7 years
- Leasehold improvements: Asset life or lease term, whichever is shorter

Income taxes

The Company follows the liability method of accounting for income taxes. Deferred income taxes are recorded to reflect the temporary differences in the tax bases of the assets or liabilities and their reported amounts in the financial statements.

Long-Lived Assets

Long-lived assets, such as property and equipment, are evaluated for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable through the estimated undiscounted future cash flows from the use of these assets. When any such impairment exists, the related assets will be written down to fair value.

Research and Development

Expenditures for research and development are charged to expense as incurred.

Foreign Currency Translations and Transactions

The Company's Asian subsidiary reports its financial position and results of operations in the reporting currency of the Company.

The financial position and results of operations of the Company's European subsidiaries are determined using Euros as the functional currency. Assets and liabilities of these subsidiaries are translated at the exchange rate in effect at each period end. Income statement accounts are translated at the average rate during the year.

Translation adjustments arising from the translation to U.S. Dollars at differing exchange rates are included in the accumulated other comprehensive income (loss) account in stockholders' equity. Gains and losses resulting from transactions that are denominated in currencies other than Euros are included in earnings as a component of other income. The Company had a translation loss of \$1,257,918 recorded on the balance sheet as of September 30, 2007. For the twelve months ended September 30, 2008 the Company recorded on the balance sheet deferred translation losses of \$2,088,408 resulting in a translation loss of \$3,346,326 recorded as a component of accumulated other comprehensive income as of September 30, 2008.

Derivatives and Hedging Activities

For each of the three fiscal years ended September 30, 2008, 2007 and 2006, at least 40% of the Company's sales were generated by its European subsidiary and were invoiced and collected in local currency, which was primarily the Euro. On the supply side, since the Company predominantly deals with North American and Asian suppliers and contract manufacturers, approximately 90% of the Company's inventory required to support its European sales are purchased and paid in U.S. Dollars. The combination of sales billed in Euros supported by inventory purchased in U.S. dollars results in an absence of a natural local currency hedge. Consequently, the Company's financial results are subject to market risks resulting from the fluctuations in the Euro to U.S. Dollar exchange rates.

The Company attempts to reduce these risks by entering into foreign exchange forward contracts with financial institutions. The purpose of these forward contracts is to hedge the foreign currency market exposures underlying the U.S. Dollar denominated inventory purchases required to support its European sales.

The Company does not try to hedge against all possible foreign currency exposures because of the inherent difficulty in estimating the volatility of the Euro. The contracts the Company procures are specifically entered into to as a hedge against forecasted or existing foreign currency exposure. The Company does not enter into contracts for speculative purposes. Although the Company maintains these programs to reduce the short term impact of changes in currency exchange rates, long term strengthening or weakening of the U.S. Dollar against the Euro impacts the Company's sales, gross profit, operating income and retained earnings. Factors that could impact the effectiveness of the Company's hedging program are:

- volatility of the currency markets
- availability of hedging instruments
- accuracy of the Company's inventory forecasts

Additionally, there is the risk that foreign exchange fluctuations will make the Company's products less competitive in foreign markets, which would substantially reduce the Company's sales.

As of September 30, 2008, the Company had foreign currency contracts outstanding of approximately \$14,359,000 against the delivery of the Euro. These contracts expire each month through February 2009.

The Company's accounting policies for these instruments designate such instruments as cash flow hedging transactions. The Company does not enter into such contracts for speculative purposes. The Company records all derivative gains and losses on the balance sheet as a component of stockholders' equity under the caption "Accumulated other comprehensive loss", which amounted to losses of \$16,544 and \$68,503 as of September 30, 2008 and 2007, respectively.

Fair Value of Financial Instruments

The carrying amounts of certain financial instruments, including cash, receivables and accounts payable, approximate fair value as of September 30, 2008 and 2007 because of the relatively short term maturity of these instruments.

Net income (loss) per share

Basic net income (loss) per share includes no dilution and is computed by dividing net income (loss) by the weighted average number of shares of Common Stock outstanding for the period. Diluted net income (loss) per share reflect, in periods in which they have a dilutive effect, the dilution which would occur upon the exercise of stock options. A reconciliation of the shares used in calculating basic and diluted earnings (loss) per share follows:

	Years ended September 30,		
	2008	2007	2006
Weighted average common stock outstanding-basic	9,969,939	9,862,655	9,593,050
Common stock equivalents-stock options	-	505,120	426,464
Weighted average shares outstanding-diluted	<u>9,969,939</u>	<u>10,367,775</u>	<u>10,019,514</u>

Options to purchase 1,767,744, 540,250 and 193,856 shares of Common Stock at prices ranging \$1.05 to \$8.75, \$4.67 to \$8.75 and 4.13 to \$8.75, respectively, were outstanding as of September 30, 2008, 2007 and 2006, respectively, but were not included in the computation of diluted net income per share of Common Stock because they were anti-dilutive.

Stock Based Compensation

The Company follows SFAS No. 123R, "Share-Based Payments" where the fair value of stock options are determined using the Black-Scholes valuation model and such fair value is recognized as an expense over the service period, net of estimated forfeitures.

The Company had as of September 30, 2008 options issued from four incentive option plans and one non qualified option plan. These options typically vest over a period of four to five years. Options granted subsequent to the Company's October 1, 2005 adoption of SFAS 123R have a contract term of 10 years and the fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions based on historical data of the Company's stock:

Stock option grant assumptions:	2008	2007	2006
Weighted average fair value of grants	\$ 1.02	\$ 3.40	\$ 1.89
Risk free interest rate	4.25%	4.25%	4.25%
Dividend yield	-	-	-
Expected volatility	50%	50%	50%
Expected life in years	7	7	7

As of September 30, 2008, there was \$1,302,413 of total unrecognized compensation expense net of estimated forfeitures, related to non-vested share based compensation arrangements which is expected to be recognized over a weighed average period of 3.75 years. The total fair value of shares vested during the years ended September 30, 2008, 2007 and 2006 was \$795,912 and \$501,868 and \$356,286. For September 30, 2008, 2007 and 2006 stock compensation expense of \$522,168, \$316,292 and \$263,363 have been recorded to SG&A expense and \$273,744, \$185,576 and \$92,923 have been recorded to research and development expense.

In recognition that stock compensation is a non-cash expense, the effect of expensing options had no affect on the Company's cash flow. However, it was reflected in the Company's cash flow statement as a non-cash item which was added back in the determination of cash flows from operating activities.

A summary of the Company's non-vested shares as of September 30, 2008 and changes during the twelve months ended September 30, 2008 is presented below:

	Shares	Weighted average Grant date fair value
Non-vested as of October 1, 2007	691,875	\$ 2.98
Granted	144,500	1.02
Vested	<u>(215,232)</u>	<u>2.30</u>
Non-vested as of September 30, 2008	<u>621,143</u>	<u>\$ 2.76</u>

Accrued expenses- licensing fees

The Company uses technology licensed from third parties in certain products. The Company enters into agreements to license this technology, and in return for the use of the technology, the Company pays a license fee for each unit sold that includes the licensors' technology. The licensing amount per unit varies by licensor. The Company is obligated to provide the licensor with reports which quantify the licenses used. In most instances, the licensor has the right to audit the usage reports.

The licensing fees are accounted for as a component of product cost and are charged to cost of sales. The Company accrues a licensing fee for each unit sold that uses the licensors' technology.

Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin No 51" ("SFAS No. 160"). SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, changes in a parent's ownership of a noncontrolling interest, calculation and disclosure of the consolidated net income attributable to the parent and the noncontrolling interest, changes in a parent's ownership interest while the parent retains its controlling financial interest and fair value measurement of any retained noncontrolling equity investment. SFAS No. 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company must adopt these new requirements in its first quarter of fiscal 2010. Management does not expect SFAS No. 160 to have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB approved the issuance of SFAS No. 141 (revised 2007) "Business Combinations" ("SFAS No. 141R"). SFAS No. 141R establishes principles and requirements for how the acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The provisions for SFAS No. 141R are effective for fiscal years beginning after December 15, 2008 and are applied prospectively to business combinations completed on or after that date. Early adoption is not permitted. SFAS No. 141R is effective for the Company beginning in the first quarter of fiscal 2010. The Company is evaluating the impact of SFAS No. 141R on its results of operations and financial condition.

In September 2006, the FASB issued Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurement," which defines fair value, establishes a framework for measuring fair value and expands disclosures regarding assets and liabilities measured at fair value. In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" (FSP 157-1) and FSP 157-2, "Effective Date of FASB Statement No. 157" (FSP 157-2). FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the Company's first quarter of fiscal 2010. The measurement and disclosure requirements related to financial assets and financial liabilities are effective for the Company's first quarter of fiscal 2009. The Company does not expect that the adoption of SFAS 157 will have a material impact on its consolidated financial position, results of operations or cash flows.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities- An Amendment of FASB Statement No. 133" ("SFAS No. 161"). SFAS 161 requires enhanced qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company is currently evaluating the impact of SFAS 161 on its consolidated financial statements.

Reclassifications

Certain reclassifications have been made to the prior period consolidated financial statements to conform to the current year presentation.

2. Accounts receivable

Receivables consist of:

- Trade receivables from sales to customers
- Receivables pertaining to component parts purchased from the Company by its contract manufacturers which are excluded from sales
- General services tax (GST) and value added tax (VAT) reclaimable on goods purchased by the Company's Asian and European locations
- Allowances, consisting of sales and bad debt
- Other minor non trade receivables

Attached below is a listing by category of the Company's accounts receivable as of September 30, 2008 and 2007.

Receivable detail:	As of September 30,	
	2008	2007
Trade receivables	\$ 11,668,214	\$ 19,324,565
Allowances and reserves	(4,735,814)	(4,285,814)
Net trade receivables	6,932,400	15,038,751
Receivable from contract manufacturers	1,795,225	6,673,021
GST and VAT taxes receivables	484,086	1,912,492
Other	36,746	43,562
Total other non trade receivables	\$ 2,316,057	\$ 8,629,075

3. Inventories

Inventories consist of the following:

	As of September 30,	
	2008	2007
Component Parts	\$ 4,561,140	\$ 6,298,489
Finished Goods	7,675,026	7,223,375
	<u>\$ 12,236,166</u>	<u>\$ 13,521,864</u>

4. Property, Plant and Equipment

The following is a summary of property, plant and equipment:

	As of September 30,	
	2008	2007
Office Equipment and Machinery	\$ 3,492,520	\$ 3,151,570
Leasehold Improvements	115,870	115,971
	3,608,390	3,267,541
Less: Accumulated depreciation and amortization	(2,839,102)	(2,522,420)
	<u>\$ 769,288</u>	<u>\$ 745,121</u>

Depreciation and amortization expense totaled \$ 266,858, \$ 213,207 and \$195,080 for the years ended September 30, 2008, 2007 and 2006, respectively.

5. Accrued Expenses – Licensing Fees

The Company recognizes and estimates the amount of licensing fees owed to third parties based on products sold that include software and technology licensed from these third parties. The following is a summary of the changes in the Company's accrued expenses – licensing fees for the years ended September 30, 2008 and 2007:

Balance as of September 30, 2006	\$ 5,481,005
Deduct licenses paid	(2,544,491)
Add licenses accrued	<u>2,890,842</u>
Balance as of September 30, 2007	\$ 5,827,356
Deduct licenses paid	(1,190,320)
Add licenses accrued	<u>3,315,208</u>
Balance as of September 30, 2008	<u>\$ 7,952,244</u>

During fiscal year 2008, the Company identified \$1,462,661 of license accrual amounts that were no longer considered to be owed to third parties. Certain amounts should have been adjusted in a prior year however no such adjustments were made in that prior year. As a result, the Company recorded a correction of an error in the first quarter of 2008, which resulted in a decrease to accrued expenses - licensing fees and a decrease to cost of sales of approximately \$273,000. This adjustment was a correction to a period prior to those presented herein. The Company did not deem this adjustment to be material to any prior years based upon both quantitative and qualitative factors. This matter was not corrected for periods prior to October 1, 2008 due to the immateriality of the effects of this in earlier years. In addition the Company reduced its accrued expenses – licensing fees by approximately \$1,190,000 relating to amounts that were previously accrued for and were now considered to no longer represent an accrued expense for the Company due to a change in the Company's estimate.

6. Income Taxes

The Company's income tax provision consists of the following:

	Years ended September 30,		
	2008	2007	2006
Current tax expense:			
State income taxes	\$ 25,000	\$ 38,000	\$ 20,000
Foreign income taxes	267,422	146,767	110,240
Federal income taxes due to AMT	-	108,343	60,000
Total current tax expense	<u>292,422</u>	<u>293,110</u>	<u>190,240</u>
Deferred tax (benefit)			
Federal	(474,206)	(1,351,695)	-
State	(55,789)	(138,994)	-
Total tax provision (benefit)	<u>\$ (237,573)</u>	<u>\$ (1,197,579)</u>	<u>\$ 190,240</u>

Components of deferred taxes are as follows:

	Years ended September 30,	
	2008	2007
Net operating loss foreign	\$ 475,693	\$ 475,693
Sales reserve	380,764	380,764
US Inventory obsolescence	874,000	520,600
Allowance for bad debts	338,200	167,200
Vacation accrual	24,588	24,588
Warranty reserve	9,158	9,158
263 A inventory capitalization	83,517	55,114
Depreciation	4,834	7,122
Goodwill	135,376	155,896
AMT credit	170,247	170,247
R&D credit	407,971	407,971
Subtotal	<u>2,904,348</u>	<u>2,374,353</u>
Valuation allowance	<u>(883,664)</u>	<u>(883,664)</u>
Net deferred tax assets	<u>\$ 2,020,684</u>	<u>\$ 1,490,689</u>

The deferred tax assets and the offsetting tax valuation allowance is attributable to the Company's domestic operations. For the three fiscal years ended September 30, 2007 the Company's domestic operation has had taxable income. As of September 30, 2007, the Company evaluated the future realization of the Company's deferred tax assets and the corresponding valuation allowance. The Company took into consideration:

- the taxable income of the Company's domestic operations for the last three years
- anticipated taxable income for fiscal 2008
- the utilization in fiscal 2007 of the remainder of the Company's domestic net operating loss carry forward

After evaluating the circumstances listed above, it was the Company's opinion to reduce the deferred tax valuation allowance by \$3,010,253, resulting in a tax benefit for fiscal 2007 of \$1,490,689.

As of September 30, 2008, the Company had utilized all of the Company's unrestricted domestic net operating losses. As of September 30, 2008 the Company had tax credit carry forwards for research and development expenses totaling \$408,000 (which expire between 2010 and 2014) which have a full valuation allowance recorded against them.

No provision has been made for income taxes on substantially all of the undistributed earnings of the Company's foreign subsidiaries of approximately \$14,349,433 at September 30, 2008 as the Company intends to indefinitely reinvest such earnings.

The difference between the actual income tax provision (benefit) and the tax provision (benefit) computed by applying the Federal statutory income tax rate of 34% to the income before income tax is attributable to the following:

	Years ended September 30,		
	2008	2007	2006
Income tax expense at federal statutory rate	\$ (1,130,759)	\$ 1,396,654	\$ 883,950
Increase (decrease) in deferred income tax valuation allowance	-	(3,010,253)	(909,928)
Change in estimate of prior year income taxes	79,438	42,674	137,108
Permanent differences-life insurance	1,360	4,420	2,550
Permanent differences-compensation expense	270,610	170,635	-
Permanent differences-other	1,700	(49,594)	1,190
State income taxes, net of federal benefit	(39,289)	(53,376)	108,982
Foreign earnings taxed at rates other than the federal statutory rate . . .	544,782	301,261	(33,612)
Other	34,585	-	-
Taxes (benefit) on income	<u>\$ (237,573)</u>	<u>\$ (1,197,579)</u>	<u>\$ 190,240</u>

The Company's Luxembourg corporation functions as the entity which services the Company's European customers. The Company has separate domestic and foreign tax entities, with the Luxembourg entity paying a royalty fee to the Company's domestic operation for use of the Hauppauge name.

Net of royalty fees charged to the Company's European subsidiary, the Company's domestic operation incurred a pretax loss of \$2,509,998 for the year ended September 30, 2008 and a pre tax profit of \$3,632,459 and \$2,134,157, respectively, for the years ended September 30, 2007 and 2006. The Company's international operations had pretax net income (loss) net of royalty fees of \$(815,764), \$475,346 and \$465,695, respectively, for the years ended September 30, 2008, 2007 and 2006.

7. Stockholders' Equity

a. Treasury Stock

The Company's Board of Directors approved a stock repurchase program which allows for the repurchase of 1,200,000 shares under the plan. As of September 30, 2008, the Company held 759,579 treasury shares purchased for \$2,404,337 at an average purchase price of approximately \$3.17 per share

b. Stock Compensation Plans

In August 1994, the Company adopted an Incentive Stock Option Plan ("ISO"), as defined in section 422(A) of the Internal Revenue Code. Pursuant to the ISO, 400,000 options may be granted for up to ten years with exercise prices at the fair market value of the Common Stock at the date of the grant, subject to adjustment as provided in the plan. As of September 30, 2008, 2007 and 2006, 33,867, 33,867 and 45,867 options were outstanding, respectively, ranging in prices from \$1.35 to \$2.54.

On December 14, 1995, the Board of Directors authorized the adoption of the 1996 Non-Qualified Stock Option Plan (the "1996 Non-Qualified Plan") which was approved by the Company's stockholders on March 5, 1996.

The 1996 Non-Qualified Plan authorizes the grant of 500,000 shares of Common Stock, subject to adjustment as provided in the plan. The plan terminated on March 5, 2006. This plan does not qualify for treatment as an incentive stock option plan under the Internal Revenue Code. There are various tax benefits which could accrue to the Company upon exercise of non-qualified stock options that may not be available to the Company upon exercise of qualified incentive stock options. The purpose of the plan is to provide the Company greater flexibility in rewarding key employees, consultants, and other entities without burdening the Company's cash resources. As of September 30, 2008, 2007 and 2006, 186,975, 248,975 and 285,975 options ranging in prices from \$1.08 to \$4.13 were outstanding under the 1996 Non-Qualified Plan.

On December 17, 1997, the Company's Board of Directors adopted and authorized a new incentive stock option plan ("1997 ISO") pursuant to section 422A of the Internal Revenue Code. This plan was approved by the Company's stockholders at the Company's March 12, 1998 annual stockholders' meeting. The 1997 ISO plan as adopted authorizes the grant of up to 700,000 shares of Common Stock, subject to adjustment as provided in the plan. This plan terminated on December 16, 2007. The option terms may not exceed ten years. Options cannot be granted at less than 100% of the market value at the time of grant. Options granted to employees who own more than 10% of the Company's outstanding Common Stock cannot be granted at less than 110% of the market value at the time of grant. As of September 30, 2008, 2007 and 2006, 270,610, 300,960 and 375,785 options were outstanding with exercise prices from \$1.08 to \$ 8.75.

The Company's Board of Directors, on May 9, 2000, adopted the 2000 Performance and Equity Incentive Plan (the "2000 Plan"). This plan was approved by the stockholders at the Company's July 18, 2000 annual stockholders' meeting. The purpose of the 2000 Plan is to attract, retain and motivate key employees, directors and non-employee consultants.

The 2000 Plan as adopted reserves 500,000 shares of Common Stock to be issued pursuant to stock options grants or other awards, subject to adjustment for any merger, reorganization, consolidation, recapitalization, stock dividend, stock split or any other changes in corporate structure affecting the Common Stock. This plan is to be administered by the Board of Directors. Grants of awards to non-em-

ployee directors require the approval of the Board of Directors.

The 2000 plan allows the granting of options as either incentive stock options or non-qualified options. Non-employee directors and non-employee consultants may only be granted Non-Qualified Stock Options. Incentive stock options are priced at the market value at the time of grant and shall be exercisable no more than ten years after the date of the grant. Incentive stock options granted to employees who own 10% or more of the Company's combined voting power cannot be granted at less than 110% of the market value at the time of grant. Non-qualified options shall be granted at a price determined by the Board of Directors, or a committee thereof, and shall be exercisable no more than 10 years and one month after the grant. The aggregate fair market value of shares subject to an incentive stock option granted to an optionee in any calendar year shall not exceed \$100,000. As of September 30, 2008, 2007 and 2006, 202,667, 208,667 and 259,142 options were outstanding from this plan ranging in prices from \$1.05 to \$5.78.

The Company's Board of Directors on May 16, 2003 adopted the 2003 Performance and Equity Incentive Plan (the "2003 Plan"). This plan was approved by the stockholders at the Company's September 22, 2003 annual stockholders' meeting. The purpose of the 2003 Plan is to provide equity ownership opportunities and performance based incentives to attract and retain the services of key employees, Directors and non-employee consultants of the Company and to motivate such individuals to put forth maximum efforts on behalf of the Company.

The 2003 Plan as adopted reserves up to 500,000 shares of Common Stock to be issued pursuant to stock options grants or other awards, subject to adjustment for any merger, reorganization, consolidation, recapitalization, stock dividend, stock split or any other changes in corporate structure affecting the Common Stock. All of the Common Stock which may be awarded under the 2003 Plan may be subject to delivery through Incentive Stock Option Plans. The 2003 Plan will be administered by the Board of Directors or a Committee thereof composed of two or more members who are non-employee Directors (the "Committee"). Grants of awards under the 2003 Plan to non-employee Directors require the approval of the Board of Directors. On September 5, 2006 the Company's Board of Directors approved an amendment which increased the number of shares of Common Stock authorized and reserved for issuance under the plan by an additional 1,000,000 shares. The amendment was approved by the Company's stockholders at the Company's October 17, 2006 Annual Stockholders Meeting.

The Board or the Committee may amend, suspend or discontinue the 2003 Plan or any portion thereof at any time, but no amendment, suspension or discontinuation shall be made which would impair the right of any holder without the holder's consent. Subject to the foregoing, the Board or the Committee has the authority to amend the 2003 Plan to take into account changes in law and tax and accounting rules, as well as other developments. The Board or the Committee may institute loan programs to assist participants in financing the exercise of options through full recourse interest bearing notes not to exceed the cash consideration plus all applicable taxes in connection with the acquisition of shares.

This plan allows the granting of options as either incentive stock options or non-qualified options. Non-employee directors and non-employee consultants may only be granted Non-Qualified Stock Options. Incentive stock options are priced at the market value at the time of grant and shall be exercisable no more than ten years after the date of the grant. Incentive stock options granted to employees who own 10% or more of the Company's combined voting power cannot be granted at less than 110% of the market value at the time of grant. Non-qualified options shall be granted at a price determined by the Board of Directors and shall be exercisable no more than 10 years and one month after the grant. The aggregate fair market value of shares subject to an incentive stock option granted to an optionee in any calendar year shall not exceed \$100,000. Any fair value at the time of grant that exceeds \$100,000 in any calendar year will not be deemed as incentive stock options. As of September 30, 2008, 2007 and 2006, 1,073,625, 932,125 and 468,000 were outstanding from this plan ranging in prices from \$1.64 to \$ 7.45.

The Board or the Committee may grant options with a reload feature. A reload feature shall only apply when the option price is paid by delivery of Common Stock held by the optionee for at least 12 months. The agreement for options containing the reload feature shall provide that the option holder shall receive, contemporaneously with the payment of the option price in Common Stock, a reload stock option to purchase the number of Common Stock equal to the number of Common Stock used to exercise the option, and, to the extent authorized by the Board or the Committee, the number of Common Stock used to satisfy any tax withholding requirement incident to the underlying Stock Option. The exercise price of the reload options shall be equal to the fair market value of the Common Stock on the date of grant of the reload option and each reload option shall be fully exercisable six months from the effective date of the grant of such reload option. The term of the reload option shall be equal to the remaining term of the option which gave rise to the reload option. No additional reload options shall be granted to optionees when Stock Options are exercised following the termination of the optionee's employment. Subject to the foregoing, the terms of the 2003 Plan applicable to the option shall be equally applicable to the reload option.

Stock Appreciation Rights may be granted in conjunction with all or part of any stock option granted under the 2003 Plan or independent of a stock option grant. Stock Appreciation Rights shall be subject to such terms and conditions as shall be determined by the Board or the Committee. Upon the exercise of a Stock Appreciation Right, a holder shall be entitled to receive an amount in cash, Common Stock, or both, equal in value to the excess of the fair market value over the option exercise price per Common Stock. Shares of Restricted Stock may also be issued either alone or in addition to other amounts granted under the 2003 Plan. The Board or the Committee shall determine the officers, key employees and non-employee consultants to whom and the time or times at which grants of Restricted Stock will be made, the number of shares to be awarded, the time or times within which such awards may be subject to forfeiture and any other terms and conditions of the awards. Long term performance awards (or "Award") may be awarded either alone or in addition to other awards granted under the 2003 Plan. The Board or the Committee shall determine the nature, length, and starting date of the performance period which shall generally be at least two years. The maximum award for any individual with respect to any one year of any applicable performance period shall be 100,000 shares of Common Stock.

Upon a Change in Control as defined in the 2003 Plan, but only to the extent determined by the Board or the Committee, stock options, stock appreciation rights and long term performance awards (the "Award") will vest, provided that no award granted to an employee of the Company shall vest or be exercisable unless the employee's employment is terminated within 24 months from the date of the Change

in Control, (as defined in the 2003 Plan) unless the employee is terminated for Cause, as defined in the 2003 Plan or if the employee resigns his employment without Good Reason, as defined in the 2003 Plan. Otherwise, the Award shall not vest and be exercisable upon a Change in Control, unless otherwise determined. The employee shall have 30 days from after his employment is terminated due to a Change in Control to exercise all unexercised Awards. However, in the event of the death or disability of the employee, all unexercised Awards must be exercised within twelve (12) months after the death or disability of the employee. The Company's Board of Directors on May 9, 2000 adopted the Employee Stock Purchase Plan. This plan was approved by the Company's stockholders' at the Company's July 18, 2000 annual stockholders' meeting. This plan is intended to provide the Company's full-time employees an opportunity to purchase an ownership interest in the Company through the purchase of Common Stock. The Company had reserved 100,000 shares of Common Stock for issuance under the plan. This plan is to be administered by the Board of Directors. Employees who have completed six months of employment and who work more than 20 hours per week for more than five months in the year are eligible to participate in the plan. The employee may elect payroll deductions up to 10% per pay period. The purchase price shall either be the lower of 85% of the closing price on the offering commencement date or the offering termination date. No employee will be granted an option to purchase shares of Common Stock if such employee would own shares or holds options to purchase shares which would cause the employee to own more than 5% of the combined voting power of all classes of stock. Non-employees are not eligible to participate. The plan's initial termination date was December 31, 2003. The maximum number of shares that may be issued in any quarterly offering is 10,000, plus un-issued shares from prior offerings whether offered or not. At the Company's September 6, 2002 stockholders' meeting, the Company's stockholders' approved an increase in shares reserved under this plan to 180,000, and extended the plan termination date to December 31, 2004. At the Company's September 27, 2004 stockholders' meeting the Company's stockholders' approved an increase in shares reserved under this plan to 260,000, and extended the plan termination date to December 31, 2006. On May 25, 2006 the Company's Board of Directors approved a third amendment to the plan increasing the number of shares available to 420,000 and extending the expiration date of the plan to December 31, 2010. The amendment was approved by the Company's stockholders' at the Company's October 17, 2006 annual stockholders' meeting. As of September 30, 2008, 2007 and 2006, 175,324, 155,409 and 142,736 shares of Common Stock were purchased under this plan.

A summary of the status of the Company's fixed options plans as of September 30, 2008, 2007 and 2006 and changes during the years ending those dates is presented below:

	<u>ISO</u>	<u>Weighted Average Exercise Price</u>	<u>Non Qualified</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average contracted term (years)</u>	<u>Aggregate intrinsic value</u>
Balance at September 30, 2005	1,159,119	\$ 2.91	332,975	\$ 4.02		
Granted	136,000	3.40	50,000	3.38		
Exercised	(87,462)	1.61	(24,935)	1.38		
Forfeited	(58,863)	3.28	(12,065)	1.50		
Balance at September 30, 2006	1,148,794	\$ 3.05	345,975	\$ 4.24		
Granted	510,250	5.98	-	3.38		
Exercised	(183,425)	2.25	(37,000)	3.10		
Balance at September 30, 2007	1,475,619	\$ 4.16	308,975	\$ 3.24		
Granted	144,500	1.79	-	-		
Exercised	-	-	(28,550)	2.36		
Forfeited	(39,350)	2.29	(93,450)	2.36		
Balance at September 30, 2008	1,580,769	\$ 3.99	186,975	\$ 3.53	5.76	\$ (4,731,394)
Options exercisable at September 30, 2008	959,626	\$ 3.44	186,975	\$ 3.53	5.28	\$ (2,553,934)

The aggregate intrinsic value of options exercised during the years ended September 30, 2008 and 2007 was approximately \$309,000 and \$1,002,000. The following table summarizes information about stock options outstanding at September 30, 2008:

Options Outstanding Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Options Exercisable Number Exercisable	Weighted Average Exercise Price
\$ 1.35	10,000	0.10	\$ 1.35	10,000	\$ 1.35
1.87	3,200	0.24	1.87	3,200	1.87
2.07	9,000	0.57	2.07	9,000	2.07
2.54	40,000	0.67	2.54	40,000	2.54
2.25	8,200	0.45	2.25	8,200	2.25
3.87	10,000	0.53	3.87	10,000	3.87
3.94	92,402	0.33	3.94	92,402	3.94
2.82	60,000	0.16	2.82	60,000	2.82
8.75	20,000	0.64	8.75	20,000	8.75
5.25	41,900	0.83	5.25	41,900	5.25
5.78	34,600	1.80	5.78	34,600	5.78
4.13	37,500	2.08	4.13	37,500	4.13
1.38	43,050	1.25	1.38	43,050	1.38
1.05	48,000	3.00	1.05	48,000	1.05
3.05	40,000	4.75	3.05	40,000	3.05
1.08	146,267	3.04	1.08	146,267	1.08
3.02 to 3.64	159,125	5.85	3.02 to 3.64	137,375	3.02 to 3.64
4.45	30,000	5.50	4.45	30,000	4.45
4.40	16,000	5.75	4.40	16,000	4.40
4.62	70,000	6.43	4.62	100,000	4.62
3.56	90,250	6.88	3.56	42,857	3.56
3.19 to 3.21	93,500	7.04	3.19 to 3.21	64,500	3.19 to 3.21
4.67	10,000	6.16	4.67	7,500	4.67
5.72	144,750	8.04	5.72	57,750	5.72
4.96	200,000	8.17	4.96	40,000	4.96
7.45	165,500	8.75	7.45	6,500	7.45
1.64 to 4.39	144,500	9.42	1.64 to 4.39	-	1.64 to 4.39
	<u>1,767,744</u>			<u>1,146,601</u>	

c. Stockholders' Rights Agreements

On July 19, 2001, the Company's Board of Directors adopted a stockholder rights plan, as set forth in the Rights Agreement, dated as of July 20, 2001 (the "Rights Agreement") between the Company and North American Transfer Company as Rights Agent. Pursuant to the Rights Agreement, one Right was issued for each share of Common Stock the Company had outstanding as of August 5, 2001. Each of the Rights entitles the registered holder to purchase from the Company one share of Common Stock at a price of \$11.00 per share, subject to adjustment. The Rights generally will not become exercisable unless and until, among other things, any person acquires 10% to 12% or more of the outstanding Common Stock or makes a tender offer to acquire 10% or more of the outstanding Common Stock. The 10% threshold will not be applicable to institutional investors who stay below a 20% ownership level and who report their ownership on a Schedule 13G under the Securities Exchange Act of 1934. In addition, stockholders of more than 10% of the Common Stock as of July 19, 2001 were grandfathered at their then current level plus 1% unless they later fall below the 10% threshold. The Rights are redeemable under certain circumstances at \$0.001 per Right and will expire, unless earlier redeemed or extended, on July 19, 2011.

8. Significant Customer Information

For fiscal 2008, the Company had one customer, Hon Hai Precision Industry Co. LTD, that accounted for approximately 16% of our sales. For fiscal 2007, the Company had two customers, Hon Hai Precision Industry Co. LTD and Asustek Computer Inc., which accounted for approximately 24% and 14%, respectively, of the Company's sales. For fiscal 2006, we had no single customer which accounted for more than 10% of our net sales.

As of September 30, 2008, the Company had thirty two customers who accounted for 88% of the net accounts receivable and twenty two customers who accounted for 90% of the Company's net accounts receivable as of September 30, 2007.

9. Related Party Transactions

The Company occupies a facility located at 91 Cabot Court, Hauppauge, New York for its executive offices and for the testing, storage and shipping of its products. Hauppauge Computer Works, Inc., ("HCW") leases the premises (the "1990 Lease"), from Ladokk Realty Co., a real estate partnership which is principally owned by Kenneth Plotkin, the Company's President, Chairman of the Board, Chief Executive Officer and Chief Operating Officer and a stockholder of the Company, Dorothy Plotkin, the wife of Kenneth Plotkin and a stockholder of the Company and Laura Aupperle, the widow of Kenneth Aupperle, a founder and former President of the Company. The Company is obligated to pay real estate taxes and operating costs of maintaining the premises subject to the 1990 Lease.

The Lease ends on August 31, 2011 and calls for base rent in the first year of the term of \$300,000, payable monthly in the amount of \$25,000. Rent is subject to an annual increase of 3% over the term. The execution of the Lease Amendment was approved by our Board of Directors, following the recommendation of our Audit Committee. HCW is obligated to pay for utilities, repairs to the Premises, and taxes during the term.

The Company had amounts payable to this related party for unpaid rent of \$48,667 and \$108,667 as of September 30, 2008 and 2007, respectively. Rent expense to related parties and non related third parties totaled approximately \$687,000, \$639,000 and \$597,000 for the years ended September 30, 2008, 2007 and 2006 respectively. The Company pays the real estate taxes and it is responsible for normal building maintenance.

Minimum annual lease payments to related parties and unrelated third parties are as follows:

<u>Years Ended September 30,</u>	
2009	\$ 610,721
2010	511,818
2011	479,570
2012	85,026
2013	0
Total	<u>\$ 1,687,135</u>

10. Litigation

In the normal course of business the Company is party to various claims and/or litigation. To the best of its knowledge management believes that there is currently no material litigation which, considered in the aggregate would have a material adverse effect on the Company's financial position and results of operations.

11. Quarterly Information (Unaudited)

The following presents certain unaudited quarterly financial data:

	<u>(In thousands, except per share data)</u>					
	<u>Net Sales</u>	<u>Gross Profit</u>	<u>Operating Income (loss)</u>	<u>Net Income (loss)</u>	<u>Net Income (loss) Per Share Basic</u>	<u>Net Income (loss) Per Share Diluted</u>
Fiscal 2008						
First quarter (1)	\$ 37,047	\$ 8,141	\$ 2,675	\$ 2,463	\$ 0.25	\$ 0.24
Second quarter	17,513	3,339	(1,590)	(1,525)	(\$ 0.15)	(\$ 0.15)
Third quarter	19,416	3,848	(1,117)	(1,118)	(\$ 0.12)	(\$ 0.12)
Fourth quarter	15,725	2,354	(3,323)	(2,908)	(\$ 0.29)	(\$ 0.29)

(In thousands, except per share data)

	Net Sales	Gross Profit	Operating Income	Net Income	Net Income Per Share Basic	Net Income Per Share Diluted
Fiscal 2007						
First quarter	\$ 29,919	\$ 6,818	\$ 2,262	\$ 2,203	\$ 0.23	\$ 0.22
Second quarter	29,892	5,644	1,343	1,277	\$ 0.13	\$ 0.12
Third quarter	23,540	4,607	215	181	\$ 0.02	\$ 0.02
Fourth quarter	27,545	5,175	276	1,644	\$ 0.17	\$ 0.16

As the Company's sales are primarily to the consumer market the Company has experienced certain seasonal revenue trends. The Company's products, which are primarily sold through distributors and retailers, have historically been stronger during the Company's first fiscal quarter (October to December), which due to the holiday season is a strong quarter for computer equipment sales. In addition, the Company's international sales, mostly in the European market, were 52%, 44% and 54% of sales for the years ended September 30, 2008, 2007 and 2006, respectively. Due to this, the Company's sales for its fourth fiscal quarter (July to September) can be potentially impacted by the reduction of activity experienced with Europe during the July and August summer holiday period.

(1) During the first quarter of the fiscal year ended September 30, 2008 the Company increased its inventory reserve by approximately \$930,000 which was due to the expected loss of a customer program and the continued decreases in the analog product market. The Company also decreased its accrued licensing fees in this quarter by approximately \$1,100,000 due to an \$827,000 change in estimate and a \$273,000 correction of an error.

As of September 30, 2007, the Company evaluated the future realization of its deferred tax assets and its corresponding valuation allowance. The Company took into consideration the taxable income of the Company's domestic operations for the last three years, anticipated taxable income for fiscal 2008 and the utilization in fiscal 2007 of the remainder of the Company's net operating loss carry forward. After evaluating the circumstances listed above, it was the Company's opinion to reduce the deferred tax valuation allowance by \$3,010,253, which was reduced by deferred tax expense, resulting in a tax benefit for fiscal 2007 of \$1,490,689. The remaining valuation allowance relates to certain research and development credits and foreign net operating losses whose realization is not likely.

12. Subsequent events

Effective December 24, 2008, pursuant to an Asset Purchase Agreement, dated as of October 25, 2008, as amended by that certain Amendment No. 1 to the Asset Purchase Agreement (the "Amendment") (together with the Amendment, the "Asset Purchase Agreement"), PCTV Systems, Sarl, a Luxembourg company ("Buyer") and a wholly-owned subsidiary of ours, acquired certain assets and properties (the "Acquired Assets") of Avid Technology, Inc. ("Avid"), a Delaware corporation, Pinnacle Systems, Inc., a California corporation ("Pinnacle"), Avid Technology GmbH, a limited liability company organized under the laws of Germany, Avid Development GmbH, a limited liability company organized under the laws of Germany, and Avid Technology International BV (collectively, the "Sellers"). The purchase price consisted of \$2,500,000 payable in cash; \$2,500,000 payable pursuant to Promissory Note, dated December 24, 2008, made payable by the Buyer to Avid (the "Note") and the assumption of certain liabilities. In connection with the transaction, the Buyer or one or more of its affiliates are employing certain employees and occupying certain facilities located in Braunschweig, Germany. Pursuant to the terms of the Asset Purchase Agreement, it is contemplated that we and the Buyer will also receive certain audited historical financial statements of the Sellers. The Acquired Assets are used by the Sellers in the business of, among other things, the development, manufacture and sale of personal devices containing a television tuner for receiving over-the-air, satellite and/or cable television signals that are used in conjunction with personal computers for personal television viewing.

The principal amount due pursuant to the Note is payable in 12 equal monthly installments of \$208,333.33, with the first such payment due and payable on January 24, 2009. Interest on the outstanding principal amount of the Note is payable at a rate equal to (i) from December 24, 2008 until the Maturity Date (as defined in the Note), five percent (5%), (ii) from and after the Maturity Date, or during the continuance of an Event of Default (as defined in the Note), at seven percent (7%). Pursuant to the terms of the Note, the Buyer and its affiliates are prohibited from (i) declaring or paying any cash dividend, or making a distribution on, repurchasing, or redeeming, any class of stock or other equity or ownership interest in the Buyer or its affiliates, (ii) selling, leasing, transferring or otherwise disposing of any assets or property of the Buyer or any of its affiliates, or attempting to or contracting to do so, other than (a) the sale of inventory in the ordinary course of business and consistent with past practice, (b) the granting of non-exclusive licenses of intellectual property in the ordinary course of business and consistent with past practice and (c) the sale, lease, transfer or disposition of any assets or property (other than the Acquired Assets) with a value not to exceed \$500,000 in the aggregate, or (iii) dissolving or liquidating, or merging or consolidating with any other entity, or acquiring all or substantially all of the stock or assets of any other entity.

In connection with the transactions contemplated by the Asset Purchase Agreement, the Buyer, Hauppauge Digital Europe Sarl ("HDES"), and Hauppauge Computer Works, Inc. ("HCW"), each a wholly-owned subsidiary of ours (collectively, the "Subsidiaries") and the Sellers entered into a Transition Services Agreement, dated December 24, 2008 (the "TSA"), pursuant to which, among other things, the parties agreed to provide each other with certain services relating to infrastructure and systems, order processing and related matters and systems transition and related matters (the "Services"), as set forth in detail in the TSA. The fees for such Services are set forth in the TSA. The term of the TSA shall be until the earlier to occur of (i) 18 months following the Closing or (ii) termination of the last of the Services to be provided pursuant to the TSA. The TSA may be terminated by the Subsidiaries at any time upon thirty (30) days prior written notice to

the Sellers and may be terminated with respect to any particular Service to be provided pursuant to the TSA upon ten (10) days prior written notice to Seller.

Further, Avid, Avid Technology International BV (collectively, the "Consignor"), and HCW and HDES (collectively, the "Consignee") entered into an Inventory and Product Return Agreement, dated December 24, 2008 (the "Inventory Agreement"). Pursuant to the terms of the Inventory Agreement, the Consignor is obligated to deliver the Consigned Inventory (as defined in the Inventory Agreement) to the Consignee and the Consignee is obligated to, as applicable, fill orders from products held as Consigned Inventory before filling any such orders with products or inventory other than the Consigned Inventory. Upon the sale of Consigned Inventory by the Consignee, the Consignee has agreed to pay the Consignor for such Consigned Inventory as follows: (i) if Consignee sells Consigned Inventory for a price equal to or greater than Consignor's Cost (as defined in the Inventory Agreement) for such Consigned Inventory, then Consignee has agreed to pay Consignor an amount equal to one hundred percent (100%) of the Consignor Cost for such Consigned Inventory; or (ii) if Consignee sells Consigned Inventory for a price less than the Consignor Cost for such Consigned Inventory, then Consignee has agreed to pay Consignor an amount equal to eighty percent (80%) of the sales price for such Consigned Inventory. The term of the Inventory Agreement expires 18 months from the date of execution.

In connection with the transactions contemplated by the Asset Purchase Agreement, Avid, Pinnacle and the Buyer also entered into an Intellectual Property License Agreement, dated December 24, 2008 (the "IP Agreement"). Pursuant to the terms of the IP Agreement, Avid and Pinnacle have granted the Buyer certain irrevocable, personal, non-exclusive, worldwide, fully paid, royalty-free and non-transferable licenses to certain copyrights and other intellectual property rights owned by Avid, Pinnacle and their respective subsidiaries, subject to certain termination provisions as set forth in the IP Agreement.

13. Line of credit

On December 12, 2008, Hauppauge Computer Works, Inc. ("HCW"), a wholly-owned subsidiary of ours, executed a Fourth Amended and Restated Promissory Note (the "Fourth Amendment") to the order of JPMorgan Chase Bank, N.A. (the "Bank"). The Fourth Amendment modified the terms and conditions of that certain Promissory Note dated December 1, 2005, executed by HCW and made payable to the order of the Bank (the "Note"), as amended by an Amended and Restated Promissory Note dated March 31, 2006, as further amended by a Second Amended and Restated Promissory Note dated February 28, 2007 and as further amended by a Third Amended and Restated Promissory Note dated March 31, 2008. The Fourth Amendment, among other things, reduces the amount HCW is authorized to borrow from the Bank from a principal amount of up to Five Million Dollars (\$5,000,000) to a principal amount of up to Seven Hundred Thousand Dollars (\$700,000), based upon borrowings made under the Fourth Amendment which may be made from time to time by HCW (each, a "Loan"). The Fourth Amendment matures on March 31, 2009 (the "Maturity Date") and principal payments are due on the Maturity Date, and thereafter on demand. Until the Maturity Date, Loans made under the Amendment bear interest annually at HCW's option of (i) the Eurodollar Rate (as defined in the Fourth Amendment) (each, a "Eurodollar Loan") or (ii) the Prime Rate (as defined in the Fourth Amendment) minus one percent (1.0%) (each, a "Prime Loan"). Interest is payable with respect to each Eurodollar Loan at the end of one month after the date of such Loan (the "Interest Period"), provided that, upon the expiration of the first Interest Period and each Interest Period thereafter, each Eurodollar Loan will be automatically continued with an Interest Period of the same duration, unless HCW notifies the Bank that it intends to convert a Eurodollar Loan to a Prime Loan or if the Bank is prohibited from making Eurodollar Loans, and with respect to each Prime Loan the last day of each calendar month during the term of the Fourth Amendment and on the date on which a Prime Loan is converted to a Eurodollar Loan, until such Loan(s) shall be due and payable. Interest due after the Maturity Date shall be payable at a rate of three percent (3%) per annum over the Prime Rate.

In connection with the Fourth Amendment, we agreed that all of the terms and conditions of (i) our Guaranty as entered into with the Bank, dated as of December 1, 2005, and (ii) the Pledge Agreement by and among us, the Bank and HCW, dated as of December 1, 2005 (pursuant to which, among other things, we granted to the Bank a first priority right of pledge on approximately two-thirds of the outstanding capital shares of Hauppauge Digital Europe Sarl), each as amended, restated, supplemented or modified, from time to time and as entered into in connection with the Note, shall remain in full force and effect and apply to the terms and conditions of the Amendment.

Further, on December 12, 2008, in connection with the Fourth Amendment, HCW entered into a Pledge Security Agreement with the Bank (the "Pledge Security Agreement"), whereby HCW grants the Bank a security interest in its certificate of deposit account held with the Bank. The aggregate value of the Collateral (as defined in the Pledge Security Agreement) held pursuant to the Pledge Security Agreement shall not be less than Seven Hundred Thousand Dollars (\$700,000) at any given time.

There were no borrowings outstanding and \$680,000 letters of credit outstanding as of September 30, 2008.

corporate information

Executive Offices

Hauppauge Digital, Inc.
91 Cabot Court
Hauppauge, New York 11788 U.S.A.

Subsidiaries

Hauppauge Computer Works, Inc.
HCW Distributing Corp.
Hauppauge Digital Europe, S.A.R.L.
Hauppauge Computer Works, S.A.R.L. (France)
Hauppauge Digital Asia Pte, Ltd. (Singapore)
Hauppauge Computer Works, Ltd. (Virgin Islands)
Hauppauge Computer Works, GmbH (Germany)
Hauppauge Computer Works, Ltd. (U.K.)
Hauppauge Digital Taiwan
PCTV Systems Sarl
PCTV Corp.

Transfer Agent

Continental Stock Transfer & Trust Co.
17 Battery Place
New York, NY 10004-1123

General Counsel

Certilman Balin Adler & Hyman, LLP
90 Merrick Ave.
East Meadow, NY 11554

Auditors

BDO Seidman, LLP
407 Broadhollow Rd.
Melville, NY 11747

Common Stock

NASDAQ Global Market; symbol: HAUP

Officers and Directors

Kenneth Plotkin
Chairman of the Board, President and
Chief Executive Officer

Gerald Tucciarone
Chief Financial Officer and Treasurer

John Casey
Vice-President of Technology

Bernard Herman
Director - Retired President of Okidata America

Seymour G. Siegel
Director - Partner, Rothstein, Kass & Company

Christopher G. Payan
Director - Chief Executive Officer, Emerging Vision, Inc.

Annual Report on form 10-K available

A copy of the Company's Annual Report, including the financial statements and the financial statement schedules on Form 10-K, as filed with the Securities and Exchange Commission for the year ended September 30, 2008, can be obtained from the Company without charge by writing to:

**Hauppauge Digital, Inc.
91 Cabot Court
Hauppauge, New York 11788
Attention: Gerald Tucciarone, Chief Financial Officer**



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