

CSP INC /MA/
Form 10-Q
May 14, 2012
United States
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 31, 2012.

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
For the transition period from _____ to _____.

Commission File Number 0-10843

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

Massachusetts 04-2441294
(State of incorporation) (I.R.S. Employer Identification No.)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer,

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or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company) Smaller reporting company ☒

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

As of May 7, 2012, the registrant had 3,432,554 shares of common stock issued and outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

| | March 31, 2012 (Unaudited) | September 30, 2011 |
|--|----------------------------------|-----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$14,833 | \$15,874 |
| Accounts receivable, net of allowances of \$278 and \$302 | 14,215 | 13,148 |
| Inventories | 5,960 | 6,777 |
| Refundable income taxes | 120 | 231 |
| Deferred income taxes | 104 | 158 |
| Other current assets | 2,862 | 1,690 |
| Total current assets | 38,094 | 37,878 |
| Property, equipment and improvements, net | 947 | 833 |
| Other assets: | | |
| Intangibles, net | 533 | 574 |
| Deferred income taxes | 633 | 663 |
| Cash surrender value of life insurance | 3,098 | 2,918 |
| Other assets | 225 | 242 |
| Total other assets | 4,489 | 4,397 |
| Total assets | \$43,530 | \$43,108 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$10,758 | \$12,103 |
| Deferred revenue | 4,162 | 2,937 |
| Pension and retirement plans | 691 | 709 |
| Income taxes payable | 160 | 121 |
| Total current liabilities | 15,771 | 15,870 |
| Pension and retirement plans | 9,085 | 9,056 |
| Other long term liabilities | 299 | 286 |
| Total liabilities | 25,155 | 25,212 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Common stock, \$.01 par value per share; authorized, 7,500 shares; issued and outstanding 3,432 and 3,417 shares, respectively | 34 | 34 |
| Additional paid-in capital | 10,867 | 10,880 |
| Retained earnings | 13,446 | 12,885 |
| Accumulated other comprehensive loss | (5,972) | (5,903) |

| | | |
|--|----------|----------|
| Total shareholders' equity | 18,375 | 17,896 |
| Total liabilities and shareholders' equity | \$43,530 | \$43,108 |

See accompanying notes to unaudited consolidated financial statements.

CSP INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands, except for per share data)

| | For the three months ended | | For the six months ended | |
|---|----------------------------|---------------|--------------------------|---------------|
| | March 31, | March 31, | March 31, | March 31, |
| | 2012 | 2011 | 2012 | 2011 |
| Sales: | | | | |
| Product | \$ 12,125 | \$ 12,767 | \$ 27,279 | \$ 28,058 |
| Services | 6,904 | 4,862 | 12,843 | 10,198 |
| Total sales | 19,029 | 17,629 | 40,122 | 38,256 |
| Cost of sales: | | | | |
| Product | 10,610 | 9,961 | 23,375 | 23,376 |
| Services | 3,704 | 3,419 | 7,209 | 6,103 |
| Total cost of sales | 14,314 | 13,380 | 30,584 | 29,479 |
| Gross profit | 4,715 | 4,249 | 9,538 | 8,777 |
| Operating expenses: | | | | |
| Engineering and development | 474 | 508 | 857 | 1,018 |
| Selling, general and administrative | 3,572 | 3,310 | 7,248 | 6,685 |
| Total operating expenses | 4,046 | 3,818 | 8,105 | 7,703 |
| Operating income | 669 | 431 | 1,433 | 1,074 |
| Other income (expense): | | | | |
| Foreign exchange gain (loss) | (10) | 12 | (26) | 8 |
| Other income (expense), net | (26) | (13) | (44) | (30) |
| Total other income (expense), net | (36) | (1) | (70) | (22) |
| Income before income taxes | 633 | 430 | 1,363 | 1,052 |
| Income tax expense | 191 | 144 | 460 | 377 |
| Net income | \$442 | \$286 | \$903 | \$675 |
| Net income attributable to common stockholders | \$434 | \$282 | \$888 | \$666 |
| Net income per share – basic | \$0.13 | \$0.08 | \$0.26 | \$0.19 |
| Weighted average shares outstanding – basic | 3,363 | 3,437 | 3,360 | 3,455 |
| Net income per share – diluted | \$0.13 | \$0.08 | \$0.26 | \$0.19 |
| Weighted average shares outstanding – diluted | 3,401 | 3,471 | 3,398 | 3,491 |

See accompanying notes to unaudited consolidated financial statements.

CSP INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

For the Six Months Ended March 31, 2012:

(Amounts in thousands)

| | Shares | Amount | Additional Paid-in Capital | Retained Earnings | Accumulated other comprehensive loss | Total Shareholders' Equity | Comprehensive Income |
|---|--------|--------|----------------------------------|----------------------|---|----------------------------------|-------------------------|
| Balance as of September 30, 2011 | 3,417 | \$34 | \$ 10,880 | \$12,885 | \$ (5,903) | \$ 17,896 | |
| Comprehensive income (loss): | | | | | | | |
| Net income | — | — | — | 903 | — | 903 | \$ 903 |
| Other comprehensive income: | | | | | | | |
| Effect of foreign currency translation | — | — | — | — | (69) | (69) | (69) |
| Total comprehensive income | | | | | | | \$ 834 |
| Stock-based compensation | — | — | 13 | — | — | 13 | |
| Purchase of common stock | (23) | — | (81) | — | — | (81) | |
| Restricted stock issuance | 38 | — | 55 | — | — | 55 | |
| Cash dividends on common stock (\$0.10 per share) | — | — | — | (342) | — | (342) | |
| Balance as of March 31, 2012 | 3,432 | \$34 | \$ 10,867 | \$13,446 | \$ (5,972) | \$ 18,375 | |

See accompanying notes to unaudited consolidated financial statements.

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

| | For the six months ended | |
|---|--------------------------|-------------------|
| | March 31, 2012 | March 31, 2011 |
| Cash flows from operating activities: | | |
| Net income | \$903 | \$675 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation and amortization | 181 | 182 |
| Amortization of intangibles | 41 | 56 |
| Loss on disposal of fixed assets, net | — | 3 |
| Foreign exchange loss (gain) | 26 | (8) |
| Non-cash changes in accounts receivable | 32 | 34 |
| Stock-based compensation expense on stock options and restricted stock awards | 69 | 92 |
| Deferred income taxes | 82 | — |
| Increase in cash surrender value of life insurance | (43) | (41) |
| Changes in operating assets and liabilities: | | |
| Increase in accounts receivable | (1,103) | (202) |
| (Increase) decrease in inventories | 827 | (2,442) |
| Decrease in refundable income taxes | 110 | 502 |
| Increase in other current assets | (1,169) | (601) |
| Decrease in other assets | 17 | 52 |
| Increase (decrease) in accounts payable and accrued expenses | (1,368) | 386 |
| Increase in deferred revenue | 1,219 | 509 |
| Increase (decrease) in pension and retirement plans liability | (53) | 83 |
| Increase in income taxes payable | 38 | 127 |
| Increase in other long term liabilities | 14 | — |
| Net cash used in operating activities | (177) | (593) |
| Cash flows from investing activities: | | |
| Life insurance premiums paid | (137) | (137) |
| Purchases of property, equipment and improvements | (295) | (211) |
| Net cash used in investing activities | (432) | (348) |
| Cash flows from financing activities: | | |
| Dividends paid | (342) | — |
| Proceeds from issuance of shares under employee stock purchase plan | — | 75 |
| Purchase of common stock | (81) | (395) |
| Net cash used in financing activities | (423) | (320) |
| Effects of exchange rate on cash | (9) | 102 |
| Net decrease in cash and cash equivalents | (1,041) | (1,159) |
| Cash and cash equivalents, beginning of period | 15,874 | 15,531 |
| Cash and cash equivalents, end of period | \$14,833 | \$14,372 |
| Supplementary cash flow information: | | |
| Cash paid for income taxes | \$326 | \$251 |
| Cash paid for interest | \$85 | \$85 |

See accompanying notes to unaudited consolidated financial statements.

CSP INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
THREE AND SIX MONTHS ENDED MARCH 31, 2012 AND 2011

Organization and Business

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

1. Basis of Presentation

The accompanying consolidated financial statements have been prepared by the Company, without audit, and reflect all adjustments which, in the opinion of management, are necessary for a fair statement of the results of the interim periods presented. All adjustments were of a normal recurring nature. Certain information and footnote disclosures normally included in the annual financial statements, which are prepared in accordance with accounting principles generally accepted in the United States, have been condensed or omitted. Accordingly, the Company believes that although the disclosures are adequate to make the information presented not misleading, the unaudited financial statements should be read in conjunction with the footnotes contained in the Company’s Annual Report on Form 10-K for the fiscal year ended September 30, 2011.

2. Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates under different assumptions or conditions.

3. Earnings Per Share of Common Stock

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

We are required to present earnings per share, or EPS, utilizing the two class method because we had outstanding, non-vested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents, which are considered participating securities.

Basic and diluted earnings per share computations for the Company’s reported net income attributable to common stockholders are as follows:

| | For the three months ended | | For the six months ended | |
|--|--|-------------------|--------------------------|-------------------|
| | March 31, 2012 | March 31, 2011 | March 31, 2012 | March 31, 2011 |
| | (Amounts in thousands except per share data) | | | |
| Net income | \$442 | \$286 | \$903 | \$675 |
| Less: Net income attributable to nonvested common stock | 8 | 4 | 15 | 9 |
| Net income attributable to common stockholders | \$434 | \$282 | \$888 | \$666 |
| Weighted average total shares outstanding – basic | 3,425 | 3,492 | 3,417 | 3,504 |
| Less: weighted average non-vested shares outstanding | 62 | 55 | 57 | 49 |
| Weighted average number of common shares outstanding – basic | 3,363 | 3,437 | 3,360 | 3,455 |
| Potential common shares from non-vested stock awards and the assumed exercise of stock options | 38 | 34 | 38 | 36 |
| Weighted average common shares outstanding – diluted | 3,401 | 3,471 | 3,398 | 3,491 |
| Net income per share – basic | \$0.13 | \$0.08 | \$0.26 | \$0.19 |
| Net income per share – diluted | \$0.13 | \$0.08 | \$0.26 | \$0.19 |

All anti-dilutive securities, including stock options, are excluded from the diluted income per share computation. For the three and six months ended March 31, 2012, 195,000 and 200,000 options, respectively, were excluded from the diluted income per share calculation because their inclusion would have been anti-dilutive.

4. Inventories

Inventories consist of the following:

| | March 31, 2012 | September 30, 2011 |
|-----------------|------------------------|-----------------------|
| | (Amounts in thousands) | |
| Raw materials | \$1,363 | \$886 |
| Work-in-process | 675 | 539 |
| Finished goods | 3,922 | 5,352 |
| Total | \$5,960 | \$6,777 |

Finished goods includes inventory that has been shipped, but for which all revenue recognition criteria has not been met of approximately \$1.6 million and \$3.4 million as of March 31, 2012 and September 30, 2011, respectively.

Total inventory balances in the table above are shown net of reserves for obsolescence of approximately \$4.3 million and \$4.3 million as of March 31, 2012 and September 30, 2011, respectively.

5. Accumulated Other Comprehensive Loss

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

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| | For the Three Months Ended | | For the Six Months Ended | |
|--|----------------------------|-------------------|--------------------------|-------------------|
| | March 31, 2012 | March 31, 2011 | March 31, 2012 | March 31, 2011 |
| | (Amounts in thousands) | | | |
| Net income | \$442 | \$286 | \$903 | \$675 |
| Effect of foreign currency translation | 45 | 102 | (69) | 41 |
| Minimum pension liability | — | — | — | — |
| Comprehensive income (loss) | \$487 | \$388 | \$834 | \$716 |

The components of Accumulated Other Comprehensive Loss are as follows:

| | March 31, 2012 | September 30, 2011 |
|---|------------------------|-----------------------|
| | (Amounts in thousands) | |
| Cumulative effect of foreign currency translation | \$ (2,297) | \$ (2,228) |
| Additional minimum pension liability | (3,675) | (3,675) |
| Accumulated Other Comprehensive Loss | \$ (5,972) | \$ (5,903) |

6. Pension and Retirement Plans

The Company has defined benefit and defined contribution plans in the United Kingdom, Germany and the U.S. In the United Kingdom and Germany, the Company provides defined benefit pension plans and defined contribution plans for the majority of its employees. In the U.S., the Company provides benefits through supplemental retirement plans to certain current and former employees. The domestic supplemental retirement plans have life insurance policies which are not plan assets but were purchased by the Company as a vehicle to fund the costs of the plan. Domestically, the Company also provides for officer death benefits through post-retirement plans to certain officers. All of the Company's defined benefit plans are closed to newly hired employees and have been for the two years ended September 30, 2011 and for the six months ended March 31, 2012.

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

Our pension plan in the United Kingdom is the only plan with plan assets. The plan assets consist of an investment in a commingled fund which in turn comprises a diversified mix of assets including corporate equity securities, government securities and corporate debt securities.

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

| | For the Three Months Ended March 31, 2012 | | | 2011 | | |
|--------------------------------|--|-------|--------|---------|-------|--------|
| | Foreign | U.S. | Total | Foreign | U.S. | Total |
| | (Amounts in thousands) | | | | | |
| Pension: | | | | | | |
| Service cost | \$ 15 | \$ 3 | \$ 18 | \$ 18 | \$ 2 | \$ 20 |
| Interest cost | 178 | 20 | 198 | 172 | 25 | 197 |
| Expected return on plan assets | (104) | — | (104) | (126) | — | (126) |
| Amortization of: | | | | | | |
| Prior service gain | — | — | — | — | — | — |
| Amortization of net gain | 22 | 8 | 30 | 17 | 8 | 25 |
| Net periodic benefit cost | \$ 111 | \$ 31 | \$ 142 | \$ 81 | \$ 35 | \$ 116 |
| Post Retirement: | | | | | | |
| Service cost | \$ — | \$ — | \$ — | \$ — | \$ 5 | \$ 5 |
| Interest cost | — | 18 | 18 | — | 17 | 17 |
| Amortization of net gain | — | 17 | 17 | — | 12 | 12 |
| Net periodic benefit cost | \$ — | \$ 35 | \$ 35 | \$ — | \$ 34 | \$ 34 |
| | | | | | | |
| | For the Six Months Ended March 31, 2012 | | | 2011 | | |
| | Foreign | U.S. | Total | Foreign | U.S. | Total |
| | (Amounts in thousands) | | | | | |
| Pension: | | | | | | |
| Service cost | \$ 32 | \$ 5 | \$ 37 | \$ 36 | \$ 4 | \$ 40 |
| Interest cost | 357 | 42 | 399 | 342 | 50 | 392 |
| Expected return on plan assets | (209) | — | (209) | (251) | — | (251) |
| Amortization of: | | | | | | |
| Prior service gain | — | — | — | — | — | — |
| Amortization of net gain | 44 | 15 | 59 | 34 | 16 | 50 |
| Net periodic benefit cost | \$ 224 | \$ 62 | \$ 286 | \$ 161 | \$ 70 | \$ 231 |
| Post Retirement: | | | | | | |
| Service cost | \$ — | \$ — | \$ — | \$ — | \$ 10 | \$ 10 |
| Interest cost | — | 36 | 36 | — | 34 | 34 |
| Amortization of net gain | — | 35 | 35 | — | 24 | 24 |
| Net periodic benefit cost | \$ — | \$ 71 | \$ 71 | \$ — | \$ 68 | \$ 68 |

7. Segment Information

The following table presents certain operating segment information.

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| For the Three Months Ended March 31 | Systems Segment (Amounts in thousands) | Service and System Integration Segment | | | Total | Consolidated Total |
|--|--|--|-------------------|----------|-----------|-----------------------|
| | | Germany | United Kingdom | U.S. | | |
| 2012 | | | | | | |
| Sales: | | | | | | |
| Product | \$ 223 | \$ 3,968 | \$ 718 | \$ 7,216 | \$ 11,902 | \$ 12,125 |
| Service | 2,141 | 3,703 | 292 | 768 | 4,763 | 6,904 |
| Total sales | 2,364 | 7,671 | 1,010 | 7,984 | 16,665 | 19,029 |
| Profit from operations | 443 | 164 | 91 | (29) | 226 | 669 |
| Assets | 12,628 | 16,523 | 2,571 | 11,808 | 30,902 | 43,530 |
| Capital expenditures | 88 | 90 | 6 | 26 | 122 | 210 |
| Depreciation and amortization | 25 | 42 | 7 | 38 | 87 | 112 |
| 2011 | | | | | | |
| Sales: | | | | | | |
| Product | \$ 1,931 | \$ 2,785 | \$ 61 | \$ 7,990 | \$ 10,836 | \$ 12,767 |
| Service | 368 | 3,401 | 364 | 729 | 4,494 | 4,862 |
| Total sales | 2,299 | 6,186 | 425 | 8,719 | 15,330 | 17,629 |
| Profit from operations | 72 | 39 | 15 | 305 | 359 | 431 |
| Assets | 13,335 | 13,150 | 3,847 | 13,075 | 30,072 | 43,407 |
| Capital expenditures | 77 | 11 | 1 | 11 | 23 | 100 |
| Depreciation and amortization | 21 | 45 | 7 | 45 | 97 | 118 |

| For the Six Months Ended March 31, | Systems Segment (Amounts in thousands) | Service and System Integration Segment | | | Total | Consolidated Total |
|---------------------------------------|--|--|-------------------|-----------|-----------|-----------------------|
| | | Germany | United Kingdom | U.S. | | |
| 2012 | | | | | | |
| Sales: | | | | | | |
| Product | \$ 1,462 | \$ 7,819 | \$ 1,071 | \$ 16,927 | \$ 25,817 | \$ 27,279 |
| Service | 3,248 | 7,290 | 608 | 1,697 | 9,595 | 12,843 |
| Total sales | 4,710 | 15,109 | 1,679 | 18,624 | 35,412 | 40,122 |
| Profit from operations | 471 | 439 | 117 | 406 | 962 | 1,433 |
| Assets | 12,628 | 16,523 | 2,571 | 11,808 | 30,902 | 43,530 |
| Capital expenditures | 117 | 116 | 25 | 37 | 178 | 295 |
| Depreciation and amortization | 48 | 81 | 14 | 79 | 174 | 222 |
| 2011 | | | | | | |
| Sales: | | | | | | |
| Product | \$ 2,240 | \$ 6,251 | \$ 72 | \$ 19,495 | \$ 25,818 | \$ 28,058 |
| Service | 1,884 | 6,022 | 696 | 1,596 | 8,314 | 10,198 |
| Total sales | 4,124 | 12,273 | 768 | 21,091 | 34,132 | 38,256 |
| Profit (loss) from operations | 186 | 151 | (15) | 752 | 888 | 1,074 |
| Assets | 13,335 | 13,150 | 3,847 | 13,075 | 30,072 | 43,407 |
| Capital expenditures | 133 | 47 | 3 | 28 | 78 | 211 |
| Depreciation and amortization | 41 | 92 | 14 | 91 | 197 | 238 |

Profit (loss) from operations is sales less cost of sales, engineering and development, selling, general and administrative expenses but is not affected by either non-operating charges/income or by income taxes. Non-operating charges/income consists principally of investment income and interest expense. All intercompany transactions have been eliminated.

The following table lists customers from which the Company derived revenues in excess of 10% of total revenues for the three and six month periods ended March 31, 2012, and 2011.

| | For the Three Months Ended | | | | | | For the Six Months Ended | | | | | |
|------------|----------------------------|---------------|--|----------------|---------------|--|--------------------------|---------------|--|----------------|---------------|--|
| | March 31, 2012 | | | March 31, 2011 | | | March 31, 2012 | | | March 31, 2011 | | |
| | Amount | % of Revenues | | Amount | % of Revenues | | Amount | % of Revenues | | Amount | % of Revenues | |
| | (dollars in millions) | | | | | | | | | | | |
| Customer A | \$ 5.8 | 30 % | | \$ 3.2 | 18 % | | \$ 10.3 | 26 % | | \$ 4.8 | 13 % | |
| Customer B | \$ 1.5 | 8 % | | \$ 1.8 | 10 % | | \$ 6.7 | 17 % | | \$ 4.3 | 11 % | |
| Customer C | \$ 2.2 | 12 % | | \$ 0.3 | 1 % | | \$ 3.4 | 9 % | | \$ 1.7 | 4 % | |

8. Fair Value Measures

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

| | Fair Value Measurements Using Quoted Prices in Active Markets for Identical Instruments (Level 1) | | | | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Balance | Gain or (loss) | | | |
|--|--|-------|--|----|---|--|------------------|----------------------|-------|----|---|
| As of March 31, 2012 (Amounts in thousands) | | | | | | | | | | | |
| Assets: | | | | | | | | | | | |
| Money Market funds | \$ | 3,495 | | \$ | — | \$ | — | \$ | 3,495 | \$ | — |
| Total assets measured at fair value | \$ | 3,495 | | \$ | — | \$ | — | \$ | 3,495 | \$ | — |

| | | | | | | | | |
|--|----|-------|--|----|---|----|-------|------|
| As of September 30, 2011 (Amounts in thousands) | | | | | | | | |
| Assets: | | | | | | | | |
| Money Market funds | \$ | 3,493 | | \$ | — | \$ | 3,493 | \$ — |
| Total assets measured at fair value | \$ | 3,493 | | \$ | — | \$ | 3,493 | \$ — |

These assets are included in cash and cash equivalents in the accompanying consolidated balance sheets. All other monetary assets and liabilities are short-term in nature and approximate their fair value. The Company did not have any transfers between Level 1, Level 2 or Level 3 measurements.

The Company had no liabilities measured at fair value as of March 31, 2012 or September 30, 2011. The Company had no assets or liabilities measured at fair value on a non recurring basis as of March 31, 2012 or September 30, 2011.

9. Common Stock Repurchase

Pursuant to prior authorizations by the Board of Directors, the Company repurchased approximately 23 thousand shares of its outstanding common stock during the six months ended March 31, 2012. As of March 31, 2012, approximately 205 thousand shares remain authorized for repurchase under the Company's stock repurchase program.

10. Dividend

On January 12, 2012, our Board of Directors declared a cash dividend of \$.10 per share which was paid on February 3, 2012 to stockholders of record as of January 27, 2012, the record date.

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

Forward-Looking Statements

The discussion below contains certain forward-looking statements related to, among others, but not limited to, statements concerning future revenues and future business plans. In addition, forward-looking statements include statements in which we use words such as "expect," "believe," "anticipate," "intend," or similar expressions. Although we

believe the expectations reflected in such forward-looking statements are based on reasonable assumptions, we cannot assure you that these expectations will prove to have been correct, and actual results may vary from those contained in such forward-looking statements.

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

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our estimates, including those related to uncollectible receivables, inventory valuation, income taxes, deferred compensation and retirement plans, estimated selling prices used for revenue recognition and contingencies. We base our estimates on historical performance and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. A description of our critical accounting policies is contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2011 in the “Critical Accounting Policies” section of Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Results of Operations

Overview of the six months ended March 31, 2012 Results of Operations

Highlights include:

Revenue increased by approximately \$1.9 million, or 5%, to \$40.1 million for the six months ended March 31, 2012 versus \$38.3 million for the six months ended March 31, 2011.

For the six months ended March 31, 2012, we had an operating profit of approximately \$1.4 million versus an operating profit of approximately \$1.1 million for the six months ended March 31, 2011, for an increase of approximately \$0.4 million, or 33% in our operating result.

For the six months ended March 31, 2012, net income was approximately \$0.9 million versus net income of approximately \$0.7 million for the six months ended March 31, 2011, for an increase of approximately \$0.2 million, or 34%.

The following table details our results of operations in dollars and as a percentage of sales for the six months ended March 31, 2012 and 2011:

| | March 31, 2012 (Dollar amounts in thousands) | % of sales | | March 31, 2011 | % of sales | |
|-------------------------------------|--|---------------|---|-------------------|---------------|---|
| Sales | \$40,122 | 100 | % | \$38,256 | 100 | % |
| Costs and expenses: | | | | | | |
| Cost of sales | 30,584 | 76 | % | 29,479 | 77 | % |
| Engineering and development | 857 | 2 | % | 1,018 | 3 | % |
| Selling, general and administrative | 7,248 | 19 | % | 6,685 | 17 | % |
| Total costs and expenses | 38,689 | 97 | % | 37,182 | 97 | % |
| Operating income | 1,433 | 3 | % | 1,074 | 3 | % |
| Other expense | (70) |) — | % | (22) |) — | % |
| Income before income taxes | 1,363 | 3 | % | 1,052 | 3 | % |
| Income tax expense | 460 | 1 | % | 377 | 1 | % |
| Net income | \$903 | 2 | % | \$675 | 2 | % |

Sales

The following table details our sales by operating segment for the six months ended March 31, 2012 and 2011:

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| | Systems (Dollar amounts in thousands) | Service and System Integration | Total | % of Total | |
|--|--|--------------------------------------|----------|---------------|---|
| For the Six Months Ended March 31, 2012: | | | | | |
| Product | \$1,462 | \$25,817 | \$27,279 | 68 | % |
| Services | 3,248 | 9,595 | 12,843 | 32 | % |
| Total | \$4,710 | \$35,412 | \$40,122 | 100 | % |
| % of Total | 12 | % 88 | % 100 | % | |

| | Systems | Service and System Integration | Total | % of Total | |
|--|---------|--------------------------------------|----------|---------------|---|
| For the Six Months Ended March 31, 2011: | | | | | |
| Product | \$2,240 | \$25,818 | \$28,058 | 73 | % |
| Services | 1,884 | 8,314 | 10,198 | 27 | % |
| Total | \$4,124 | \$34,132 | \$38,256 | 100 | % |
| % of Total | 11 | % 89 | % 100 | % | |

| | Systems | Service and System Integration | Total | % increase (decrease) | |
|---------------------|---------|--------------------------------------|---------|-----------------------------|---|
| Increase (Decrease) | | | | | |
| Product | \$(778) | \$(1) | \$(779) | (3) | % |
| Services | 1,364 | 1,281 | 2,645 | 26 | % |
| Total | \$586 | \$1,280 | \$1,866 | 5 | % |
| % increase | 14 | % 4 | % 5 | % | |

As shown above, total revenues increased by approximately \$1.9 million, or 5%, for the six months ended March 31, 2012 compared to the six months ended March 31, 2011. Revenue in the Systems segment increased for the current year six month period versus the prior year six month period by approximately \$0.6 million, while revenues in the Service and System Integration segment increased by approximately \$1.3 million.

Product revenues decreased by approximately \$0.8 million, or 3%, for the six months ended March 31, 2012 compared to the comparable period of the prior fiscal year. Product revenues in the Service and System Integration segment were unchanged while in the Systems segment product revenue decreased by approximately \$0.8 million for the six month period ended March 31, 2012 versus the six month period ended March 31, 2011.

While product sales in the Service and System Integration segment were unchanged overall, in the U.S. division of the segment, product sales decreased by approximately \$2.6 million, offset by increases in sales in this segment's German division of approximately \$1.6 million and in the UK division of approximately \$1.0 million.

In the US division, product sales to the largest customer of the division, increased by approximately \$1.8 million, and sales to a newly acquired IT infrastructure hosting company customer increased by an additional \$1.0 million. However, sales to several other customers decreased by a total of approximately \$5.4 million, resulting in the net decrease of \$2.6 million. In Germany, the \$1.6 million increase was driven primarily by increased sales to the division's largest customer, while the increase in sales in the UK division was the result of increased third party

product sales versus the prior year.

The decrease in product revenues in the Systems segment of approximately \$0.8 million was due to a decrease in sales to our Japanese defense department customer of approximately \$1.2 million, offset by an increase of \$0.4 million from the sale of parts, components and spares to existing US defense department customers.

As shown in the table above, service revenues increased by approximately \$2.6 million, or 26%. This increase was made up of an increase in the Service and System Integration segment of approximately \$1.3 million and an increase in the Systems segment of \$1.3 million. The increase in service revenues in the Service and System Integration segment was primarily from the German division's largest customer, in connection with a large IT security services project. The increase in the Systems segment service revenue was due to higher royalty income recorded in the six months ended March 31, 2012 which was approximately \$3.0 million versus \$1.6 million for the six months ended March 31, 2011.

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

| For the six months ended, | | | | | | | | |
|-------------------------------|-------------------|-----|---|-------------------|-----|---|---------------------------|-----------------------------|
| | March 31, 2012 | % | | March 31, 2011 | % | | \$ Increase (Decrease) | % Increase (Decrease) |
| (Dollar amounts in thousands) | | | | | | | | |
| Americas | \$ 21,918 | 55 | % | \$ 22,901 | 60 | % | \$ (983) | (4)% |
| Europe | 17,321 | 43 | % | 13,219 | 34 | % | 4,102 | 31 % |
| Asia | 883 | 2 | % | 2,136 | 6 | % | (1,253) | (59)% |
| Totals | \$ 40,122 | 100 | % | \$ 38,256 | 100 | % | \$ 1,866 | 5 % |

The decrease in Americas revenue for the six months ended March 31, 2012 versus the six months ended March 31, 2011 was primarily the result of the fluctuations described above in the Systems segment and the US division of the Service and System Integration segment.

The increase in sales in Europe was primarily the result of the higher sales described above from the German and UK divisions of the Service and System Integration segment. The decrease in Asia sales was the result of the decrease in sales to our existing customer that supplies a large Japanese defense program (see discussion above).

Cost of Sales and Gross Margins

The following table details our cost of sales by operating segment for the six months ended March 31, 2012 and 2011:

| | Systems | | Service and System Integration | | Total | % of Total | |
|--|---------|----|--------------------------------------|----|----------|---------------|----|
| (Dollar amounts in thousands) | | | | | | | |
| For the Six Months Ended March 31, 2012: | | | | | | | |
| Product | \$1,077 | | \$22,298 | | \$23,375 | 76 | % |
| Services | 127 | | 7,082 | | 7,209 | 24 | % |
| Total | \$1,204 | | \$29,380 | | \$30,584 | 100 | % |
| % of Total | 4 | % | 96 | % | 100 | % | |
| % of Sales | 26 | % | 83 | % | 76 | % | |
| Gross Margins: | | | | | | | |
| Product | 26 | % | 14 | % | 14 | % | |
| Services | 96 | % | 26 | % | 44 | % | |
| Total | 74 | % | 17 | % | 24 | % | |
| | | | | | | | |
| For the Six Months Ended March 31, 2011: | | | | | | | |
| Product | \$995 | | \$22,381 | | \$23,376 | 79 | % |
| Services | 137 | | 5,966 | | 6,103 | 21 | % |
| Total | \$1,132 | | \$28,347 | | \$29,479 | 100 | % |
| % of Total | 4 | % | 96 | % | 100 | % | |
| % of Sales | 27 | % | 83 | % | 77 | % | |
| Gross Margins: | | | | | | | |
| Product | 56 | % | 13 | % | 17 | % | |
| Services | 93 | % | 28 | % | 40 | % | |
| Total | 73 | % | 17 | % | 23 | % | |
| | | | | | | | |
| Increase (decrease) | | | | | | | |
| Product | \$82 | | \$(83 |) | \$(1 |) | — |
| Services | (10 |) | 1,116 | | 1,106 | | 18 |
| Total | \$72 | | \$1,033 | | \$1,105 | | 4 |
| % Increase | 6 | % | 4 | % | 4 | % | |
| % of Sales | (1 |)% | — | % | (1 |)% | |
| Gross Margins: | | | | | | | |
| Product | (30 |)% | 1 | % | (3 |)% | |
| Services | 3 | % | (2 |)% | 4 | % | |
| Total | 1 | % | — | % | 1 | % | |

Total cost of sales increased by approximately \$1.1 million when comparing the six months ended March 31, 2012 versus the six months ended March 31, 2011. This increase in cost of sales of 4% overall, is consistent with the increase in sales of 5% overall as described previously. The resulting higher gross profit margin ("GPM") of 24% for the six months ended March 31, 2012 versus 23% for 2011 was due to several factors which are discussed below.

In the Service and System Integration segment, the overall GPM was 17% for the six months ended March 31, 2012 versus 17% for the prior year six month period. Product GPM in the segment increased from 13% for the six months ended March 31, 2011, to 14% for the six months ended March 31, 2012, while the segment's service GPM decreased from 28% to 26%. The product GPM increase was due to a more favorable product mix in the current year six month periods versus the prior year. Current year product sales included more networking and data security products as

opposed to sales of servers and other lower margin products in the prior year six month period in both the US and German divisions. The decrease in service GPM in the Service and System Integration segment from 28% for the six month period ended March 31, 2011 to 26% for the six months ended March 31, 2012 was due to several factors including greater use of contractors versus in-house resources particularly in Germany and lower third party maintenance revenue for which the Company is not the primary obliger, in the six months ended March 31, 2012 versus the six months ended March 31, 2011. (Note, third party maintenance for which the company is not the primary obliger is recorded at net value, with no cost of sales.)

In the Systems segment, the overall GPM increased from 73% to 74% as shown in the table above. This was because in the current year six month period, royalty revenue, which carries a 100% GPM, made up a much greater percentage of total revenue (63%), versus the prior year six month period royalty revenue which was 40% of total revenue. Offsetting the favorable GPM impact of the greater royalty revenue in the current year six month period, however, was the impact of significantly lower product GPM in the current six month period versus the prior year. As shown in the table above, the GPM on product sales was only 26% for the current year six month period versus the prior year product GPM of 56%. The reason for this is because in the current six month period the low volume of production and product sales resulted in insufficient absorption of fixed factory overhead, therefore these fixed costs were proportionately higher versus production and sales volume, which resulted in the low GPM on product sales in the current year six month period.

Engineering and Development Expenses

The following table details our engineering and development expenses by operating segment for the six months ended March 31, 2012 and 2011:

| | For the six months ended, March 31, 2012 | | | March 31, 2011 | | | | |
|--------------------------------|---|-----|---|----------------|-----|---|-------------|---------------|
| | % of Total | | | % of Total | | | \$ Decrease | % Decrease |
| | (Dollar amounts in thousands) | | | | | | | |
| By Operating Segment: | | | | | | | | |
| Systems | \$ 857 | 100 | % | \$ 1,018 | 100 | % | \$ (161) | (16)% |
| Service and System Integration | — | — | | — | — | | — | — |
| Total | \$ 857 | 100 | % | \$ 1,018 | 100 | % | \$ (161) | (16)% |

The \$0.2 million decrease in engineering and development expenses displayed above was due to lower engineering consulting expenditures in connection with the development of the next generation of MultiComputer products in the Systems segment.

Selling, General and Administrative

The following table details our selling, general and administrative (“SG&A”) expense by operating segment for the six months ended March 31, 2012 and 2011:

| | For the six months ended, March 31, 2012 | | | March 31, 2011 | | | | | |
|--------------------------------|---|-----|---|----------------|-----|---|-------------|------------|---|
| | % of Total | | | % of Total | | | \$ Increase | % Increase | |
| (Dollar amounts in thousands) | | | | | | | | | |
| By Operating Segment: | | | | | | | | | |
| Systems | \$ 2,178 | 30 | % | \$ 1,788 | 27 | % | \$ 390 | 22 | % |
| Service and System Integration | 5,070 | 70 | % | 4,897 | 73 | % | 173 | 4 | % |
| Total | \$ 7,248 | 100 | % | \$ 6,685 | 100 | % | \$ 563 | 8 | % |

The increase in SG&A expense in both segments was primarily the result of an increase in bonus and commission expense owing to the more favorable revenue, gross profit and overall operating results for the six months ended

March 31, 2012 versus the comparable period in the prior year.

Other Income/Expenses

The following table details our other income/expenses for the six months ended March 31, 2012 and 2011:

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| | For the six months ended, | | |
|------------------------------|---------------------------|-----------|----------|
| | March 31, | March 31, | |
| | 2012 | 2011 | Decrease |
| | (Amounts in thousands) | | |
| Interest expense | \$ (43) | \$ (43) | \$ — |
| Interest income | 16 | 16 | — |
| Foreign exchange gain (loss) | (26) | 8 | (34) |
| Other income (expense), net | (17) | (3) | (14) |
| Total other expense, net | \$ (70) | \$ (22) | \$ (48) |

Other income (expense), net, for the six month periods ended March 31, 2012 and 2011 was not significant nor was the change from the prior year six month period to that of the current year.

Overview of the three months ended March 31, 2012 Results of Operations

Highlights include:

- Revenue increased by approximately \$1.4 million, or 8%, to \$19.0 million for the three months ended March 31, 2012 versus \$17.6 million for the three months ended March 31, 2011.

For the three months ended March 31, 2012, we had an operating profit of approximately \$0.7 million versus operating profit of approximately \$0.4 million for the three months ended March 31, 2011, for an increase of approximately \$0.2 million, or 55% in our operating result.

For the three months ended March 31, 2012, net income was approximately \$0.4 million versus net income of approximately \$0.3 million for the three months ended March 31, 2011, for an increase of approximately \$0.2 million, or 55%.

The following table details our results of operations in dollars and as a percentage of sales for the three months ended March 31, 2012 and 2011:

| | March 31, 2012 | % of sales | | March 31, 2011 | % of sales | |
|-------------------------------------|-------------------------------|------------|---|-------------------|------------|---|
| | (Dollar amounts in thousands) | | | | | |
| Sales | \$ 19,029 | 100 | % | \$ 17,629 | 100 | % |
| Costs and expenses: | | | | | | |
| Cost of sales | 14,314 | 75 | % | 13,380 | 76 | % |
| Engineering and development | 474 | 2 | % | 508 | 3 | % |
| Selling, general and administrative | 3,572 | 19 | % | 3,310 | 19 | % |
| Total costs and expenses | 18,360 | 96 | % | 17,198 | 98 | % |
| Operating income | 669 | 3 | % | 431 | 2 | % |
| Other expense | (36) | — | % | (1) | — | % |
| Income before income taxes | 633 | 3 | % | 430 | 2 | % |
| Income tax expense | 191 | 1 | % | 144 | 1 | % |
| Net income | \$442 | 2 | % | \$286 | 1 | % |

Sales

The following table details our sales by operating segment for the three months ended March 31, 2012 and 2011:

| | Systems (Dollar amounts in thousands) | Service and System Integration | Total | % of Total | |
|---|--|--------------------------------------|-----------|---------------|---|
| For the Three Months Ended March 31, 2012: | | | | | |
| Product | \$ 223 | \$ 11,902 | \$ 12,125 | 64 | % |
| Services | 2,141 | 4,763 | 6,904 | 36 | % |
| Total | \$ 2,364 | \$ 16,665 | \$ 19,029 | 100 | % |
| % of Total | 12 | % 88 | % 100 | % | |

| | Systems | Service and System Integration | Total | % of Total | |
|---|----------|--------------------------------------|-----------|---------------|---|
| For the Three Months Ended March 31, 2011: | | | | | |
| Product | \$ 1,931 | \$ 10,836 | \$ 12,767 | 72 | % |
| Services | 368 | 4,494 | 4,862 | 28 | % |
| Total | \$ 2,299 | \$ 15,330 | \$ 17,629 | 100 | % |
| % of Total | 13 | % 87 | % 100 | % | |

| Increase (Decrease) | Systems | Service and System Integration | Total | % increase (decrease) | |
|---------------------|-----------|--------------------------------------|---------|-----------------------------|----|
| Product | \$(1,708) |) \$1,066 | \$(642) |) (5 |)% |
| Services | 1,773 | 269 | 2,042 | 42 | % |
| Total | \$65 | \$1,335 | \$1,400 | 8 | % |
| % increase | 3 | % 9 | % 8 | % | |

As shown above, total revenues increased by approximately \$1.4 million, or 8%, for the three months ended March 31, 2012 compared to the three months ended March 31, 2011. Revenue in the Systems segment increased for the current year three month period versus the prior year three month period by approximately \$0.1 million, while revenues in the Service and System Integration segment increased by approximately \$1.3 million.

Product revenues decreased by approximately \$0.6 million, or 5%, for the three months ended March 31, 2012 compared to the comparable period of the prior fiscal year. This change in product revenues was made up of an increase in product revenues in the Service and System Integration segment of approximately \$1.1 million and an offsetting decrease in product revenues in the Systems segment of approximately \$1.7 million for the three month period ended March 31, 2012 versus the three month period ended March 31, 2011.

The increase in the Service and System Integration segment product sales of approximately \$1.1 million was due primarily to an increase in sales in this segment's German division of approximately \$1.2 million and in the UK division of approximately \$0.7 million, offset by a decrease in product sales in the US division of the segment of approximately \$0.8 million.

In Germany, the \$1.2 million increase was driven primarily by increased sales to the division's largest customer, while the increase in sales in the UK division was the result of increased third party product sales versus the prior year. In the US division, product sales to existing customers declined by approximately \$2.3 million, while new customer sales increased by approximately \$1.5 million, resulting in the overall decrease in product sales of \$0.8 million.

The decrease in product revenues in the Systems segment of approximately \$1.7 million resulted primarily from lower sales to our Japanese defense department customer which decreased by \$1.9 million when comparing the quarter ended March 31, 2012 to the quarter ended March 31, 2011. Sale of parts, components and spares into existing programs to our US defense department customers increased by approximately \$0.2 million.

As shown in the table above, service revenues increased by approximately \$2.0 million, or 42%. This increase was made up of an increase in Systems segment service revenues of approximately \$1.8 million and an increase in Service and System Integration segment service revenues of approximately \$0.3 million. The increase in Systems segment service revenues was due to royalty income recorded in the three months ended March 31, 2012 of approximately \$2.0 million versus royalty revenue of approximately \$0.2 million for the three months ended March 31, 2011. In the Service and System Integration segment service revenue in the German division increased by approximately \$0.3 million from services provided to the division largest customer, in connection with a large IT security services project.

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

| For the three Months Ended | | | | | | | | | |
|-------------------------------|-------------------|-----|---|-------------------|-----|---|---------------------------|-----------------------------|---|
| | March 31, 2012 | % | | March 31, 2011 | % | | \$ Increase (Decrease) | % Increase (Decrease) | |
| (Dollar amounts in thousands) | | | | | | | | | |
| Americas | \$ 10,104 | 53 | % | \$ 8,848 | 50 | % | \$ 1,256 | 14 | % |
| Europe | 8,856 | 47 | % | 6,784 | 39 | % | 2,072 | 31 | % |
| Asia | 69 | — | % | 1,997 | 11 | % | (1,928) | (97) | % |
| Totals | \$ 19,029 | 100 | % | \$ 17,629 | 100 | % | \$ 1,400 | 8 | % |

The increase in Americas revenue for the three months ended March 31, 2012 versus the three months ended March 31, 2011 was primarily the result of the higher royalty revenue in the Systems segment which accounts for an increase of approximately \$1.8 million, and increases in components and spares sales into existing programs to our US defense department customers which increased by approximately \$0.2 million, offset by the total decrease in sales of the US division of the Service and System Integration segment of approximately \$0.7 million.

The increase in sales in Europe was primarily the result of the higher sales described above from the German and UK divisions of the Service and System Integration segment. The decrease in Asia sales was the result of the decrease in sales to our existing customer that supplies a large Japanese defense program, as described above.

Cost of Sales and Gross Margins

The following table details our cost of sales by operating segment for the three months ended March 31, 2012 and 2011:

| | Systems | Service and System Integration | Total | % of Total | |
|--|---------|--------------------------------------|----------|---------------|---|
| (Dollar amounts in thousands) | | | | | |
| For the Three Months Ended March 31, 2012: | | | | | |
| Product | \$250 | \$10,360 | \$10,610 | 74 | % |
| Services | 71 | 3,633 | 3,704 | 26 | % |
| Total | \$321 | \$13,993 | \$14,314 | 100 | % |
| % of Total | 2 | % 98 | % 100 | % | |
| % of Sales | 14 | % 84 | % 75 | % | |
| Gross Margins: | | | | | |
| Product | (12 |)% 13 | % 12 | % | |
| Services | 97 | % 24 | % 46 | % | |
| Total | 86 | % 16 | % 25 | % | |
| For the Three Months Ended March 31, 2011: | | | | | |
| Product | \$750 | \$9,211 | \$9,961 | 74 | % |
| Services | 63 | 3,356 | 3,419 | 26 | % |
| Total | \$813 | \$12,567 | \$13,380 | 100 | % |
| % of Total | 6 | % 94 | % 100 | % | |
| % of Sales | 35 | % 82 | % 76 | % | |
| Gross Margins: | | | | | |
| Product | 61 | % 15 | % 22 | % | |
| Services | 83 | % 25 | % 30 | % | |
| Total | 65 | % 18 | % 24 | % | |
| Increase (decrease) | | | | | |
| Product | \$(500 |) \$1,149 | \$649 | 7 | % |
| Services | 8 | 277 | 285 | 8 | % |
| Total | \$(492 |) \$1,426 | \$934 | 7 | % |
| % Increase (decrease) | (61 |)% 11 | % 7 | % | |
| % of Sales | (21 |)% 2 | % (1 |)% | |
| Gross Margins: | | | | | |
| Product | (73 |)% (2 |)% (10 |)% | |
| Services | 14 | % (1 |)% 16 | % | |
| Total | 21 | % (2 |)% 1 | % | |

Total cost of sales increased by approximately \$0.9 million when comparing the three months ended March 31, 2012 versus the three months ended March 31, 2011. This increase in cost of sales of 7% overall is consistent with the increase in sales of 8% overall as described previously. The resulting higher profit margin of 25% for the three months ended March 31, 2012 versus 24% for 2011 was due to several factors which are discussed below.

In the Service and System Integration segment, the overall gross margin was 16% for the three months ended March 31, 2012 versus 18% for the prior year three month period. Product gross margin in the segment decreased from 15% for the three months ended March 31, 2011, to 13% for the three months ended March 31, 2012, while the segment's service gross margin decreased from 25% to 24%. The product gross margin decrease was due to a less favorable product mix in the current year quarter versus the prior year. Prior year product sales included more

networking and data security products versus more sales of servers and other lower margin products in the current year quarter primarily in the US division of the segment. The decrease in service gross margin in the Service and System Integration segment was due to greater use of contractors versus in-house resources particularly in Germany in the quarter ended March 31, 2012 versus the quarter ended March 31, 2011, and lower volume of third party maintenance contract revenue in the current quarter versus the prior year period.

In the Systems segment, the gross profit margin increased from 65% to 86% as shown in the table above. This was primarily the result of higher royalty revenue, which carries a 100% gross margin, in the current quarter versus the prior year period as described above.

Engineering and Development Expenses

The following table details our engineering and development expenses by operating segment for the three months ended March 31, 2012 and 2011:

| | For the Three Months Ended | | | | | | | | |
|--------------------------------|----------------------------|---------------|---|-------------------|---------------|---|-------------|---------------|---|
| | March 31, 2012 | % of total | | March 31, 2011 | % of total | | \$ Decrease | % Decrease | |
| (Dollar amounts in thousands) | | | | | | | | | |
| By Operating Segment: | | | | | | | | | |
| Systems | \$ 474 | 100 | % | \$ 508 | 100 | % | \$ (34) | (7) | % |
| Service and System Integration | — | — | | — | — | | — | — | |
| Total | \$ 474 | 100 | % | \$ 508 | 100 | % | \$ (34) | (7) | % |

The decrease in engineering and development expenses displayed above was due to lower engineering consulting expenditures in connection with the development of the next generation of MultiComputer products in the Systems segment.

Selling, General and Administrative

The following table details our selling, general and administrative (“SG&A”) expense by operating segment for the three months ended March 31, 2012 and 2011:

| | For the Three Months Ended | | | | | | | | |
|--------------------------------|----------------------------|---------------|---|-------------------|---------------|---|-------------|---------------|---|
| | March 31, 2012 | % of total | | March 31, 2011 | % of total | | \$ Increase | % Increase | |
| (Dollar amounts in thousands) | | | | | | | | | |
| By Operating Segment: | | | | | | | | | |
| Systems | \$ 1,126 | 32 | % | \$ 906 | 27 | % | \$ 220 | 24 | % |
| Service and System Integration | 2,446 | 68 | % | 2,404 | 73 | % | 42 | 2 | % |
| Total | \$ 3,572 | 100 | % | \$ 3,310 | 100 | % | \$ 262 | 8 | % |

The increase in SG&A expense in both segments was primarily the result of an increase in bonus and commission expense owing to the more favorable revenue, gross profit and overall operating results for the three months ended March 31, 2012 versus the comparable period in the prior year.

Other Income/Expenses

The following table details our other income/expenses for the three months ended March 31, 2012 and 2011:

| | For the Three Months Ended | | |
|------------------------------|----------------------------|-------------------|------------------------|
| | March 31, 2012 | March 31, 2011 | Increase (Decrease) |
| | (Amounts in thousands) | | |
| Interest expense | \$ (21) | \$ (21) | \$ — |
| Interest income | 11 | 9 | 2 |
| Foreign exchange gain (loss) | (12) | 12 | (24) |
| Other income (expense), net | (14) | (1) | (13) |
| Total other expense, net | \$ (36) | \$ (1) | \$ (35) |

Other income (expense), net, for the three month periods ended March 31, 2012 and 2011 was not significant nor was the change from the prior year three month period to that of the current year.

Income Taxes

Income Tax Provision

The Company recorded income tax expense of approximately \$0.2 million for the quarter ended March 31, 2012 reflecting an effective income tax rate of 30% compared to income tax expense of approximately \$0.1 million for the quarter ended March 31, 2011, which reflected an effective income tax rate of 33%.

In assessing the realizability of deferred tax assets, we considered our taxable future earnings and the expected timing of the reversal of temporary differences. Accordingly, we have recorded a valuation allowance which reduces the gross deferred tax asset to an amount that we believe will more likely than not be realized. Our inability to project future profitability beyond fiscal year 2012 in the U.S. and cumulative losses incurred in recent years in the United Kingdom represent sufficient negative evidence to record a valuation allowance against certain deferred tax assets. We maintained a substantial valuation allowance against our United Kingdom deferred tax assets as we have experienced cumulative losses and do not have any indication that the operation will be profitable in the future to an extent that will allow us to utilize much of our net operating loss carryforwards. To the extent that actual experience deviates from our assumptions, our projections would be affected and hence our assessment of realizability of our deferred tax assets may change.

Liquidity and Capital Resources

Our primary source of liquidity is our cash and cash equivalents, which decreased by approximately \$1.0 million to \$14.8 million as of March 31, 2012 from \$15.9 million as of September 30, 2011. At March 31, 2012, cash equivalents consisted of money market funds which totaled \$3.5 million.

Significant uses of cash for the six months ended March 31, 2012 included an increase in accounts receivable of approximately \$1.1 million, an increase in other assets of approximately \$1.2 million, a decrease in A/P and accrued expenses of approximately \$1.4 million and payment of dividends of approximately \$0.3 million. Offsetting these uses of cash, significant sources of cash were net income of approximately \$0.9 million, a decrease in inventories of approximately \$0.8 million and an increase in deferred revenue of approximately \$1.2 million.

Cash held by our foreign subsidiaries located in Germany and the United Kingdom totaled approximately \$5.6 million as of March 31, 2012 and September 30, 2011. This cash is included in our total cash and cash equivalents reported above. We consider this cash to be permanently reinvested into these foreign locations because repatriating it would result in unfavorable tax consequences. Consequently, it is not available for activities that would require it to be repatriated to the U.S.

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

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of March 31, 2012. Our chief executive officer, our chief financial officer, and other members of our senior management team supervised and participated in this evaluation. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company’s management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of March 31, 2012, the Company’s chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Controls over Financial Reporting

During the period covered by this report, there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Share Repurchase Plans. The following table provides information with respect to shares of our common stock that we repurchased during the six months ended March 31, 2012:

| Period | Issuer Purchases of Equity Securities | | Total Number of Shares Purchased as Part of Publicly Announced Plans (1) | Maximum Number of Shares that May Yet Be Purchased Under the Plans |
|---------------------|---------------------------------------|------------------------------|--|--|
| | Total Number of Shares Purchased | Average Price Paid per Share | | |
| October 1-31, 2011 | 6,914 | \$3.47 | 6,914 | |
| November 1-30, 2011 | 1,500 | \$3.50 | 1,500 | |
| December 1-31, 2011 | 8,413 | \$3.44 | 8,413 | |
| January 1-31, 2012 | 5,895 | \$3.34 | 5,895 | |
| February 1-29, 2012 | — | — | — | |
| March 1-31, 2012 | 700 | \$3.84 | 700 | |

| | | | | |
|-------|--------|--------|--------|---------|
| Total | 23,422 | \$3.44 | 23,422 | 205,403 |
|-------|--------|--------|--------|---------|

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- (1) All shares were purchased under publicly announced plans. For additional information about these publicly announced plans, please refer to Note 12 of our audited financial statements in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2011.

Item 6. Exhibits

| Number | Description |
|--------|---|
| 3.1 | Articles of Organization and amendments thereto (incorporated by reference to Exhibit 3.1 to our Form 10-K for the year ended September 30, 2007) |
| 3.2 | By-Laws, as amended (incorporated by reference to Exhibit 3.2 to our Form 8-K filed on May 11, 2012) |
| 31.1* | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2* | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1* | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101* | Interactive Data Files regarding (a) our Consolidated Balance Sheets as of March 31, 2012 and September 30, 2011, (b) our Consolidated Statements of Operations for the Three and Six Months Ended March 31, 2012 and 2011, (c) our Consolidated Statement of Shareholders' Equity for the Six Months Ended March 31, 2012, (d) our Consolidated Statements of Cash Flows for the Six Months Ended March 31, 2012 and 2011 and (e) the Notes to such Consolidated Financial Statements. |

*Filed Herewith

SIGNATURES

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

CSP INC.

Date: May 14, 2012

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

Date: May 14, 2012

By: /s/ Gary W. Levine
Gary W. Levine
Chief Financial Officer

Exhibit Index

| Number | Description |
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*Filed Herewith