

AVOCENT CORP  
Form 10-Q  
May 07, 2007

# U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-Q

(Mark One)

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended March 30, 2007 or

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from            to

Commission file number: 000-30575

## AVOCENT CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or Other Jurisdiction of Incorporation or Organization)

**91-2032368**

(I.R.S. Employer Identification Number)

**4991 Corporate Drive  
Huntsville, Alabama**

(Address of Principal Executive Offices)

**35805**

(Zip Code)

**256-430-4000**

(Registrant's Telephone Number, Including Area Code)

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, as amended, 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. (See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Securities Exchange Act.)

Large Accelerated filer

Accelerated Filer

Non- Accelerated filer

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

As of May 1, 2007, the number of outstanding shares of the Registrant's Common Stock was 50,459,429.

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AVOCENT CORPORATION

FORM 10-Q

March 30, 2007

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Signature

## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

**AVOCENT CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(Unaudited, in thousands, except per share data)

|  | For the three months ended |                   |
|--|----------------------------|-------------------|
|  | March 30,<br>2007          | March 31,<br>2006 |
| Net sales:   |                            |                   |
| Products and services  | \$ 113,576                 | \$ 88,190         |
| Licenses and royalties   | 19,575                     | 6,322             |
| Total net sales  | 133,151                    | 94,512            |
| Cost of sales:   |                            |                   |
| Products and services  | 49,094                     | 38,555            |
| Licenses and royalties   | 3,042                      |                   |
| Total cost of sales (includes \$179 and \$50 of stock compensation expense in 2007 and 2006 respectively; includes \$2,683 of intangible asset amortization in 2007) | 52,136                     | 38,555            |
| Gross profit   | 81,015                     | 55,957            |
| Research and development expenses (includes \$1,116 and \$301 of stock compensation expense in 2007 and 2006, respectively)  | 20,881                     | 13,209            |
| Acquired in-process research and development expense   |                            | 2,100             |
| Selling, general and administrative expenses (includes \$2,366 and \$490 of stock compensation expense in 2007 and 2006, respectively)                               | 48,660                     | 23,384            |
| Amortization of intangible assets  | 8,962                      | 2,351             |
| Total operating expenses   | 78,503                     | 41,044            |
| Income from operations   | 2,512                      | 14,913            |
| Net investment income  | 879                        | 3,091             |
| Net realized investment losses   |                            | (55 )             |
| Interest expense   | (2,234 )                   |                   |
| Other income (expense), net  | (317 )                     | (20 )             |
| Income before provision for income taxes   | 840                        | 17,929            |
| Provision for income taxes   | 94                         | 4,996             |
| Net income   | \$ 746                     | \$ 12,933         |
| Earnings per share:  |                            |                   |
| Basic  | \$ 0.01                    | \$ 0.26           |
| Diluted  | \$ 0.01                    | \$ 0.26           |
| Weighted average shares used in computing earnings per share:  |                            |                   |
| Basic  | 50,733                     | 49,095            |
| Diluted  | 51,886                     | 50,109            |

See notes accompanying these condensed consolidated financial statements.



## Avocent Corporation

## Consolidated Balance Sheets

March 30, 2007 and December 31, 2006

(Unaudited, in thousands, except per share data)

|  | March 30,<br>2007 | December 31,<br>2006 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Current assets:  |                   |                      |
| Cash and cash equivalents  | \$ 70,840         | \$ 81,301            |
| Investments maturing within one year   | 38,099            | 25,864               |
| Accounts receivable, less allowance for doubtful accounts of \$2,064 and \$2,449 at March 30, 2007 and December 31, 2006, respectively   | 109,192           | 126,471              |
| Other receivables  | 12,393            | 13,365               |
| Inventories  | 40,137            | 41,765               |
| Other current assets   | 5,507             | 3,904                |
| Deferred tax assets, net   | 8,705             | 7,355                |
| Total current assets   | 284,873           | 300,025              |
| Investments  |                   | 987                  |
| Property and equipment, net  | 38,087            | 38,004               |
| Goodwill   | 606,787           | 607,488              |
| Other intangible assets, net   | 199,235           | 209,674              |
| Other assets   | 2,370             | 2,676                |
| Total assets   | \$ 1,131,352      | \$ 1,158,854         |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                   |                      |
| Current liabilities:   |                   |                      |
| Accounts payable   | \$ 15,294         | \$ 16,260            |
| Accrued wages and commissions  | 16,087            | 25,511               |
| Accrued liabilities  | 24,756            | 29,754               |
| Income taxes payable   | 20,340            | 17,364               |
| Deferred revenue, current  | 45,144            | 44,453               |
| Total current liabilities  | 121,621           | 133,342              |
| Unsecured bank line of credit  | 150,000           | 150,000              |
| Deferred tax liabilities, net  | 28,137            | 30,377               |
| Deferred revenue, non-current  | 9,593             | 10,070               |
| Other non-current liabilities  | 872               | 1,222                |
| Total liabilities  | 310,223           | 325,011              |
| Commitments and contingencies ( <i>see Note 11</i> )   |                   |                      |
| Stockholders equity:   |                   |                      |
| Preferred stock, par value \$0.001 per share; 5,000 shares authorized; no shares issued and outstanding  |                   |                      |
| Common stock, par value \$0.001 per share; 200,000 shares authorized; March 30, 2007 53,752 shares issued and 50,525 outstanding; December 31, 2006 53,382 shares issued and 50,642 outstanding; | 54                | 53                   |
| Additional paid-in capital   | 1,189,690         | 1,185,114            |
| Accumulated other comprehensive income   | 143               | 65                   |
| Accumulated deficit ( <i>see Note 10</i> )   | (263,902)         | (261,971)            |
| Treasury stock, at cost; March 30, 2007, 3,227 shares; December 31, 2006, 2,740 shares;  | (104,856)         | (89,418)             |
| Total stockholders equity  | 821,129           | 833,843              |
| Total liabilities and stockholders equity  | \$ 1,131,352      | \$ 1,158,854         |

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See notes accompanying these condensed consolidated financial statements.

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## AVOCENT CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

|   | For the three months ended |                   |
|---|----------------------------|-------------------|
|   | March 30,<br>2007          | March 31,<br>2006 |
| Cash flows from operating activities:   |                            |                   |
| Net income  | \$ 746                     | \$ 12,933         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                            |                   |
| Depreciation  | 2,354                      | 1,774             |
| Amortization of intangible assets   | 11,747                     | 2,351             |
| Stock-based compensation  | 3,661                      | 841               |
| Acquired in-process research and development expenses                             |                            | 2,100             |
| Amortization of premiums (discounts) on investments                               | (73 )                      | 16                |
| Net loss on sales of investments  |                            | 55                |
| Net loss on disposition of fixed assets   | 214                        |                   |
| Excess tax benefit from stock-based compensation                                  | (820 )                     | (3,695 )          |
| Changes in operating assets and liabilities, net of acquisition:                  |                            |                   |
| Accounts receivable, net  | 17,332                     | 6,568             |
| Inventories   | 1,640                      | (1,855 )          |
| Other assets  | (302 )                     | 391               |
| Accounts payable  | (956 )                     | (1,466 )          |
| Accrued wages and commissions   | (9,424 )                   | (2,219 )          |
| Accrued other liabilities and deferred revenue (2)                                | (4,984 )                   | (1,991 )          |
| Income taxes, current and deferred  | (3,291 )                   | 761               |
| Net cash provided by operating activities   | 17,844                     | 16,564            |
| Cash flows from investing activities:   |                            |                   |
| Purchase of other intangible assets   | (2,769 )                   |                   |
| Purchase of Cyclades, net of cash received (1)                                    |                            | (72,751 )         |
| Purchases of property and equipment (2)   | (2,616 )                   | (1,689 )          |
| Purchases of investments  | (26,124 )                  | (89,928 )         |
| Maturities and proceeds from sales of investments                                 | 15,005                     | 173,805           |
| Net cash (used in) provided by investing activities                               | (16,504 )                  | 9,437             |
| Cash flows from financing activities:   |                            |                   |
| Proceeds from employee stock option exercises                                     | 2,793                      | 19,198            |
| Excess tax benefit from stock-based compensation                                  | 820                        | 3,695             |
| Purchases of treasury stock   | (15,438 )                  | (26,952 )         |
| Net cash used in financing activities   | (11,825 )                  | (4,059 )          |
| Effect of exchange rate changes on cash and cash equivalents                      | 24                         | 17                |
| Net increase (decrease) in cash and cash equivalents                              | (10,461 )                  | 21,959            |
| Cash and cash equivalents at beginning of period                                  | 81,301                     | 66,425            |
| Cash and cash equivalents at end of period  | \$ 70,840                  | \$ 88,384         |

(1) \$17,135 of the purchase consideration for Cyclades was not yet paid at March 31, 2006. These funds were distributed in April 2006.

(2) \$6,250 included in accrued liabilities related to the purchase of certain tangible and intangible assets of an existing product line on March 31, 2006.



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See notes accompanying these condensed consolidated financial statements.

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## AVOCENT CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited, in thousands, except per share data)

## Note 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with United States generally accepted accounting principles and reflect all adjustments consisting of normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results for the periods shown. The results of operations for these periods are not necessarily indicative of the results expected for the full fiscal year or for any future periods. The preparation of financial statements in conformity with generally accepted accounting principles 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 revenue and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the related notes contained in our Annual Report on Form 10-K for the year ended December 31, 2006, which is on file with the Securities and Exchange Commission and is available at our website, [www.avocent.com](http://www.avocent.com). The consolidated balance sheet presented in the accompanying condensed consolidated financial statements for December 31, 2006, was derived from the audited financial statements filed in our 10-K for the period ended December 31, 2006, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

We report our annual results based on years ending December 31. We report our quarterly results for the first three interim periods based on 13 week periods ending on Fridays and for the fourth interim period ending on December 31.

Our financial statements are consolidated and include the accounts of Avocent Corporation and our wholly owned subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation.

## Note 2. Inventories

Inventories consisted of the following at:

|                 | March 30, 2007 | December 31, 2006 |
|-----------------|----------------|-------------------|
| Raw materials   | \$ 3,169       | \$ 3,022          |
| Work-in-process | 1,401          | 1,411             |
| Finished goods  | 35,567         | 37,332            |
| Inventories     | \$ 40,137      | \$ 41,765         |

Inventories above have been reduced by reserves for excess and obsolete inventories of \$7,256 and \$5,578 as of March 30, 2007 and December 31, 2006, respectively.

## Note 3. Equity and Treasury Stock

Stock option exercises and restricted stock unit (RSU) vesting Shares of our common stock issued as a result of option exercises totaled 136 shares during the quarter ended March 30, 2007 and 915 shares during the quarter ended March 31, 2006. In the first quarter of 2007, a total of 329 restricted stock units vested. At the release of these shares, 96 shares were withheld for taxes, resulting in issuance of 233 shares, net of tax withholding.

Stock repurchases We repurchased 487 shares of our common stock during the quarter ended March 30, 2007 at a cost totaling \$15,438. We repurchased 825 shares of our common stock during the quarter ended March 31, 2006 at a cost totaling \$26,952. These treasury shares were purchased on the open market through various brokers under the stock re-purchase plan approved by our Board of Directors. During the first quarter of 2007, our Board approved an additional 2,000 shares for repurchase under our share repurchase program and has approved a total of 12,000 shares for repurchase under the program. As of March 30, 2007 we may repurchase an additional 1,700 shares under this program.



## Note 4. Accumulated Other Comprehensive Income (Loss)

We record unrealized gains and losses on our foreign currency translation adjustments, unrealized gains and losses on derivatives which are cash flow hedges, and unrealized holding gains or losses on our available-for-sale securities, net of tax, as accumulated other comprehensive income (loss), which is included as a separate component of stockholders' equity. Comprehensive income in the first quarter of 2007 of totaling \$825 consists of \$746 of net income, \$37 of unrealized gains on investments (net of deferred income taxes) and \$38 of unrealized losses on the cash flow hedge (net of deferred income taxes) and \$80 of foreign currency translation adjustments. Comprehensive income in the first quarter of 2006 of \$13,016 consists of \$12,933 of net income, \$8 of unrealized gains on investments (net of deferred income taxes) and \$75 of foreign currency translation adjustments. As of March 30, 2007 and December 31, 2006, total accumulated other comprehensive income was \$143 and \$65, respectively.

## Note 5. Earnings Per Share

|   | Income (Numerator) | Shares<br>(Denominator) | Per-Share<br>Amount |
|---|--------------------|-------------------------|---------------------|
| <b>For the three months ended March 30, 2007</b>                    |                    |                         |                     |
| <b>Basic EPS</b>  |                    |                         |                     |
| Net income available to common stockholders                         | \$ 746             | 50,733                  | \$ 0.01             |
| <b>Effect of Dilutive Securities</b>                                |                    |                         |                     |
| Stock options and unvested RSUs                                     |                    | 1,153                   |                     |
| <b>Diluted EPS</b>  |                    |                         |                     |
| Net income available to common stockholders and assumed conversions | \$ 746             | 51,886                  | \$ 0.01             |
| <b>For the three months ended March 31, 2006</b>                    |                    |                         |                     |
| <b>Basic EPS</b>  |                    |                         |                     |
| Net income available to common stockholders                         | \$ 12,933          | 49,095                  | \$ 0.26             |
| <b>Effect of Dilutive Securities</b>                                |                    |                         |                     |
| Stock options   |                    | 1,014                   |                     |
| <b>Diluted EPS</b>  |                    |                         |                     |
| Net income available to common stockholders and assumed conversions | \$ 12,933          | 50,109                  | \$ 0.26             |

Anti-dilutive options to purchase common stock outstanding were excluded from the calculations above. Anti-dilutive options totaled 2,130 and 2,369 as of March 30, 2007 and March 31, 2006, respectively.

## Note 6. Segment Reporting

In the first quarter of 2007, we merged the Mobile Technologies Division into the LANDesk Division as their products consist primarily of software sold to similar customer groups. Also in the first quarter of 2007, we merged the Embedded Software and Solutions Division into the Management Systems Division as they are serving similar customers and market segments. As a result of merging these two divisions we re-evaluated our segment disclosures and identified two reportable segments. Accordingly, we have provided revenue and operating income (loss) below under the new segment structure and have retroactively adjusted the segment information previously disclosed for the three months ended March 31, 2006 to conform to the current segment disclosures. In addition, as a result of the merger of divisions, we reallocated goodwill among our reporting units (see Note 8).

We evaluate the performance of our segments based on revenue and operating profit, which is calculated before corporate and unallocated costs, amortization of intangibles, acquired in-process research and development expense, and stock compensation costs. We do not track or use assets by segment as a measure of performance, therefore, we have not presented assets by segment. The following is a presentation of information for our two reportable segments, Management



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Systems and LANDesk:

|                           | <b>For the three months ended</b> |                       |
|---------------------------|-----------------------------------|-----------------------|
|                           | <b>March 30, 2007</b>             | <b>March 31, 2006</b> |
| Net revenue:              |                                   |                       |
| Management Systems        | \$ 105,104                        | \$ 90,498             |
| LANDesk                   | 23,078                            |                       |
| Other business units      | 4,219                             | 3,021                 |
| Corporate and unallocated | 750                               | 993                   |
| Total net revenue         | \$ 133,151                        | \$ 94,512             |

|  | <b>For the three months ended</b> |                       |
|--|-----------------------------------|-----------------------|
|  | <b>March 30, 2007</b>             | <b>March 31, 2006</b> |
| Operating income (loss):                             |                                   |                       |
| Management Systems                                   | \$ 25,911                         | \$ 25,783             |
| LANDesk  | (536)                             | )                     |
| Other business units                                 | (3,149)                           | (2,698)               |
| Corporate and unallocated costs                      | (3,615)                           | (2,729)               |
| Amortization of intangibles                          | (12,438)                          | (2,502)               |
| Acquired in-process research and development expense |                                   | (2,100)               |
| Stock-based compensation expense                     | (3,661)                           | (841)                 |
| Total income from operations                         | 2,512                             | 14,913                |
| Other income (expense)                               | (1,672)                           | 3,016                 |
| Income before provision for income taxes             | \$ 840                            | \$ 17,929             |

**Revenue and operating income for our Management Systems Division includes the operating results of Cyclades from the date of the acquisition on March 30, 2006.**

Sales by product line for our Management Systems Division and LANDesk Division for the three months ended March 30, 2007 and March 31, 2006 are as follows:

|  | <b>For the Three Months Ended</b> |                       |
|--|-----------------------------------|-----------------------|
|  | <b>March 30, 2007</b>             | <b>March 31, 2006</b> |
| Management Systems Division (MSD) net revenue: |                                   |                       |
| KVM  | \$ 80,688                         | \$ 77,975             |
| Serial management                              | 11,286                            | 993                   |
| Embedded software and solutions                | 7,577                             | 6,133                 |
| Other  | 5,553                             | 5,397                 |
| Total MSD net revenue                          | \$ 105,104                        | \$ 90,498             |

|                               | <b>For the Three<br/>months ended<br/>March 30, 2007</b> |
|-------------------------------|--|
| LANDesk Division net revenue: |  |
| Licenses and royalties        | \$ 13,094  |
| Maintenance and services      | 9,979  |
| Total LANDesk net revenue     | \$ 23,073  |

We sell our products internationally to customers in several countries; however no foreign country accounted for more than 10% of sales in the first quarter of 2007 or 2006.



As of March 30, 2007, long-lived assets totaled \$844,109, which includes \$552,936 held in the U.S. and \$291,173 held outside of the U.S. As of December 31, 2006, long-lived assets totaled \$855,166, which includes \$539,684 held in the U.S. and \$315,482 held outside of the U.S.

#### Note 7. Forward Contracts and Interest Rate Swap

We use forward contracts to reduce our foreign currency exposure related to the net cash flows from our international operations. The majority of these contracts are short-term contracts (three months or less) and are marked-to-market each quarter and included in trade payables, with the offsetting gain or loss included in other income (expense) in the accompanying consolidated statements of income. As of March 30, 2007, we had three open forward contracts with an approximate fair value of \$2. As of December 31, 2006, we had one open forward contract with an approximate fair value of zero.

In 2006, we entered into an interest rate swap agreement with a notional amount of \$125,000. The objective of the rate swap agreement is to provide a hedge against rising LIBOR interest rates that would have a negative effect on our cash flows due to changes in interest rates on the line of credit. The swap was effective on August 31, 2006 and terminates on December 31, 2008. The swap calls for us to make fixed rate payments of 5.42% over the term of the hedge and to receive floating rate payments based on LIBOR (matching the LIBOR rate in the line of credit above) from the counter-party. We anticipate that the hedge will be settled upon maturity and it is being accounted for as a cash flow hedge. The interest rate swap is recorded at fair value each reporting period with the changes in the fair value of the hedge that take place through the date of maturity recorded in accumulated other comprehensive income (OCI).

At March 30, 2007, we recorded an unrealized loss on the swap, net of tax, of \$319 in accumulated OCI. There was no ineffectiveness in the year and we anticipate no reclassification of OCI into earnings in the next 12 months.

#### Note 8. Goodwill and Other Intangible Assets

Other intangible assets subject to amortization were as follows:

|  | March 30, 2007         |                          | December 31, 2006      |                          |
|--|------------------------|--------------------------|------------------------|--------------------------|
|  | Gross Carrying Amounts | Accumulated Amortization | Gross Carrying Amounts | Accumulated Amortization |
| Developed technology                     | \$ 69,740              | \$ 21,564                | \$ 68,720              | \$ 17,741                |
| Internally developed software for resale | 21,900                 | 2,129                    | 21,900                 | 1,217                    |
| Patents and trademarks                   | 35,781                 | 9,065                    | 35,520                 | 7,753                    |
| Customer base and certifications         | 100,147                | 13,472                   | 100,120                | 9,449                    |
| Maintenance contracts                    | 9,600                  | 1,120                    | 9,600                  | 640                      |
| Non-compete agreements                   | 12,720                 | 4,780                    | 12,720                 | 3,775                    |
| Other                                    | 4,228                  | 2,751                    | 4,228                  | 2,559                    |
|  | \$ 254,116             | \$ 54,881                | \$ 252,808             | \$ 43,134                |

During the first quarter of 2007, we acquired an existing product line and related technology from a third party for approximately \$1,020 in cash, which we recorded in intangible assets. The amounts are subject to future amortization over an estimated three year life. Additionally, the purchase agreement provides for certain incentive payments of approximately \$600. These potential incentive costs will be recognized as expense over the periods for which the related services are provided.

For the three months ended March 30, 2007 and March 31, 2006, amortization expense for other intangible assets was \$11,747 and \$2,351, respectively. The approximate estimated annual amortization for other intangibles is as follows:



## Years ending December 31:

|                 |           |
|-----------------|-----------|
| 2007, remaining | \$ 32,350 |
| 2008            | \$ 42,097 |
| 2009            | \$ 37,507 |
| 2010            | \$ 34,499 |
| 2011            | \$ 26,034 |
| Thereafter      | \$ 26,748 |

As a result of the merger of certain divisions (see Note 6) there were changes in the carrying amount of goodwill among the divisions for the three months ended March 30, 2007, as follows:

|                                   | Management<br>Systems<br>Division | LANDesk<br>Division | Embedded<br>Software and<br>Solutions<br>Divisions | Other<br>Business<br>Units | Total      |
|-----------------------------------|-----------------------------------|---------------------|--|----------------------------|------------|
| Balance as of December 31, 2006   | \$ 316,430                        | \$ 274,613          | \$ 11,862  | \$ 4,583                   | \$ 607,488 |
| Reallocation from segment changes | 11,862                            |                     | (11,862)   |                            |            |
| Adjustments during the quarter    |                                   | (701)               |  |                            | (701)      |
| Balance as of March 30, 2007      | \$ 328,292                        | \$ 273,912          | \$   | \$ 4,583                   | \$ 606,787 |

For the three months ended March 31, 2006, we recorded \$61,741 of goodwill related to the Cyclades Corporation acquisition and \$181 of adjustments to goodwill related to a prior acquisition and are included in MSD.

**Note 9. Product Warranties and Deferred Revenue**

The activity within the liability for warranty returns for the quarter ended March 30, 2007 is as follows:

| <b>2007</b>  |          |
|--|----------|
| Balance, January 1, 2007                                 | \$ 2,486 |
| Accruals for product warranties issued during the period | 1,036    |
| Settlements made during the period                       | (1,036)  |
| Balance, March 30, 2007                                  | \$ 2,486 |

Deferred revenue related to our extended warranty for hardware products program was \$4,298 at March 30, 2007 and \$4,545 at December 31, 2006. We recorded earned revenue from the amortization of deferred revenue related to extended warranties of \$1,022 during the three months ended March 30, 2007. In addition, we recorded new extended warranties of \$994 during the three months ended March 30, 2007.

We defer revenue for subscription, service and maintenance contracts until earned, which is generally over the term of the contract or when services are performed. As of March 30, 2007, deferred revenue was \$54,737, of which approximately \$48,761 related to LANDesk. As of December 31, 2006, deferred revenue was \$53,514, of which approximately \$47,858 related to LANDesk.



Note 10. Income taxes

The effective tax rate in the first quarter of 2007 was approximately 11.2% compared to an effective tax rate of approximately 27.9% in the first quarter of 2006. The provision for income taxes was \$94 for the first quarter of 2007, compared to \$5,000 in the first quarter of 2006. The decrease in the effective tax rate was primarily the result of the change in the mix of pre-tax profit among our U.S. and international companies, the reinstatement of the U.S. Research and Development Tax Credit, expenses related to stock options, and in the first quarter of 2006 an acquisition occurred resulting in an increase in the effective tax rate for In-process Research and Development. The decreases to the effective tax rate were partially offset by an increase due to the lower amount of interest earned on tax-free municipal bonds.

We adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 on January 1, 2007. As a result of adopting this FASB Interpretation, we recorded an increase to reserves for uncertain tax positions of \$2,900. This increase was recorded as an increase to the January 1, 2007 accumulated deficit balance. As of the adoption date, we had total reserves for uncertain tax positions related to gross unrecognized tax benefits of \$11,400 of which \$9,300, if recognized, would affect the effective tax rate. We recognize potential accrued interest and penalties related to unrecognized tax benefits from our global operations within income tax expense. As of the adoption date, we had accrued interest expense related to the unrecognized tax benefits of approximately \$2,200. Penalties may be charged in certain jurisdictions for the underpayment or late payment of tax. As of the adoption date, we had accrued penalties related to the unrecognized tax benefits of approximately \$200.

We conduct business globally, and as a result our subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. In the normal course of business we are subject to examinations by taxing authorities throughout the world including the U.S. With few exceptions, we are no longer subject to U.S. federal, state, and local, or non-U.S. income tax examinations before 2003.

We are currently under audit by the Internal Revenue Service for the 2004 and 2005 tax years. It is likely that the examination phase of the audit for those years will conclude in 2007, and it is reasonably possible a change in the unrecognized tax benefits may occur; however, quantification of an estimated range cannot be made at this time.

The amortization of the other intangible assets acquired and the goodwill recorded related to the LANDesk acquisition in 2006 may be tax deductible if we make certain tax elections. We are currently evaluating the impact of these elections, which must be made within certain prescribed time periods following the date of acquisition (May 15, 2007). We have indemnified former LANDesk shareholders for any personal tax consequences should our election create current tax obligations for these former shareholders. Our initial purchase price allocation of this acquisition does not take into consideration the tax impact should these elections be made within the required time period, thus previously established deferred taxes and intangible assets may be adjusted if we choose to make these elections.

Note 11. Litigation

On March 14, 2006, TFS Electronic Manufacturing Services, Inc. (TFS) filed a Third-Party Complaint and an Objection to Claim of Avocent Corporation with the United States Bankruptcy Court, District of Arizona. As a result of the complaint, an adversary proceeding has been commenced against Avocent in the TFS bankruptcy case in an effort to disallow Avocent's claim in its entirety. TFS also seeks damages in an undetermined amount for Avocent's alleged breach of contract, negligence, negligent misrepresentations, breaches of warranty, unjust enrichment, disparagement of TFS's business, and quantum merit. TFS is seeking recovery of actual damages, punitive damages, attorneys' fees, pre- and post-judgment interest, costs, and the imposition of joint and several liability as to Avocent and a named co-defendant, TopSearch Printed Circuits (HK), Ltd. (TopSearch). The matter has been consolidated with a separate matter between TFS and TopSearch pending in the United States District Court for the District of Arizona, for purposes of discovery through pre-trial. The court has ordered that early mediation be scheduled and a mediator has been assigned. Discovery is under way. We intend to vigorously defend our positions.

In January 2007, we filed a complaint for patent infringement in the United States District Court for the Western District of Washington against Aten Technology, Inc., Aten International Co., Ltd, Belkin Corporation, Rose Electronics and its general partners, and Trippe Manufacturing Company. The defendants have filed counterclaims alleging non-infringement, unenforceability, and invalidity, and discovery is currently underway.

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In March 2007, KBM Enterprises, formerly a contract manufacturer for Avocent, filed a complaint against Avocent in the Circuit Court of Madison County, Alabama, seeking \$9.5 million for costs allegedly incurred by KBM in its manufacturing efforts on behalf of Avocent. Avocent has filed a motion to dismiss the case. We intend to vigorously defend our positions.

In April 2007, we filed a complaint for declaratory judgment against Aten International Co., Ltd. in the United States District Court for the Northern District of Alabama. We are seeking a declaratory judgment that two patents owned by Aten and asserted against Avocent are invalid and that certain of products alleged by Aten to infringe do not infringe these patents.

### **Note 12. Subsequent Events**

During the period from March 31, 2007 through May 1, 2007, we purchased 100 additional shares of our common stock under our share repurchase program for a total cost of \$2,493.

During the second quarter of 2007 our Compensation Committee approved the grant of 1,075 time-based and 399 performance-based restricted stock units to our officers, directors and other employees.

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

*THE INFORMATION IN THIS ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS CONTAINS FORWARD-LOOKING STATEMENTS, INCLUDING, WITHOUT LIMITATION, STATEMENTS RELATING TO OUR FUTURE BUSINESS PROSPECTS AND ECONOMIC CONDITIONS IN GENERAL; STATEMENTS REGARDING OUR ABILITY TO PREDICT FUTURE SALES AND MANAGE INVENTORY LEVELS; STATEMENTS REGARDING PRICING PRESSURE; STATEMENTS REGARDING THE FLUCTUATION OF OUR REVENUE GROWTH IN RELATION TO ECONOMIC CONDITIONS AND IT RELATED SPENDING TRENDS; STATEMENTS REGARDING OUR PRODUCT PLATFORMS AND OUR ABILITY TO RESUME GROWTH IN OUR OVERALL BUSINESS; STATEMENTS REGARDING INCREASED SALES OF OUR DIGITAL PRODUCTS AND EMBEDDED SOLUTIONS AND THEIR ABILITY TO OFFSET PRICE DECLINES AND COMPETITIVE FACTORS; STATEMENTS REGARDING OUR GROSS MARGINS, OUR RESEARCH AND DEVELOPMENT EXPENSES AND OUR SELLING, GENERAL AND ADMINISTRATIVE EXPENSES IN THE SECOND QUARTER OF 2007; AND STATEMENTS REGARDING OUR LEGAL COSTS FOR PATENT AND OTHER LITIGATION MATTERS. THESE FORWARD-LOOKING STATEMENTS ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE OUR ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED IN PART II, ITEM 1A RISK FACTORS.*

**Overview**

Avocent Corporation designs, manufactures, licenses, and sells software and hardware products and technologies that provide connectivity and centralized management of information technology (IT) infrastructure. We (meaning Avocent and its wholly-owned subsidiaries) provide connectivity and systems management products and technologies that centralize control of servers, desktop computers, serial devices, wireless devices, mobile devices, and network appliances, thus increasing the efficiency of IT personnel. Server manufacturers resell private-labeled Avocent KVM (keyboard, video, and mouse) switches and embedded software and hardware technology in their systems, and companies large and small depend on our software and hardware products and technologies for managing their growing IT infrastructure.

For a more complete description of our products, technologies and markets, please refer to our Form 10-K, which was filed on March 1, 2007.

A substantial portion of our revenue is derived from sales to major server OEMs who purchase our switching systems on a private-label or branded basis for integration and sale with their own products, sales through our reseller and distributor network, and sales to a limited number of direct customers. Sales to our branded customers accounted for 64% of sales in the first quarter of 2007 and 51% of sales in the first quarter of 2006. Sales to our OEM customers accounted for 36% of sales in the first quarter of 2007 and 49% of sales in the first quarter of 2006. We do not have contracts with many of our branded customers, and in general, our OEM and branded business customers are obligated to purchase products from us only pursuant to binding purchase orders. The loss of, or material decline in orders from, these customers would have a material adverse effect on our business, financial condition, results of operations, and cash flows. Our top five customers include both OEM and branded customers, and accounted for 44% and 65% of sales in the first quarter of 2007 and 2006, respectively.

We sell products to resellers, distributors, end-users, and OEMs in the United States, Canada, Europe, and Asia as well as in other foreign markets. Sales within the United States accounted for approximately 55% of first quarter sales in both 2007 and 2006. Sales outside of the United States accounted for 45% of first quarter sales in both 2007 and 2006. No foreign country accounted for more than 10% of sales in the first quarter of 2007 or 2006.

With continued industry-wide initiatives to reduce all channel inventories and to shorten lead times, trends with our major customers are, generally, to reduce the number of weeks of forward-committed firm orders. This trend continues to affect our business with certain distributors, OEMs, and other server manufacturers, and we believe that it will continue to make our future sales more difficult to predict and inventory levels more difficult to manage.

We continue to experience significant price competition in the market for all of our products, and we expect that pricing pressures will continue in the future. In addition, general economic conditions are not predictable and we expect our revenue growth rate to fluctuate in relation to economic conditions and IT related spending trends.

Many of our executive officers and directors are vested in significant amounts of options to purchase shares of our common stock and RSUs. These officers and directors have informed us that they have sold, and may sell additional, shares of our common stock to provide liquidity and diversify their portfolios. During the second quarter of 2007 and 2006 our Board of Directors granted both time-based and performance-based restricted stock units (RSUs) with two and three year vesting.

In the first quarter of 2007, we merged our Mobile Technologies Division into the LANdesk Division and our Embedded Software and Solutions Division into the Management Systems Division to better focus on the respective customer needs and sales channels. We believe our new divisions allow us to focus on new technology and growth opportunities to add product and customer value

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in the future. We believe this structure enhances customer service, speeds delivery of products to market and better focuses Avocent's research, development, and marketing activities.

Our largest division, the Management Systems Division (which now includes our former Embedded Software and Solutions Division), comprised 79% of our consolidated net revenue in the first quarter of 2007 and 96% in 2006. Our LANDesk Division (which is our newest division and now includes our former Mobile Technologies Division), contributed 17% of net revenue to the first quarter of 2007. Our other divisions and unallocated revenue comprised the remaining 4% of our consolidated net revenue in 2007 and 2006. See Note 6 in the notes to the condensed consolidated financial statements contained in Part I, Item 1 of this document.

In the first quarter of 2007, we merged our Mobile Technologies Division into the LANDesk Division and our Embedded Software and Solutions Division into the Management Systems Division to better focus on the respective customer needs and sales channels. We believe our new divisions allow us to focus on new technology and growth opportunities to add product and customer value in the future. We believe this structure enhances customer service, speeds delivery of products to market and better focuses Avocent's research, development, and marketing activities.

### Results of Operations

The following table sets forth, for the periods indicated, selected statement of income data expressed as a percentage of net sales:

|  | Three Months Ended |   |           |   |
|--|--------------------|---|-----------|---|
|  | March 30,          |   | March 31, |   |
|  | 2007               | % | 2006      | % |
| Net sales  | 100.0              | % | 100.0     | % |
| Cost of sales  | 39.2               |   | 40.8      |   |
| Gross profit   | 60.8               |   | 59.2      |   |
| Operating expenses:                                  |                    |   |           |   |
| Research and development expenses                    | 15.7               |   | 14.0      |   |
| Acquired in-process research and development expense |                    |   | 2.2       |   |
| Selling, general and administrative expenses         | 36.5               |   | 24.7      |   |
| Amortization of intangible assets                    | 6.7                |   | 2.5       |   |
| Total operating expenses                             | 58.9               |   | 43.4      |   |
| Income from operations                               | 1.9                |   | 15.8      |   |
| Net investment income                                | 0.7                |   | 3.3       |   |
| Net realized investment losses                       |                    |   | (0.1)     | ) |
| Interest expense                                     | (1.7)              | ) |           |   |
| Other income (expense), net                          | (0.2)              | ) |           |   |
| Income before provision for income taxes             | 0.7                |   | 19.0      |   |
| Provision for income taxes                           | 0.1                |   | 5.3       |   |
| Net income   | 0.6                | % | 13.7      | % |

*Net sales.* Net sales increased 41% to \$133.2 million for the first quarter of 2007 from \$94.5 million for the first quarter of 2006. The increase in sales resulted primarily from the contribution of revenue from both our Cyclades acquisition, completed on March 30, 2006 and our LANDesk acquisition, completed on August 31, 2006. Branded sales increased 77% from \$47.9 million in the first quarter of 2006 to \$85.1 million in the first quarter of 2007. As a percentage of sales, branded revenue accounted for 64% of sales in the first quarter of 2007 and 51% of revenue in the first quarter of 2006. OEM sales grew 3% from \$46.6 million in the first quarter of 2006 to \$48.1 million in the first quarter of 2007. OEM sales were 36% of sales for the first quarter of 2007, compared to 49% of sales for the first quarter of 2006. Sales of our digital products increased 28% to \$64.7 million in the first quarter of 2007 from \$50.6 million in the first quarter of 2006. Although revenue from sales of digital products increased in dollars, as a percentage of sales of our digital products represented 48% of our revenue in the first quarter of 2007 compared to 54% of our revenue in the first quarter of 2006. This percentage decline combined with the overall dollar increase is a result of the diversification to our business that the LANDesk acquisition provided.

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From a divisional perspective, revenues from our Management Systems Division increased from \$90.5 million in the first quarter of 2006 to \$105.1 million in the first quarter of 2007. Our Management Systems Division is comprised of our traditional KVM products, our serial products and our embedded software and solutions products. Revenue from the Management Systems Division accounted for 79% of our revenue in the first quarter of 2007 and 96% of our revenue in the first quarter of 2006. The decline in Management System s percentage of revenue is a result of the diversification of our business, primarily as a result of the addition of LANDesk. Our Management Systems Division still generates a majority of our revenue and experienced an increase in revenue for the first quarter of 2007 primarily as a result of the additional sales contributed by our acquisition of Cyclades. Sales by product line for our Management Systems Division for the three months ended March 30, 2007 and March 31, 2006 are as follows:

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|   | <b>For the three months ended</b> |                           |
|---|-----------------------------------|---------------------------|
|   | <b>March 30,<br/>2007</b>         | <b>March 31,<br/>2006</b> |
| <b>Management Systems Division (MSD) net revenue:</b> |                                   |                           |
| KVM   | \$ 80,688                         | \$ 77,975                 |
| Serial management                                     | 11,286                            | 993                       |
| Embedded software and solutions                       | 7,577                             | 6,133                     |
| Other   | 5,553                             | 5,397                     |
| Total MSD net revenue                                 | \$ 105,104                        | \$ 90,498                 |

The LANDesk Division contributed \$23.1 million of net revenue during the first quarter of 2007, or 17% of our net revenue. LANDesk's revenue and bookings are comprised of both license-based revenue, primarily LANDesk Management Suite, and subscription-based revenue, primarily LANDesk Security Suite, with the growth in bookings from the subscription-based revenue outpacing the license-based revenue. This change in mix has an impact on the revenue we recognize because subscription revenue is deferred and amortized over the subscription term. Sales by product line for our LANDesk Division for the three months ended March 30, 2007 and March 31, 2006 are as follows:

|                                      | <b>For three months ended</b> |                           |
|--------------------------------------|-------------------------------|---------------------------|
|                                      | <b>March 30,<br/>2007</b>     | <b>March 31,<br/>2006</b> |
| <b>LANDesk Division net revenue:</b> |                               |                           |
| Licenses and royalties               | \$ 13,094                     | \$                        |
| Maintenance and services             | 9,979                         |                           |
| Total LANDesk net revenue            | \$ 23,073                     | \$                        |

Sales increased 41%, both within the United States and internationally, from the first quarter of 2006 to the first quarter of 2007 due to the additional revenue resulting from our acquisitions. Sales within the United States were \$73.8 million and \$52.4 million in the first quarter of 2007 and 2006 respectively. International sales were \$59.4 million and \$42.1 million in the first quarter of 2007 and 2006, respectively. Sales within the United States were 55% of sales in the first quarter of 2007 and 2006. International sales were 45% of sales in the first quarter of 2007 and 2006.

We typically experience a sequential decrease in business from the fourth quarter of one year to the first quarter of the following year. This trend was again evident from the fourth quarter of 2006 to the first quarter of 2007. In recent years, we have also experienced a sequential increase in revenue from the first quarter to the second quarter, primarily as a result of similar trends in IT spending for this period, and we believe the trend will continue in 2007. We believe the tone of our business is generally positive and industry analysts continue to forecast growth in IT spending on a year-over-year basis. Accordingly, for the second quarter of 2007, we expect revenue to be in the \$145 million to \$154 million range.

*Gross profit.* Gross profit is affected by a variety of factors: including the ratio of sales among our distribution channels, as OEM sales typically have lower gross margins than our branded sales; absorption of fixed costs as sales levels fluctuate; product mix; raw material costs; labor costs; new product introductions by us and by our competitors; sales levels of our software products which tend to have higher gross margins; and our outsourcing of manufacturing and assembly services. Gross profit increased to 60.8% in the first quarter of 2007 compared to 59.2% in the first quarter of 2006 due to:

- Higher revenue from our digital, serial and embedded products as our digital KVM and embedded solutions typically carry higher margins than our analog solutions (sold through our Management Systems Division);
- Sales by our LANDesk Division, whose products are primarily higher margin software with related service and maintenance revenue; and
- Sales by our Cyclades branded products, which are sold primarily through our branded channels and, as a result, have a higher gross margin.

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These increases to gross margins were somewhat offset by:

- Additional costs included in cost of sales from amortization of other intangible assets recorded as a result of the LANDesk acquisition related to internally developed software for resale;
- Additional excess and obsolete inventory reserves related to product end-of-life issues, including legacy Cyclades products that were replaced or enhanced; and
- Lower than anticipated revenue that did not fully absorb our previously committed fixed indirect costs and overhead.

Based on our forecasted revenue range for the second quarter of 2007, we expect positive contributions from LANDesk and

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higher revenue from our digital products and embedded solutions in the second quarter of 2007, all of which we expect will have a positive affect on our gross margin. We expect the combination of these factors to offset price declines and competitive factors in the second quarter of 2007. Accordingly, we expect gross margins to be between 63% and 66% in the second quarter of 2007.

*Research and development expenses.* Research and development expenses were \$20.9 million, or 15.7% of sales, in the first quarter of 2007 compared to \$13.2 million, or 14.0% of net sales, in the first quarter of 2006. The increase in the amount spent on research and development was due to the additional costs from the Cyclades and LANDesk acquisitions, including costs related to the integration of the Avocent and LANDesk software platforms. The amount of stock compensation expensed in the first quarter of 2007 was higher as compared to 2006 because our Board did not approve the 2006 grants until the second quarter of 2006, and therefore, we did not begin expensing the related cost until the second quarter of 2006.

We believe that the timely development of innovative products and enhancements to existing products is essential to maintaining our competitive position, and we will continue to make significant investments in research and development. We believe research and development expenses in the second quarter of 2007 will be relatively consistent with the first quarter of 2007.

*Acquired in-process research and development expense.* Acquisition related expenses in 2006 were comprised solely of the non-recurring write-off of \$2.1 million of in-process research and development expense related to the acquisition of Cyclades. There were no such charges in the first quarter of 2007.

*Selling, general and administrative expenses.* Selling, general and administrative expenses were \$48.7 million, or 36.5% of net sales, for the first quarter of 2007 compared to \$23.4 million, or 24.7% of net sales, for the first quarter of 2006. The increase in selling, general and administrative expenses was attributed to increased headcount as a result of the acquisitions of Cyclades and LANDesk. We also experienced higher costs as a result of equity-based compensation awards as compared to 2006 because our Board did not approve the 2006 grants until the second quarter of 2006. We believe certain elements of selling, general and administrative expenses will be flat from the first quarter of 2007, with the exception of sales incentive compensation, which we expect to increase as a result of increased revenue as compared to the first quarter of 2007. As a result of these factors, including stock compensation expense, we expect selling, general and administrative expenses to be in the range of \$51 to \$54 million in the second quarter of 2007.

*Amortization of intangible assets.* Amortization of \$9.0 million in the first quarter of 2007 included the amortization of the identifiable intangible assets created as a result of the acquisitions of OSA, Sonic Mobility, Cyclades, and LANDesk. Amortization of \$2.4 million in the first quarter of 2006 included primarily the amortization of the identifiable intangible assets created as a result of the acquisitions of Equinox, 2C, Soronti, Crystal Link, OSA, and Sonic Mobility. The increase in amortization expense relates primarily to additional amortization expense related to the intangible assets recorded in the acquisitions of Cyclades and LANDesk. Amortization expense is expected to be approximately \$9.0 million in the second quarter of 2007.

*Stock Compensation.* We record compensation expense in each line of our condensed consolidated financial statements based on the department in which an employee works. Stock compensation increased from \$841,000 in the first quarter of 2006 to \$3.7 million in the first quarter of 2007. The increase was due primarily to the fact that most of our outstanding option awards were vested at the end of 2005 and our Board did not approve our restricted stock unit grants until the second quarter of 2006. Accordingly our stock compensation expense was lower in the first quarter of 2006. Of the \$3.7 million of stock compensation recorded in the first quarter of 2007, \$179,000 was recorded in cost of goods sold, \$1.1 million was recorded in research and development expense, and \$2.4 million was recorded in selling, general and administrative expenses. Of the \$841,000 of stock based compensation recorded in the first quarter of 2006, \$50,000 was recorded in cost of goods sold, \$301,000 was recorded in research and development expense, and \$490,000 was recorded in selling, general and administrative expenses.

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During the second quarter of 2007 our Compensation Committee approved the grant of 815 time-based and 220 performance-based restricted stock units to our officers, directors, and other employees. The awards will vest over two or three years and in some cases are subject to the achievement of certain performance goals. We expect stock compensation expense to be in the range of \$4.0 million to \$5.0 million in the second quarter of 2007. We believe equity based compensation is an important part of our total compensation packages and is needed to attract and retain key employees.

*Net investment income.* Net investment income decreased to \$879,000 in the first quarter of 2007 as compared to \$3.1 million in the first quarter of 2006. The decrease in investment income in the first quarter of 2007 was the result of lower cash and investments as a result of funding the purchase of Cyclades late in the first quarter of 2006 and the cash component of the LANDesk acquisition in the third quarter of 2006, as well as funding the purchase of common stock under our stock repurchase program.

*Net realized investment losses.* Net realized investment losses decreased from \$55,000 in the first quarter of 2006 to zero in first quarter of 2007.

*Interest expense.* Interest expense was \$2.2 million in the first quarter of 2007. There were no such expenses in the first quarter of 2006. Interest expense results from borrowings under our \$250 million unsecured line of credit obtained in the second quarter of 2006, which we used to finance a portion of the LANDesk acquisition and share repurchases.

*Other income (expense), net.* Net other income increased from an expense of \$20,000 in the first quarter of 2006 to \$317,000 in the first quarter of 2007.

*Provision for income taxes.* The effective tax rate in the first quarter of 2007 was approximately 11.2% compared to an effective tax rate of approximately 27.9% in the first quarter of 2006. The provision for income taxes was \$94,000 for the first quarter of 2007, compared to \$5.0 million in the first quarter of 2006. The decrease in the effective tax rate was primarily the result of the change in the mix of pre-tax profit among our U.S. and international companies, the reinstatement of the U.S. research and development tax credit and expenses related to stock options. In addition, in the first quarter of 2006, the Cyclades acquisition occurred resulting in an increase in the effective tax rate for in-process research and development. The decreases to the effective tax rate were partially offset by an increase due to the lower amount of interest earned on tax-free municipal bonds. We adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 on January 1, 2007. As a result of adopting this FASB Interpretation, we recorded an increase to reserves for uncertain tax positions of \$2.9 million. This increase was recorded as an increase to the January 1, 2007 accumulated deficit.

*Net income.* Net income for the first quarter of 2007 was \$746,000 compared to \$12.9 million for the first quarter of 2006, as a result of the factors detailed in the above discussion. Net income, as a percentage of sales for the first quarter of 2007, was 0.6% compared to 13.7% for the first quarter of 2006.

#### **Liquidity and Capital Resources**

As of March 30, 2007, our principal sources of liquidity consisted of \$109 million in cash, cash equivalents, and investments. We also have a \$250 million unsecured five year revolving bank line of credit that is available for general corporate purposes. The line of credit currently bears an interest rate of LIBOR plus 87.5 basis points. There was approximately \$150 million outstanding under the line of credit as of March 30, 2007. We classify the entire obligation as long-term as it carries a five-year term and has no required repayment schedule. We expect to repay the borrowings with future cash flows from operations or potential future capital raising activities.

Our operating activities generated cash of \$17.8 million in the first three months of 2007, compared to approximately \$16.6 million in the first three months of 2006. The improvement in cash flow in the first quarter of 2007 was primarily the result of increases in accounts receivable collections during the first quarter of 2007. Our accounts receivable decreased \$17.3 million from December 31, 2006 to March 30, 2007 as a result of the improved cash collections as well as the lower sales experienced in the first quarter of 2007 as compared to the fourth quarter of 2006. Although our accounts receivable balance declined, our days sales outstanding (DSO) increased to 74 days from approximately 70 days at the end of 2006. DSO increased as a result of a higher concentration of sales in the third month of the first quarter of 2007 than we typically experience. Also, adding LANDesk customer balances to our receivables, which tend to have longer payment terms than legacy Avocent balances, increased our DSO. Excluding our LANDesk Division, our DSO was approximately 67 days at the end of the first quarter of 2007 and was 57 days at the end of 2006.

Inventories decreased \$1.6 million from December 31, 2006 to March 30, 2007. Our operations group worked to reduce our inventories in the first quarter of 2007, despite planning and stocking for higher sales volume in the quarter. However, our inventory turns decreased to 4.9, primarily as a result of our lower sales volume experienced in the first quarter of 2007. Had we achieved our revenue expectation, the inventory levels would have been lower at quarter end. A decline in accrued compensation due to the payment of 2006 annual bonuses somewhat offset the decline in accounts receivable and inventories impact to cash flow from operations for the first quarter of 2007.

In the ordinary course of our business, we may at any point in time have a significant amount of contractual commitments not yet recognized in our financial statements. These commitments relate primarily to our need to schedule the purchase of inventories in advance of the related forecasted sales to customers. We have longer lead times for the products we purchase from suppliers based in Asia than those for our U.S. based and European suppliers. Our actual contractual commitments are typically limited to products needed for one to three months of forecasted sales. The liabilities for these inventory purchases along with the related inventory assets are typically recognized upon our receipt of the products. We also have at any point in time a variety of short term contractual commitments for services such as advertising, marketing, accounting, legal, and research and development activities. The liabilities for these services and the related expenses are typically recognized

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upon our receipt of the related services. As of March 30, 2007, we had approximately \$23.0 million of such purchase commitments. None of our expected purchase commitments requires payment beyond the next year.

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We adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 on January 1, 2007. As a result of adopting this FASB Interpretation, we recorded an increase to reserves for uncertain tax positions of \$2.9 million. This increase was recorded as an increase to the January 1, 2007 accumulated deficit balance. As of the adoption date, we had total reserves for uncertain tax positions related to gross unrecognized tax benefits of \$11.4 million of which \$9.3 million, if recognized, would affect the effective tax rate. We recognize potential accrued interest and penalties related to unrecognized tax benefits from our global operations within income tax expense. As of the adoption date, we had accrued interest expense related to the unrecognized tax benefits of approximately \$2.2 million. Penalties may be charged in certain jurisdictions for the underpayment or late payment of tax. As of the adoption date, we had accrued penalties related to the unrecognized tax benefits of approximately \$200,000 (*see Note 10 in the notes to the condensed consolidated financial statements in Part I, Item 1*).

We may use a portion of our cash and investments or our line of credit for strategic acquisitions of technologies and companies that will enhance and complement our existing technologies and help increase our sales.

We repurchased 487,000 shares of our common stock for a total cost of approximately \$15.4 million during first quarter of 2007 under the stock repurchase program approved by our Board of Directors. During the first quarter of 2007, our Board approved the repurchase of up to an additional 2.0 million shares under our share repurchase program. As of March 30, 2007 we had the authority to repurchase an additional 1.7 million shares under this program.

### **Investments**

Our investments consist of corporate bonds, municipal bonds, commercial paper, and mortgage backed securities guaranteed by U.S. government agencies. We classify our debt and equity securities as available-for-sale securities and report them at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity. We periodically review our investment portfolio for investments considered to have sustained an other-than-temporary decline in value. Upon review of our investment portfolio as of March 30, 2007, no investments were considered to have sustained an other-than-temporary decline, and no charge was recorded in the first quarter of 2007.

### **Recently Issued Accounting Standards and Regulatory Standards**

See above regarding adoption of FIN 48 during the first quarter of 2007.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Our primary market risk is the potential loss arising from increases in interest rates, which could have an adverse impact on the fair value of our investment securities. Our investment policy is to manage our investment portfolio to preserve principal and liquidity while maximizing the return on our investment portfolio through the investment of available funds. We diversify our investment portfolio by investing in a variety of highly-rated investment-grade securities and through the use of different investment managers. Our investment securities portfolio is primarily invested in securities with maturities (or interest rate resets) of two years or less with at least an investment grade rating to minimize interest rate and credit risk as well as to provide for an immediate source of funds. Market risk, calculated as the potential change in fair value in our investment portfolio resulting from a hypothetical 10% change in interest rates, was not material at March 30, 2007. We generally hold investment securities until maturity.

We also face interest rate risk on our bank line of credit which currently bears interest at a variable rate of LIBOR plus 87.5 basis points. We have partially hedged this exposure to interest rate risk with an interest rate swap, which has a notional amount of \$125 million, through a well-established financial institution.

We also face foreign currency exchange rate risk to the extent that the value of certain foreign currencies relative to the U.S. dollar affects our financial results. Our international operations transact a portion of our business in currencies other than the U.S. dollar, predominantly the euro, and changes in exchange rates may positively or negatively affect our revenue, gross margins, operating expenses, and retained earnings since these transactions are reported by us in U.S. dollars. We occasionally purchase foreign currency forwards aimed at limiting the impact of currency fluctuations. These instruments provide only limited protection against currency exchange risks, and there can be no assurance that such an approach will be successful, especially if a significant and sudden decline occurs in the value of local currencies. As of March 30, 2007, we had three open forward contracts with an approximate fair value of \$2,000.

### **Item 4. Controls and Procedures.**

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(a) *Evaluation of disclosure controls and procedures.* Based on their evaluation as of March 30, 2007, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective.

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(b) *Changes in internal control over financial reporting.* There were no changes in our internal controls over financial reporting during the quarter ended March 30, 2007 that materially affected or is reasonably likely to materially affect, our internal controls over financial reporting. We have begun to integrate LANDesk into our standard processes and controls and ERP System and we expect to complete the integration during 2007.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings.

On March 14, 2006, TFS Electronic Manufacturing Services, Inc. ( TFS ) filed a Third-Party Complaint and an Objection to Claim of Avocent Corporation with the United States Bankruptcy Court, District of Arizona. As a result of the complaint, an adversary proceeding has been commenced against Avocent in the TFS bankruptcy case in an effort to disallow Avocent's claim in its entirety. TFS also seeks damages in an undetermined amount for Avocent's alleged breach of contract, negligence, negligent misrepresentations, breaches of warranty, unjust enrichment, disparagement of TFS's business, and quantum meruit. TFS is seeking recovery of actual damages, punitive damages, attorneys' fees, pre- and post-judgment interest, costs, and the imposition of joint and several liability as to Avocent and a named co-defendant, TopSearch Printed Circuits (HK), Ltd. ( TopSearch ). The matter has been consolidated with a separate matter between TFS and TopSearch pending in the United States District Court for the District of Arizona, for purposes of discovery through pre-trial. The court has ordered that early mediation be scheduled and a mediator has been assigned. Discovery is under way. We intend to vigorously defend our positions.

In January 2007, we filed a complaint for patent infringement in the United States District Court for the Western District of Washington against Aten Technology, Inc., Aten International Co., Ltd, Belkin Corporation, Rose Electronics and its general partners, and Trippe Manufacturing Company. The defendants have filed counterclaims alleging non-infringement, unenforceability, and invalidity, and discovery is currently underway.

In March 2007, KBM Enterprises, formerly a contract manufacturer for Avocent, filed a complaint against Avocent in the Circuit Court of Madison County, Alabama, seeking \$9.5 million for costs allegedly incurred by KBM in its manufacturing efforts on behalf of Avocent. Avocent has filed a motion to dismiss the case. We intend to vigorously defend our positions.

In April 2007, we filed a complaint for declaratory judgment against Aten International Co., Ltd. in the United States District Court for the Northern District of Alabama. We are seeking a declaratory judgment that two patents owned by Aten and asserted against Avocent are invalid and that certain of products alleged by Aten to infringe do not infringe these patents.

### Item 1A. Risk Factors.

*THIS QUARTERLY REPORT CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES THAT COULD CAUSE OUR ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE DISCUSSED IN THIS QUARTERLY REPORT. THESE RISKS AND UNCERTAINTIES INCLUDING THE FOLLOWING:*

#### **Our acquisition of LANDesk could disrupt our business, expose us to new risks, and adversely affect the results of our operations.**

We acquired LANDesk Group Limited ( LANDesk ) in the third quarter of 2006. This acquisition represents a departure from our core products and technologies and our entry into a new market (systems management software products and services) in which we have very limited experience. The market for systems management products is highly competitive, and we expect competition in this market to continue and intensify. Many of LANDesk's competitors have substantially greater financial, customer support, technical and marketing resources, larger customer bases, longer operating histories, greater name recognition, and more established relationships in the industry than LANDesk has, and we may not have the resources or expertise to compete successfully with them in the future.

The LANDesk acquisition may divert the attention of management and other personnel from our core business operations, which may adversely affect our financial performance in one or more quarters. LANDesk presents us with new and different issues regarding revenue recognition, channel management, and collection of existing or new receivables, any of which could have a material adverse effect on our business, financial condition, and results of operations. We will need to expand and improve our internal systems, including our management information systems, to monitor these items. In particular, we have not yet completed our review and assessment of the internal systems and controls over the LANDesk financial reporting and information systems, and we will also need to expand our operating, administrative, and financial systems and controls to include the LANDesk operations. The acquisition



and integration of LANDesk and its software products and services will require significant time, expense, and resources and subject us to the acquisition risks detailed below as we move into this new market. Any failure to successfully integrate and operate LANDesk could thus materially and adversely affect our result of operations, cash flows, and financial position.

**We have acquired, and expect to continue to acquire, technologies, and companies and these acquisitions could disrupt our business or expose us to other risks.**

A key component of our engineering and product development strategy and our future growth is the investment in or the acquisition of technologies and companies. We acquired Equinox Systems Inc. in 2001, 2C Computing, Inc. in 2002, Soronti, Inc. in 2003, and Crystal Link Technologies, OSA Technologies, Inc., Sonic Mobility, Inc. in 2004, and Cyclades Corporation and LANDesk in 2006. We intend to continue to execute our strategy through the acquisition of technologies or companies or through investments in complementary companies, products, personnel, or technologies, and it is likely we will complete such acquisitions or investments in the future. These acquisitions and investments involve many risks, including the following:

- Difficulty integrating the acquired company's personnel, products, product roadmaps, technologies, systems, processes, and operations, including product delivery, order management, and information systems;
- Difficulty in conforming the acquired company's financial policies and practices to our policies and practices and in implementing and maintaining adequate internal systems and controls over the financial reporting and information systems of the acquired company;
- Diversion of management's attention and disruption of ongoing business;
- Difficulty in combining product and technology offerings and entering into new markets (such as software) or geographical areas in which we have no or limited direct experience and where our competitors may have stronger market positions;
- Loss of management, sales, technical, or other key personnel;
- Revenue from the acquired companies not meeting our expectation, and the potential loss of the acquired companies' customers, distributors, resellers, suppliers, or other partners;
- Delays or difficulties and the attendant expense in evaluating, coordinating, and combining administrative, manufacturing, research and development and other operations, facilities, and relationships with third parties in accordance with local laws and other obligations while maintaining adequate standards, controls and procedures, including financial controls and controls over information systems;
- Difficulty in completing projects associated with acquired in-process research and development;
- Incurring amortization expense related to certain intangible assets and recording goodwill and non-amortizable assets that will be subject to impairment testing and possible impairment charges;
- Dilution of existing stockholders as a result of issuing equity securities, including the assumption of any stock options issued by the acquired company;
- Overpayment for any acquisition or investment or unanticipated costs or liabilities;
- Assumption of liabilities of the acquired company, including any potential intellectual property infringement claims or other litigation; and

- Incurring substantial write-offs, restructuring charges, and transactional expenses.

Our failure to manage these risks and challenges could materially harm our business, financial condition, and results of operations. In addition, if we do not successfully address these challenges in a timely manner, we may not fully realize all of the anticipated benefits or synergies on which the value of a transaction was based. Future transactions could cause our financial results to differ from expectations of market analysts or investors for any given quarter.

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**Intense competition from new and existing competitors or consolidation in the server and systems management sectors could impair our ability to grow our business, to sustain our profitability, and to sell our products and technologies.**

The markets for our products and technologies are highly fragmented, rapidly evolving, and intensely competitive, and we expect this competition to continue and increase. Aggressive competition from both hardware and software products and technologies could lengthen the customer evaluation process and result in price reductions and loss of sales, which would materially harm our business. Our business is becoming increasingly sensitive to the introduction of new products and technologies (such as virtualization), price changes, and marketing efforts by numerous and varied competitors. Accordingly, our future success will be highly dependent upon our timely completion and introduction of new products and technologies and features at competitive prices and performance levels that address the evolving needs of our customers. We continue to experience aggressive price competition and increased customer sensitivity to product prices, and pricing and margin pressures are likely to increase in the future. Because of this competition, we may have to continue to lower the prices of many of our products and technologies or offer greater functionality within our products to deliver greater value to customers to stay competitive, while at the same time trying to maintain or improve our revenue and gross margin. Because our business model is based on providing innovative and high quality products, we may spend a proportionately greater amount on research and development than some of our competitors. If we cannot proportionately decrease our cost structure on a timely basis in response to competitive price pressures, our gross margin and profitability could be adversely affected. In addition, if our pricing, functionality, and other factors are not sufficiently competitive, or if there is an adverse reaction to our product decisions, we may lose market share in certain areas, which could adversely affect our revenue and prospects.

We compete for sales of switching systems and extension products with companies such as Raritan Computer, Rose Electronics, Minicom Advanced Systems, Aten, Belkin, Lantronix, and Digital V6. These products also face competition from software providers (such as Microsoft, Computer Associates, Tivoli, Symantec, Novell, and BMC Software), who may be able to offer software products competitive with our hardware products at a much lower cost or even bundled for free, and from server manufacturers (including our OEM customers), who are able to offer their competitive technologies or products at the time of the server sale. These competitive software and hardware products address many of the problems our switching systems and technologies, extension products, and remote access products are designed to address.

We compete for sales of our systems management products with companies such as Microsoft, Computer Associates, BMC Software, Novell, and Symantec, many of whom have greater financial, technical, and marketing resources, a larger customer base, a longer operating history, greater name recognition, and more established relationships in the industry than we do, and may offer their own or third-party competitive software products at a lower cost or bundled for free with their other products. Microsoft, in particular, has delivered competitive systems management products and announced its intention to continue to develop competitive software. If Microsoft is successful in delivering systems management software that is competitive with our products, our ability to grow our systems management business may be limited.

These current and potential competitors may be able to respond more quickly to new or emerging technologies or products and to changes in customer requirements or to devote greater resources to the research, development, promotion, sale, and support of their products and technologies than we do. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties that expand or enhance the ability of their products and technologies to address the needs of our current and prospective customers. Some of these competitors can also bundle hardware, software, and services together, and offer a more complete set of hardware products and services than we are able to offer. We may not be able to compete successfully against current and future competitors and competitive pressure may materially harm our business, financial condition, operating results, and cash flows, or impair our ability to achieve our desired results.

Certain of our customers, such as Dell, Hewlett-Packard, IBM, Symantec, and Microsoft, presently offer competitive hardware and/or software products and technologies that address many of the problems our products and technologies address. These customers could decide to manufacture or enhance their own switching, IPMI or other embedded technologies, or systems management or security products, or offer products or technologies supplied by competitors. Companies with hardware manufacturing experience or network management products, many of which are substantially larger than we are and have significantly more financial resources than we do, also offer products or technologies that compete with us. Established companies with hardware manufacturing or network management experience (such as Intel, Cisco, or EMC) could also offer new products, new technologies (such as virtualization), or new solutions that compete with, or reduce the demand for, our products and technologies.

There has been consolidation in the markets in which we compete, which we believe will continue and could lead to increased price competition and other forms of competition as companies attempt to maintain or extend their market positions in the rapidly changing IT industry. In addition, we may face competition in the future from large established companies or from emerging companies that have not previously entered the market or that do not currently have products that directly compete with our products. This could lead to more variability in our operating results due to lengthening of the customer evaluation process and/or the loss of business to these competitors, which may adversely affect our business, financial condition, and results of operations.



**Our failure to respond to rapid technological change or to introduce successful new products and technologies may result in reduced revenue or revenue growth.**

The process of developing or acquiring new products and technologies and enhancing existing products and technologies is complex, costly, and uncertain, and any failure by us to anticipate customers' changing needs and emerging technological trends accurately could significantly harm our market share and results of operations. We must make long-term investments, develop or obtain appropriate intellectual property, and commit significant resources before knowing whether our predictions will accurately reflect customer demand for our products and services. After we develop a product, we must then accurately forecast volumes and configurations that meet customer requirements, manufacture appropriate hardware volumes quickly and at low cost and develop cost-effective software solutions, and train our sales force and resellers. Any delay in the development, production, marketing of, or training for new products or technologies could result in our not being among the first to market, which could further harm our competitive position.

Sales of switching, extension, and remote access products and technologies are characterized by rapid technological advances, frequent new product and technological introductions and enhancements, and significant price competition. If we do not keep pace with these changes, we will lose customers, and our business will be adversely affected. The introduction of products or technologies incorporating superior alternatives such as virtualization hardware and software, other switching software, the emergence of new industry standards, or changes in pricing structure could render our existing products and technologies and those under development obsolete or unmarketable. New technologies offered by us or our competitors could compete with our existing products at a lower price, which could reduce our revenue.

Our hardware products combine components, such as printed circuit boards, connectors, semiconductors, memory, cable assemblies, power supplies and enclosures that are manufactured by other companies and are generally available to competitors and potential competitors. Our software products combine software or content from third parties, such as open source software or technology, drivers, security, or anti-virus information, which may also be generally available to our competitors and potential competitors. Our future success will depend in large part upon continued innovative application of commercially available components and third party software or technology, and continued enhancements to our proprietary hardware, software, firmware, and other technologies, the expansion and enhancement of existing products and technologies, and our development and introduction of new products and technologies that address changing customer needs on a cost-effective and timely basis. If we fail to respond on a timely basis to technological developments, changes in industry standards, customer requirements, competitive products, product localization, or software innovations, we will lose customers, and our business will be greatly harmed. Similar results could occur if we experience significant delays in the development or introduction of new products or technologies.

Due to our significant reliance on OEM relationships, our hardware development efforts may often be focused on developing new products, technologies, or enhancements for OEM customers. As a result, our OEM relationships may negatively affect our ability to develop new and enhanced products and technologies for our non-OEM customers. Moreover, these new products, technologies, or enhancements for OEM customers may not be available to, or readily marketable to, other customers without significant modification and delay. The expansion, termination, or significant disruption of our relationship with certain OEMs or other customers for whom we devote significant product development resources is likely to result in lost opportunities with respect to the development of products, technologies, or enhancements for our other customers.

**We have limited protection of proprietary rights and face risks of third party infringements.**

Our future success depends in part upon our ability to protect proprietary rights in our products and technologies. We seek to protect our intellectual property rights by invoking the benefits of the patent, trademark, copyright, trade secret, and unfair competition laws of the United States and other countries and protections provided by confidentiality and nondisclosure agreements and other legal agreements. These laws and practices, however, afford only limited protection. There can be no assurance that the steps we have taken to protect our intellectual property rights, or that the steps we take in the future, will be adequate to prevent or detect misappropriation of our intellectual property or technologies or that our competitors will not independently develop proprietary or other technologies that are substantially equivalent or superior to our products or technologies. In addition, our proprietary information may be misused or improperly disclosed by third parties entrusted with this information.

The U.S. Patent and Trademark Office has issued several patents to us for various aspects of our products. We have various corresponding patent applications pending under the provisions of the Patent Cooperation Treaty, which permits the filing of corresponding foreign patent applications in numerous foreign countries within a limited time period. We also have other United States and foreign patent applications pending. There can be no assurance that any additional patents will be issued from any of those pending applications or that any patents will be issued in any additional countries where our products can be sold. Claims allowed in our patents or in any pending patent applications may not be of sufficient scope or strength for, or provide meaningful protection or





any commercial advantage to us or such claims may not be upheld if challenged. Also, competitors may develop their own intellectual property or technologies, obtain their own patents, or challenge the validity of, or be able to design around, our patents. The laws of certain foreign countries in which our products are or may be developed, manufactured, or sold (particularly certain countries in Asia) may not protect our products or intellectual property rights to the same extent as do the laws of the United States and thus increase the likelihood of piracy of our technologies and products.

In January 2007, we filed a complaint for patent infringement in the United States District Court for the Western District of Washington against Aten Technology, Inc., Aten International Co., Ltd, Belkin Corporation, Rose Electronics and its general partners, and Trippe Manufacturing Company. In April 2007, we filed a complaint for declaratory judgment against Aten International Co., Ltd. in the United States District Court for the Northern District of Alabama seeking a declaratory judgment that two patents owned by Aten and asserted against us are invalid and that certain products alleged by Aten to infringe do not infringe these patents.

We may initiate claims or litigation against other third parties for infringement of proprietary rights or to establish the validity of proprietary rights. Similarly, our competitors or other third parties may initiate claims or litigation against us alleging infringement of their proprietary rights or improper use of their intellectual property, and from time to time, third parties notify us that our products may infringe their intellectual property rights, which regardless of merit, requires our time and resources to evaluate and respond. Existing litigation, and any other litigation relating to intellectual property to which we become a party, is subject to numerous risks and uncertainties, including the risk of counterclaims or other litigation against us, and we may not be successful in any such litigation. Litigation is expensive, and the existing litigation or any other litigation by or against us could result in significant additional expense, divert the efforts of technical and management personnel, whether or not such litigation results in a favorable determination, harm our relationships with existing customers, and deter future customers from purchasing or licensing our products. In the event of an adverse result in any such litigation, we could be required to pay substantial damages, suspend or cease the development, manufacture, use, marketing, and sale of any infringing products, expend significant resources to redesign products or develop non-infringing technology, discontinue the use of certain processes, or obtain licenses to the infringing technology. There can be no assurance that we would be successful in such development or that such licenses would be available on reasonable terms, or at all, and any such development or license could require us to expend substantial time and other resources. In the event that any third party makes a successful claim against us, or our customers, and a license is not made available on commercially reasonable terms, our business, financial condition, and results of operations could be adversely affected. In addition, any dispute involving our intellectual property could result in our customers, distributors, or resellers becoming involved in the litigation, which could trigger indemnification obligations in certain of our sales, license, or service agreements.

The IT industry is characterized by vigorous pursuit and protection of intellectual property rights or positions, which has resulted in significant and often protracted and expensive litigation. We have in the past been, and we may from time to time in the future be, a party in proceedings alleging infringement of intellectual property rights owned by third parties. If necessary or desirable, we may seek licenses under such intellectual property rights. However, licenses may not be offered on terms acceptable to us, or at all. The failure to obtain a license from a third party for technology used by us could cause us to incur substantial liabilities and to suspend or cease the manufacture of products requiring such technology. Additionally, current or future competitors could obtain patents that may prevent us from developing or selling our products.

**We are likely to experience fluctuations in operating results.**

We have in the past experienced substantial fluctuations in revenue, bookings, and operating results, on a quarterly and an annual basis, and we expect these fluctuations will continue in the future. Our operating results will be affected by a number of factors, including, but not limited to:

- The volume, timing, pricing, and contractual terms of orders, particularly from OEMs, resellers, and other large customers, a significant portion of which tend to occur late in each quarter;
- The timing of shipments;
- The timing of new product introductions, new technologies, and enhancements by us and by our competitors, and the possibility that customers may defer purchases of our products in anticipation of these new products, new technologies, and enhancements;
- Changes in or our failure to accurately predict product or distribution and reseller channel mixes, including changes in the mix of software licenses in which revenue is recognized upfront as opposed to deferred over time and changes in the mix of revenue attributable to higher-margin products as opposed to lower-margin sales or services;

- Changes in demand for our products;

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- Fluctuations or a decline in sales of servers due to changes in technology (such as virtualization), economic conditions, or capital spending levels;
- Changes in pricing policies or price reductions;
- Changes in renewal rates for software upgrade protection or maintenance;
- Competition from new products and technologies and price reductions by competitors;
- The availability and cost of supplies, components, or third-party code or content on commercially reasonable terms;
- Compatibility or interoperability of our products with third-party systems and applications;
- Sales and marketing expenses related to entering into new markets, introducing new products, new technologies, and retaining current OEM and other large customers;
- Fluctuations in foreign currency exchange rates and interest rates;
- The amount and timing of operating expenses and capital expenditures relating to the expansion of our business and operations; and
- Costs associated with legal proceedings, including legal fees and any adverse judgments or settlements.

Our operating results will continue to be affected by seasonal trends, by general conditions in the IT market, and by general economic conditions. We have experienced, and we expect to continue to experience, some degree of seasonality due to customer buying cycles. We believe that the third and fourth quarters will generally have higher net sales levels due to customer budgeting and procurement cycles, which may depress net sales in other quarters. In addition, European sales are often weaker during the summer months. In the past, revenue in our fourth quarter of each year has typically been higher than revenue in prior quarters for the year, and we typically see a sequential decline in revenue from the fourth quarter of a year to the first quarter of the following year. While it is difficult to predict revenue in any quarter, we expect that this pattern will continue in the future. Many of the factors that create and affect seasonal trends are beyond our control.

Our quarterly sales have also reflected a pattern in which a disproportionate percentage of each quarter's total sales occur toward the end of the quarter, and this trend has become more pronounced in recent periods. Our acquisition of LANDesk continues this trend with a greater proportion of our software revenue coming from software license and subscriptions booked in the last weeks or days of each quarter. This uneven sales pattern makes prediction of revenue, earnings, and working capital for each financial period difficult, increases the risk of unanticipated variations in quarterly results and financial condition, and places pressure on our hardware inventory management and logistics systems. If predicted demand for hardware is substantially greater than orders, there will be excess inventory. Alternatively, if hardware orders substantially exceed predicted demand, we may not be able to fulfill all of the orders received in the last few weeks of each quarter. Other developments late in a quarter, such as a systems failure, component pricing movements, actions or announcements from our competitors, global logistics disruptions, or large sales opportunities not being completed when predicted, could adversely impact inventory levels and results of operations in a manner that is disproportionate to the number of days in the quarter affected. In addition, accounting requirements associated with satisfying the various elements necessary to recognize software revenue may result in significant fluctuations in our quarterly results.

In order to remain competitive and provide our increasingly sophisticated customers with more options, we have made and expect to continue to make new software purchasing and licensing options available to our customers. These options may result in an increase in contracts where software revenue is deferred or cash is received over time as opposed to recognition of revenue or payment at or about the time of the purchase or license.

We believe that quarter-to-quarter comparisons of our historical financial results are not meaningful indicators of our future operating results, and you should not rely on them as an indication of our future performance. If our quarterly operating results fail to meet the expectations of equity research analysts, the price of our common stock could be negatively affected.

**Our gross margins are expected to vary and may decline.**

Gross margins may vary or decline from period-to-period depending on a number of factors, including:

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- The ratio of OEM sales to branded sales, since OEM sales typically have lower gross margins than branded sales;
- The ratio of sales through indirect channels to direct sales, since indirect sales typically have lower gross margins than direct sales;
- Product mix, because sales of some of our products and technologies will have lower gross margins than sales of other products or technologies (e.g. our software products tend to have higher gross margins);
- Raw materials, freight, and labor costs;
- Introduction of new products, services, and technologies by us and by our competitors; and
- The level of outsourcing of our manufacturing and assembly services for our hardware products.

We expect that our gross margins may vary and may decline in the future primarily due to the factors listed above and to increased competition and the introduction of new products and technologies that may affect product prices and demand for our products.

**A substantial portion of our business consists of sales to a limited number of OEM customers that are not obligated to continue doing business with us, and these sales vary considerably from quarter to quarter.**

A substantial portion of our sales is concentrated among a limited number of OEM customers. Sales to these OEMs represented approximately 40% of net sales in 2006, 48% of net sales in 2005, and 45% of net sales in 2004. Sales to Hewlett-Packard represented approximately 14% of our net sales in 2006, 20% of our net sales in 2005, and 23% of our net sales in 2004. Sales to Dell represent approximately 14% of net sales in 2006, 15% of our net sales in 2005, and 12% of our net sales in 2004.

We have experienced, and we expect to continue to experience, period-to-period variability in sales to these OEM customers. Any cancellation, rescheduling, or reduction of orders by OEM customers in the future could materially adversely affect our operating results. Although our OEM customers typically place orders for products up to several months prior to scheduled shipment dates, these orders are subject to cancellation.

Our OEM business is subject to many risks, including:

- Contract termination or reduced or delayed orders;
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