

CSP INC /MA/  
Form 10-K  
December 24, 2013

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

FORM 10-K

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

For the Fiscal Year Ended September 30, 2013.

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 000-10843

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

Massachusetts  
(State of incorporation)

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

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

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

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

Securities registered pursuant to Section 12(g) of the Act:  
None

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

Edgar Filing: CSP INC /MA/ - Form 10-K

required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No .

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

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

As of March 31, 2013, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$17,570,592 based on the closing sale price of \$5.85 as reported on the Nasdaq Global Market.

As of December 2, 2013, we had outstanding 3,571,041 shares of common stock.

#### DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the information required in Part III of this Form 10-K are incorporated by reference from our definitive proxy statement for our 2013 annual meeting of stockholders to be filed with the Securities and Exchange Commission within 120 days after the end of our fiscal year ended September 30, 2013.

## TABLE OF CONTENTS

|   | Page      |
|---|-----------|
| <u>PART I.</u>  |           |
| <u>Item 1. Business</u>   | <u>1</u>  |
| <u>Item 1A. Risk Factors</u>  | <u>7</u>  |
| <u>Item 2. Properties</u>   | <u>13</u> |
| <u>Item 3. Legal Proceedings</u>  | <u>13</u> |
| <u>Item 4. Mine Safety Disclosures</u>  | <u>13</u> |
| <u>PART II.</u>   |           |
| <u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> | <u>14</u> |
| <u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                        | <u>15</u> |
| <u>Item 8. Financial Statements and Supplementary Data</u>  | <u>27</u> |
| <u>Item 9. Change in and Disagreements with Accountants on Accounting and Financial Disclosures</u>                         | <u>27</u> |
| <u>Item 9A. Controls and Procedures</u>   | <u>28</u> |
| <u>Item 9B. Other Information</u>   | <u>28</u> |
| <u>PART III.</u>  |           |
| <u>Item 10. Directors, Executive Officers and Corporate Governance</u>  | <u>29</u> |
| <u>Item 11. Executive Compensation</u>  | <u>29</u> |
| <u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>              | <u>29</u> |
| <u>Item 13. Certain Relationships, Related Transactions and Director Independence</u>                                       | <u>29</u> |
| <u>Item 14. Principal Accountant Fees and Services</u>  | <u>29</u> |
| <u>PART IV.</u>   |           |
| <u>Item 15. Exhibits and Financial Statement Schedules</u>  | <u>30</u> |

Note: Items 1B, 6 and 7A are not required for Smaller Reporting Companies and therefore are not furnished.

## PART I

## Item 1. Business

CSP Inc. (“CSPI” or “the Company” or “we” or “our”) was incorporated in 1968 and is based in Billerica, Massachusetts. To meet the diverse requirements of our industrial, commercial, and defense customers worldwide, CSPI and its subsidiaries develop and market IT integration solutions and high-performance cluster computer systems.

## Segments

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

The Systems segment consists primarily of CSPI's MultiComputer Division (the “MultiComputer Division”) which designs and manufactures commercial high-performance computer signal processing systems for a variety of complex real time applications in defense and commercial markets. In our MultiComputer Division we develop open, standards-based, vendor independent, scalable products, based on an architectural solution that is easily integrated with third-party products and compatible with future product offerings. These products utilize cluster technologies, multi-core processors, and many-core General Purpose Graphics Processing Units (“GPGPUs”). MultiComputer systems consist of “blades” (self-contained, high-density computer boards) and are designed to achieve a high level of computer processing and to operate in environments with size, weight and power (“SWaP”) limitations. The blades and other components that make up the system can be housed in commercially available air-cooled chassis or in ruggedized chassis, designed to withstand physically demanding environments. These systems have traditionally been utilized for sonar and radar digital signal processing (“DSP”) and image recognition applications. The MultiComputer Division sells all its products through its own direct sales force in the United States and via distributors and authorized resellers in Europe and the Asia-Pacific region.

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

## Financial Information about Industry Segments

The following table details our sales by operating segment for fiscal years ending September 30, 2013 and 2012. Additional segment and geographical information is set forth in Note 12 to our financial statements.

| Segment                        | 2013                   | %   | 2012       | %   |   |
|--------------------------------|------------------------|-----|------------|-----|---|
|                                | (Amounts in thousands) |     |            |     |   |
| Systems                        | \$7,000                | 8   | % \$11,141 | 13  | % |
| Service and System Integration | 80,619                 | 92  | % 73,666   | 87  | % |
| Total Sales                    | \$87,619               | 100 | % \$84,807 | 100 | % |

## Systems Segment

Products and Services

The Systems segment's MultiComputer products utilize commercially available, industry standard compliant hardware components and open source software to deliver a high-performance, high density and low power consuming computer solution to our customers. These systems incorporate tens to hundreds of processors, interconnected by a high-bandwidth network. They are specifically designed for analysis of complex signals and images in real-time or in modeling and simulations. CSPI's leadership in processing density, large memory subsystems, high-bandwidth networking components, optimized signal processing libraries, and specialized algorithms make these products a natural fit for applications in the military/defense and scientific/engineering markets.

## Hardware Products

Historically MultiComputer Division products have integrated industry standard software, hardware and architecture technologies to minimize the risks associated with proprietary solutions. Over the years CSPI has met customer requirements with scalable products based on cluster technologies, multi-core processors, and many-core GPGPUs.

Introduced in 1997, the first generation of MultiComputer Division cluster computer systems was referred to as the FastCluster 2000 SERIES. Based upon industry standards, the 2000 SERIES systems included a VME 6U form factor (the form factor best suited for use in rugged applications), the Motorola™ G4 PowerPC RISC processors with AltiVec™ technology, high-speed memory and Myrinet-2000™ cluster interconnect. The 2000 SERIES product line was ideally suited for use by customers in the aerospace, commercial and defense markets seeking Commercial-Off-The-Shelf (“COTS”) solutions to reduce costs and ensure widespread availability. To remain competitive, our COTS solutions incorporated the latest industry standard technologies and minimized the risks associated with proprietary solutions. The 2000 SERIES advanced processing capabilities coupled with the smaller footprint was also suited for exploration operations in the geophysical market.

In fiscal 2006, we announced the next generation FastCluster product line, the 3000 SERIES VXS. The 3000 SERIES VXS product line was designed to deliver performance that was superior to our predecessor products in interconnect bandwidth and processing density while preserving absolute code reuse at the application layer. The 3000 SERIES VXS product line targeted high performance DSP, signal intelligence (“SIGINT”), radar and sonar applications in airborne, shipboard and unmanned aerial vehicle (“UAV”) platforms where space, power and cooling are at a premium. With its built-in 10-Gigabit Ethernet technology, the 3000 SERIES VXS supported the most prevalent networking standard found in both business and industrial settings.

In fiscal 2010, we announced the development of the 3000 SERIES OpenVPX™ with Intel multi-core processors and the OpenVPX™ VITA/ANSI standard (Vita 65) to support high performance radar, sonar, C<sup>4</sup>ISR and SIGINT applications. OpenVPX™ is the architectural framework that defines system-level interoperability for multivendor, multimode, integrated system environments. OpenVPX™'s consideration of system-level requirements improves interoperability between computing and communications platforms and reduces customization, testing, cost and risk. Since our initial development of the first 3000 SERIES OpenVPX™ processor blade, we have introduced several enhancements including converged fabric technology and our 3300GTX NVIDIA GPGPU coprocessor board. The CSPI Converged Fabric integrates the Mellanox SwitchX™ Virtual Protocol Interconnect® technology - allowing Infiniband, Ethernet, and Fibre Channel traffic to exist on a single “one-wire” fabric. The 3300GTX coprocessor enables Teraflop levels of performance for applications that require high bandwidth data streaming and can benefit from massively parallel processing. The 3000 SERIES OpenVPX™ platform with these enhancements, is currently being marketed as our TeraXP Embedded Server. We will expend development resources we consider necessary for the TeraXP platform, as we pursue initial sales opportunities for this new product line.

In fiscal 2011, we announced our new 4000 SERIES ATCA products. The 4000 SERIES is based on InfiniBand, Advanced Telecom Computing Architecture (“AdvancedTCA” or “ATCA”) and Network Equipment Building System (“NEBS”) standards to deliver affordability, sustainability and high availability to manned and unmanned large mobile platforms (land, sea and air.) ATCA was originally designed to address the high availability, robust system management and DC power distribution needs of the telecom and communications markets. ATCA has since become attractive to defense markets as well as commercial markets.

The 4000 SERIES ATCA products target computing and communication applications that share the need for increased bandwidth and reliability, extremely robust mechanical and electrical definitions, power efficiency and unprecedented processor density. ATCA provides built-in high reliability features such as a 40-gigabit Ethernet backplane, redundant shelf managers, fail-over capability and support of live insertion of boards, power supplies and fans. We will expend

development resources we consider necessary as we pursue initial sales opportunities for the 4000 SERIES ATCA product line.

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

All MultiComputer cluster computer systems use open systems software technologies including message passing interface ("MPI") software for interprocessor communications and CSPI's highly optimized industry standard math libraries. This software facilitates the development of truly portable code for seamless reuse across applications, while taking advantage of optimized performance on both PowerPC with AltiVec and Intel processors.

## Royalties

We license the design of certain of our 2000 SERIES computer processor boards and switched interconnect technology. In exchange for licensing this technology, we receive a royalty payment for each processor board that the licensee produces that utilizes our design for these products.

## Markets, Marketing and Dependence on Certain Customers

### Aerospace & Defense Market

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

A prime contractor will typically incorporate our products into their own future product developments and, therefore, will need early access to low-level, detailed technical specifications and prototype units. These prime contractors typically demand long term product availability and support. As a supplier in this market, we recognize that there may be a significant up-front investment of time and resources in building a business partnership. However, the result of this partnership is a strong potential for long-term revenue streams as programs progress from development phases into deployment.

Our use of high performance embedded computing technologies to support information exchange in real-time are becoming increasingly significant to twenty-first century “network centric warfare” military operations. There has been steady growth of new programs requiring signal/image processing and analysis equipment as well as upgrades to existing military programs. However, the efficiency inherent in these technologies reduces the number of systems required to achieve the same results. Both new and upgraded programs require a substantial investment in development and evaluation before products deploy into field use. The time from development to deployment varies based on the program; however, it very often extends beyond twenty-four months. Looking forward to fiscal 2014 and beyond, our focus is to continue to build interest in our 3000 SERIES VXS products by integrating the latest PowerPC with AltiVec processor, and to market our 4000 SERIES ATCA and TeraXP OpenVPX™ embedded server products among our existing customers as well as additional commercial application customers.

## Competition

The Systems segment's markets are very competitive. Customer requirements coupled with advances in technology drive our efforts to continuously improve existing products and develop new ones. Applications expertise, product innovation, strong technical support and dedicated customer service allow us to compete favorably as a provider of high-performance embedded computing systems.

Our direct competitors in the aerospace and defense market are Mercury Computer Inc., Kontron, Curtis Wright and G. E. Intelligent Platforms. Our indirect competitors are the board manufacturers that specialize in the DSP segment of this market. In the past, manufacturers such as Emerson, HP, IBM and Dell participated in the low performance segment of the general-purpose computer and single board computer market. Today, those companies manufacture general-purpose computer systems incorporating multi-core processors and have the potential to become formidable competitors in compute intensive applications, such as radar and sonar. While our products are designed to offer the best overall value in combined performance, features and price, we may not overcome the capabilities of larger companies to address the needs of the cost sensitive customer, where price, as opposed to system performance, size

and specialized packaging, is the primary factor in the buying decision.

New companies enter the field periodically and larger companies with greater technical resources and marketing organizations could decide to compete in the future. The future growth of this market depends upon continued growth in strategic partnerships and providing high density and scalability in a compact, low power and cost effective package that can easily be integrated into OEM designs for high performance computation. Since the majority of sales are to prime contractors, the principal barrier to gaining market share is the reluctance of established users to redesign their product once it is in production. A key area of opportunity exists in design wins on new programs.

#### Manufacturing, Assembly and Testing

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

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

We provide a warranty covering defects arising from products sold and service performed, which varies from 90 days to one year, depending upon the particular unit.

#### Customer Support

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

We offer training courses at our corporate headquarters or the customer site. Field and customer service support is provided by employees located at our headquarters in Billerica, Massachusetts for Systems segment customers.

#### Sources and Availability of Raw Materials

Several components used in our Systems segment products are obtained from sole-source suppliers. We are dependent on key vendors like Mellanox Technologies for our high-speed interconnect components, Freescale Semiconductor, Inc. for PowerPC processors for our 2000 SERIES and our 3000 SERIES VXS products and Intel for our microprocessors for our TeraXP OpenVPX™ embedded servers and Wind River Systems, Inc. for VxWorks operating system software. Despite our dependence on these sole-source suppliers, based on our current forecast, we do not consider the risk of interruption of supply to be significant to meet our projected revenue requirements for the near term, because we have adequate inventory on hand and/or our requirements currently exist in the supply chain. Also, all components used to build our 3000 SERIES VXS, 4000 SERIES and TeraXP OpenVPX™ products are currently available in a timely manner.

#### Research and Development

For the year ended September 30, 2013, our expenses for research and development were approximately \$1.9 million compared to approximately \$1.7 million for fiscal year 2012. Expenditures for research and development are expensed as they are incurred. Product development efforts in fiscal year 2013 involved new enhancements to our VXS product line, with a focus on continuing to provide our customers with increased processing capabilities based on the latest industry standard technologies: Freescale QorIQ multi-core processors and 10 and 40 Gigabit Ethernet support. We expect to continue to make substantial expenditures related to the development of new hardware products and the software that enables the hardware to function. Our current development plan is intended to extend the usefulness and marketability of existing products by continuing to develop enhancements to our 3000 SERIES VXS, 4000 SERIES and TeraXP OpenVPX™ product lines and introduce new products into existing market segments.

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

#### Backlog

The backlog of customer orders and contracts in the Systems segment was approximately \$0.4 million at September 30, 2013 as compared to \$3.1 million at September 30, 2012. Our backlog can fluctuate greatly. These fluctuations can be due to the timing of receiving large orders representing prime contractor purchases. It is expected that all of the customer orders in backlog will ship within the next twelve months.

#### Recent Developments

On November 4, 2013, the Company purchased the assets of Myricom, Inc. (“Myricom”), a manufacturer of high performance interconnect computing devices and software. With the Myricom asset purchase, the Company has acquired interconnect technology critical to its latest generation MultiComputer products as well as a strong base of new customers in commercial growth markets. The Company will now offer Myricom’s Myri-10G Ethernet adapters and associated network adapter software. Myri-10G is a family of high performance 10 Gigabit Ethernet adapters for Linux, Windows, Mac OS X and VMware ESX. The Company also acquired inventory for use in the latest generation CSPI MultiComputers. CSPI has also retained key Myricom technical personnel who will be working on the next-generation interconnect technology.

Myricom has been a key supplier to the CSPI MultiComputer Division for more than 15 years. Its interconnect technology is an important component of the latest generation Multicomputer products that CSPI currently supplies to its customers.

The Company paid \$0.5 million in cash in exchange for the assets that were acquired in the transaction.

## Service and System Integration Segment

### Products and Services

#### Integration Solutions

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

#### Third-Party Hardware and Software

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

#### Professional Services

We provide professional IT consulting services in the following areas:

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

Implementation, integration, migration, configuration and installation services.

Storage area network (“SAN”) solutions. We help our customers implement SAN solutions using products from Hitachi, EMC, HP, DataDomain and NetApp. SANs have advantages over conventional storage architecture. These advantages include cost savings from better utilization of hardware and lower headcount requirements to run and

maintain data storage systems, higher availability and faster data access rates resulting in increased productivity.

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

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

IT security compliance services. We provide services for IT security compliance with personal privacy laws such as HIPAA and internal control regulations under the Sarbanes-Oxley Act.

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

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

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

#### Markets, Marketing and Dependence on Certain Customers

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

#### Competition

The primary competition in the Service and System Integration segment are other VARs, ranging from small companies that number in the thousands, to large enterprises such as CDW, PC Connection, Insight, MoreDirect, Dimension Data, Bechtle AG, Presidio and Computacenter AG & Co oHG. In addition, we compete directly with many of the companies who manufacture the third-party products that we sell including Cisco Systems, IBM, HP EMC, Hitachi and others. In the network management, security and storage systems integration services business, our competitors are extensive and vary to a certain degree in each of the geographical markets, but they include such competitors as HP/EDS, IBM and Cap Gemini.

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

#### Backlog

The backlog of customer orders and contracts for the Service and System Integration segment was approximately \$7.7 million at September 30, 2013, as compared to \$7.1 million at September 30, 2012. Our backlog can fluctuate greatly. These fluctuations can be due to the timing of receiving large orders for third- party products and/or IT services. It is expected that all of the customer orders in backlog will ship and/or be provided within the next twelve months.

#### Significant Customers

See Note 12 to the notes to the consolidated financial statements for detailed information regarding customers which comprised 10% or more of consolidated revenues for the years ended September 30, 2013 and 2012.

## Employees

On September 30, 2013, we had approximately 167 full time equivalent employees worldwide for our consolidated operations. None of our employees are represented by a labor union and we had no work stoppages. We consider relations with our employees to be good.

## Financial Information about Geographic Areas

Information regarding our sales by geographic area and percentage of sales based on the location to which the products are shipped or services are rendered are in Note 12 to the notes to the consolidated financial statements.

## Item 1A. Risk Factors

We depend on a small number of customers for a significant portion of our revenue and loss of any customer could significantly affect our business

We are dependent on a small number of customers for a large portion of our revenues. Both the Systems and Service and System Integration segments are reliant upon a small number of significant customers, the loss of any one of which could have a material adverse effect on our business. A significant diminution in the sales to or loss of any of our major customers would have a material adverse effect on our business, financial condition and results of operations. In addition, our revenues are largely dependent upon the ability of our customers to have continued growth or need for services or to develop and sell products that incorporate our products. No assurance can be given that our customers will not experience financial or other difficulties that could adversely affect their operations and, in turn, our results of operations.

We depend on contracts with the federal government for a significant portion of our revenue, and our business could be seriously harmed if the government significantly decreased or ceased doing business with us.

We derived 7% of our total revenue in FY2013 and 13% of our total revenue in FY2012 from the Department of Defense ("DoD") as a subcontractor. We expect that the DoD contracts will continue to be important to our business for the foreseeable future. If we were suspended or debarred from contracting with the federal government generally, the General Services Administration, or any significant agency in the intelligence community or the DoD, or if our reputation or relationship with government agencies were to be impaired, or if the government otherwise ceased doing business with us or significantly decreased the amount of business it does with us, our business, prospects, financial condition and operating results could be materially and adversely affected.

Our business has been and could continue to be adversely affected by changes in budgetary priorities of the federal government.

Because we derive a significant percentage of our revenue from contracts with the federal government, changes in federal government budgetary priorities could directly affect our financial performance. A significant decline in government expenditures, a shift of expenditures away from programs that we support or a change in federal government contracting policies could cause federal government agencies to reduce their purchases under contracts, to exercise their right to terminate contracts at any time without penalty or not to exercise options to renew contracts.

During 2011, the federal government was unable to reach agreement on budget reduction measures required by the Budget Control Act of 2011 (Budget Act) passed by Congress. Because Congress and the Administration could not reach agreement, the Budget Act triggered automatic reductions in both defense and discretionary spending in January 2013, which adversely impacted our business. While the future impact of sequestration is uncertain, these automatic across-the-board budget cuts in sequestration could continue to have significant negative consequences to our business and industry.

In years when Congress does not complete its budget process before the end of its fiscal year (September 30), government operations are funded through a continuing resolution (CR) that temporarily funds federal agencies. Recent CRs have generally provided funding at the levels provided in the previous fiscal year and have not authorized new spending initiatives. When the federal government operates under a CR, delays can occur in the procurement of products and services. Historically, such delays have not had a material effect on our business; however, should funding of the federal government by CR be prolonged or extended through the entire government 2014 fiscal year, and sequestration is not alleviated, it could continue to have significant consequences to our business and our industry.

Additionally, our business could be seriously affected if the demand for and priority of funding for combat operations in Afghanistan decreases which may reduce the demand for our services on contracts supporting some operations and maintenance activities in the Department of Defense or if we experience an increase in set-asides for small businesses, which could result in our inability to compete directly for prime contracts.

Federal government contracts contain numerous provisions that are unfavorable to us.

Federal government contracts contain provisions and are subject to laws and regulations that give the government rights and remedies, some of which are not typically found in commercial contracts, including allowing the government to:

- cancel multi-year contracts and related orders if funds for contract performance for any subsequent year become unavailable;
- claim rights in systems and software developed by us;

- suspend or debar us from doing business with the federal government or with a governmental agency;
- impose fines and penalties and subject us to criminal prosecution; and
- control or prohibit the export of our data and technology.

If the government terminates a contract for convenience, we may recover only our incurred or committed costs, settlement expenses and profit on work completed prior to the termination. If the government terminates a contract for default, we may be unable to recover even those amounts, and instead may be liable for excess costs incurred by the government in procuring undelivered items and services from another source. Depending on the value of a contract, such termination could cause our actual results to differ materially and adversely from those anticipated.

As is common with government contractors, we have experienced and continue to experience occasional performance issues under certain of our contracts. Depending upon the value of the matters affected, a performance problem that impacts our performance of a program or contract could cause our actual results to differ materially and adversely from those anticipated.

We rely on single sources for supply of certain components and our business may be seriously harmed if our supply of any of these components or other components is disrupted

Several components used in our Systems products are currently obtained from sole-source suppliers. We are dependent on key vendors like Mellanox Technologies for our high-speed interconnect components, Freescale for many of our PowerPC line of processors and Intel for our microprocessors, and Wind River Systems, Inc. for VxWorks operating system software. Generally, suppliers may terminate their purchase order with us without cause upon 30 days' notice and may cease offering products to us upon 180 days' notice. Although we do not consider the risk of interruption of supply to be a significant risk in the near term, if in the future, Mellanox Technologies or Freescale were to limit or reduce the sale of such components to us, or if these or other component suppliers to us, some of which are small companies, were to experience future financial difficulties or other problems which could prevent them from supplying us with the necessary components, such events could have a material adverse effect on our business, financial condition and results of operations. These sole source and other suppliers are each subject to quality and performance issues, materials shortages, excess demand, reduction in capacity and other factors that may disrupt the flow of goods to us or our customers, which thereby may adversely affect our business and customer relationships.

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

Our International Operations are Subject to a Number of Risks

We market and sell our products in certain international markets and we have established operations in the U.K. and Germany. Foreign-based revenue is determined based on the location to which the product is shipped or services are rendered and represented 33% and 44% of our total revenue for the fiscal years ended September 30, 2013 and 2012, respectively. If revenues generated by foreign activities are not adequate to offset the expense of establishing and maintaining these foreign subsidiaries and activities, our business, financial condition and results of operations could be materially adversely affected. In addition, there are certain risks inherent in transacting business internationally, such as changes in applicable laws and regulatory requirements, export and import restrictions, export controls relating to technology, tariffs and other trade barriers, longer payment cycles, problems in collecting accounts receivable, political instability, fluctuations in currency exchange rates, expatriation controls and potential adverse tax consequences, any of which could adversely impact the success of our international activities. A portion of our revenues are from sales to foreign entities, including foreign governments, which are primarily paid in the form of foreign currencies. There can be no assurance that one or more of such factors will not have a material adverse effect on our future international activities and, consequently, on our business, financial condition or results of operations.

We depend on key personnel and skilled employees and face competition in hiring and retaining qualified employees.

We are largely dependent upon the skills and efforts of our senior management, managerial, sales and technical employees. None of our senior management personnel or other key employees are subject to any employment contracts except Victor Dellovo, our Chief Executive Officer and President. The loss of services of any of our executives or other key personnel could have a material adverse effect on our business, financial condition and results of operations. Our future success will depend to a significant extent on our ability to attract, train, motivate and retain highly skilled technical professionals. Our ability to maintain and renew existing engagements and obtain new business depends, in large part, on our ability to hire and retain technical personnel with the skills that keep pace with continuing changes in industry standards and technologies. The inability to hire additional qualified personnel could impair our ability to satisfy our growing client base, requiring an increase in the level of responsibility for both existing and new personnel. There can be no assurance that we will be successful in retaining current or future employees.

New regulations related to conflict minerals may force us to incur additional expenses, may make our supply chain more complex and may result in damage to our relationships with customers.

On August 22, 2012, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC adopted new disclosure regulations for public companies that manufacture products that contain certain minerals and their derivatives, namely tin, tantalum, tungsten or gold, known as “conflict minerals,” if these minerals are necessary to the functionality or production of the company's products. These regulations require such issuers to report annually whether or not such minerals originate from the Democratic Republic of Congo (DRC) and adjoining countries and in some cases to perform extensive due diligence on their supply chains for such minerals.

The implementation of these new requirements could adversely affect the sourcing, availability and pricing of conflict minerals used in the manufacture of our products. In addition, we may incur additional costs to comply with the disclosure requirements, including costs related to determining the source of any of the relevant minerals used in our products. Because our supply chain is complex, the due diligence procedures that we implement may not enable us to ascertain the origins for these minerals or determine that these minerals are DRC conflict-free, which may harm our reputation. We may also face difficulties in satisfying customers who may require that our products be certified as DRC conflict-free, which could harm our relationships with these customers and lead to a loss of revenue. These new requirements also could have the effect of limiting the pool of suppliers from which we source these minerals, and we may be unable to obtain conflict-free minerals at competitive prices, which could increase our costs and adversely affect our manufacturing operations and our profitability.

Systems failures may disrupt our business and have an adverse effect on our results of operations.

Any systems failures, including network, software or hardware failures, whether caused by us, a third party service provider, unauthorized intruders and hackers, computer viruses, natural disasters, power shortages or terrorist attacks, could cause loss of data or interruptions or delays in our business or that of our clients. Like other companies, we have experienced cyber security threats to our data and systems, our company sensitive information, and our information technology infrastructure, including malware and computer virus attacks, unauthorized access, systems failures and temporary disruptions. We may experience similar security threats at customer sites that we operate and manage as a contractual requirement. Prior cyber attacks directed at us have not had a material adverse impact on our business or our financial results, and we believe that our continuing commitment toward threat detection and mitigation processes and procedures will avoid such impact in the future. Due to the evolving nature of these security threats, however, the impact of any future incident cannot be predicted.

In addition, the failure or disruption of our mail, communications or utilities could cause us to interrupt or suspend our operations or otherwise harm our business. Our property and business interruption insurance may be inadequate to

compensate us for all losses that may occur as a result of any system or operational failure or disruption and, as a result, our actual results could differ materially and adversely from those anticipated.

The systems and networks that we maintain for our clients, although highly redundant in their design, could also fail. If a system or network we maintain were to fail or experience service interruptions, we might experience loss of revenue or face claims for damages or contract termination. Our errors and omissions liability insurance may be inadequate to compensate us for all the damages that we might incur and, as a result, our actual results could differ materially and adversely from those anticipated.

We face competition that could adversely affect our sales and profitability.

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

Our operating results may fluctuate significantly.

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

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

• competitive pricing programs and volume discounts;

• loss of customers;

• market acceptance of our products;

• product obsolescence;

• general economic conditions;

• change in the mix of products sold;

• whether or not we are able to secure design wins for significant customer systems;

• timing of significant orders;

• delays in completion of internal product development projects;

• delays in shipping our products;

• delays in acceptance testing by customers;

• production delays due to quality programs with outsourced components;

• shortages of components;

• timing of product line transitions;

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

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

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

To be successful, we must respond to the rapid changes in technology.

Our future success will depend in part on our ability to enhance our current products and to develop new products on a timely and cost-effective basis in order to respond to technological developments and changing customer needs. The defense market, in particular, demands constant technological improvements as a means of gaining military advantage. Military

planners historically have funded significantly more design projects than actual deployments of new equipment and those systems that are deployed tend to contain the components of the subcontractors selected to participate in the design process. In order to participate in the design of new defense electronics systems, we must be able to demonstrate our ability to deliver superior technological performance on a timely and cost-effective basis. There can be no assurance that we will be able to secure an adequate number of defense electronics design wins in the future, that the equipment in which our products are intended to function eventually will be deployed in the field, or that our products will be included in such equipment if it is eventually deployed.

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

We need to continue to expend resources on research and development efforts to meet the needs of our customers.

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

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

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

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

Our Stock Price May Continue to be Volatile

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

• loss of a major customer;

• loss of a major supplier;

• the addition or departure of key personnel;

• variations in our quarterly operating results;

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

• acquisitions, distribution partnerships, joint ventures or capital commitments;

• regulatory changes;

- sales of our common stock or other securities in the future;
- changes in market valuations of technology companies; and
- fluctuations in stock market prices and volumes.

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

#### Factors that may Affect Future Performance

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

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

## Item 2. Properties

Listed below are our principal facilities as of September 30, 2013. Management considers all facilities listed below to be suitable for the purpose(s) for which they are used, including manufacturing, research and development, sales, marketing, service and administration.

| Location   | Principal Use  | Owned or Leased | Approximate Floor Area |
|--|--|-----------------|------------------------|
| Systems Segment Properties:  |  |                 |                        |
| CSP Inc.<br>43 Manning Road<br>Billerica, MA   | Corporate Headquarters<br>Manufacturing, Sales,<br>Marketing and<br>Administration | Leased          | 11,450 S.F.            |
| Service and Systems Integration Segment Properties:  |  |                 |                        |
| Modcomp, Inc.<br>1500 S. Powerline Road<br>Deerfield Beach, FL                                       | Division Headquarters<br>Sales, Marketing and<br>Administration                    | Leased          | 15,482 S.F.            |
| Modcomp, Inc.<br>9155 South Dadeland Blvd, Suite 1112<br>Miami, FL                                   | Sales, Marketing and Service   | Leased          | 1,356 S.F.             |
| Modular Computer Systems GmbH<br>Oskar-Jager-Strasse 50<br>D-50825 Koln<br>Germany                   | Sales, Marketing, Service<br>and Administration                                    | Leased          | 12,443 S.F.            |
| Modcomp, Ltd.<br>12a Oaklands Business Park, Fishponds Road<br>Wokingham Berkshire<br>United Kingdom | Sales, Marketing and<br>Administration   | Leased          | 2,490 S.F.             |
| Modcomp AG<br>Gartenstr. 23-27<br>D-61352 Bad Homburg<br>Germany                                     | Sales, Marketing and Service   | Leased          | 323 S.F.               |

## Item 3. Legal Proceedings

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

## Item 4. Mine Safety Disclosures

Not Applicable.

## PART II

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

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

| Fiscal Year: | 2013   |        | 2012   |        |
|--------------|--------|--------|--------|--------|
|              | High   | Low    | High   | Low    |
| 1st Quarter  | \$6.65 | \$4.51 | \$3.73 | \$3.15 |
| 2nd Quarter  | 6.89   | 5.09   | 4.48   | 3.04   |
| 3rd Quarter  | 9.43   | 5.36   | 4.53   | 3.82   |
| 4th Quarter  | 8.94   | 6.62   | 4.99   | 3.84   |

Stockholders. We had approximately 101 holders of record of our common stock as of December 11, 2013. This number does not include stockholders for whom shares were held in a “nominee” or “street” name. We believe the number of beneficial owners of our shares of common stock (including shares held in street name) at that date was approximately 1,600.

Dividends. On December 10, 2012, the Company's board of directors declared a cash dividend of \$0.20 per share which was paid on December 28, 2012 to stockholders of record as of December 20, 2012, the record date. On May 8, 2013, the Company's board of directors declared a cash dividend of \$0.10 per share which was paid on June 3, 2013 to stockholders of record as of May 24, 2013, the record date. On August 7, 2013, the Company's board of directors declared a cash dividend of \$0.10 per share which was paid on August 30, 2013 to stockholders of record as of August 21, 2013, the record date.

On January 12, 2012, our Board of Directors declared a cash dividend of \$0.10 per share which was paid on February 3, 2012 to stockholders of record as of January 27, 2012, the record date. On August 7, 2012, our board of directors declared a cash dividend of \$0.12 per share which was paid on August 31, 2012 to stockholders of record as of August 23, 2012, the record date.

On December 17, 2013, our board of directors declared a cash dividend of \$0.10 per share payable on January 7, 2014 to stockholders of record as of December 27, 2013, the record date.

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

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

Overview of Fiscal 2013 Results of Operations

CSPI operates in two segments:

**Systems** - the Systems segment consists of our MultiComputer Division which designs, commercially develops and manufactures signal processing computer platforms that are used primarily in military applications and the process control and data acquisition ("PCDA") proprietary hardware business of our Modcomp subsidiary.

**Service and System Integration** - the Service and System Integration segment includes the computer systems' maintenance and integration services and third-party computer hardware and software products businesses of our Modcomp subsidiary.

Key results include:

Revenue increased by approximately \$2.8 million, or 3%, to \$87.6 million for the year ended September 30, 2013 versus \$84.8 million for the year ended September 30, 2012.

For year ended September 30, 2012 we realized income from proceeds of an officer life insurance settlement of approximately \$2.1 million. While no such income was recognized in the ended September 30, 2013, we did receive the settlement during the current fiscal year.

For the year ended September 30, 2013, we had an operating profit of approximately \$0.7 million versus an operating profit of approximately \$5.0 million for the year ended September 30, 2012, for a decrease of approximately \$4.3 million.

For the year ended September 30, 2013, net income was approximately \$0.4 million versus net income of approximately \$6.6 million for the year ended September 30, 2012, for an decrease of approximately \$6.2 million.

Net cash provided by operating activities was approximately \$0.2 million for the year ended September 30, 2013 compared to net cash provided by operating activities of \$6.3 million for the year ended September 30, 2012.

The increase in revenues of \$2.8 million resulted from strong growth in revenues from our Service and System Integration segment partially offset by a decrease in revenues from our Systems segment. Revenues in the Service and System Integration segment increased by approximately \$7.0 million from \$73.7 million the year ended September 30, 2012 to \$80.6 million for the year ended September 30, 2013, while Systems segment revenue decreased from \$11.1 million for fiscal 2012 to \$7.0 million for fiscal 2013 for a decrease of approximately \$4.1 million.

In the Service and System Integration segment we experienced growth in both product and service revenues. Product revenues for the segment increased by \$5.0 million, which was a 9% increase from \$55.4 million in fiscal 2012 to \$60.4 million in fiscal 2013. Service revenue in the segment increased by \$2.0 million which was an 11% increase from \$18.3 million in fiscal 2012 to \$20.3 million in fiscal 2013. The product revenue increase was derived in large part from our U.S. operation, where product sales increased by approximately \$14.1 million. The increase in services revenues was due substantially to an increase in the German division, where service revenue increased by

approximately \$1.2 million and an increase in the US division of approximately \$0.7 million. In Germany, the increase was driven by service sales to new customers of approximately \$0.8 million and favorable foreign exchange of approximately \$0.2 million. In the US division, the increase in service revenues was from higher third party maintenance revenue.

The revenue decrease in the Systems segment was largely the result of lower royalty revenues which were \$6.4 million for fiscal 2012 versus \$0.8 million in fiscal 2013. Royalty revenues are particularly significant because there is no cost of sales associated with royalty revenues, hence the profit margin is 100% on this revenue. This \$5.6 million decrease in royalty revenue was partially offset by higher product revenue in fiscal 2013 versus fiscal 2012 which increased by approximately \$1.3 million.

In assessing the outlook for fiscal 2014, we expect to receive orders for royalties to fulfill a full rate production phase of the E2D program during the year. As a result, anticipating that we will realize significant royalty revenue, we are assuming a more optimistic view for the Systems segment for next year in comparison to the operating results we realized for fiscal 2013.

However, based on the risks associated with the economic environment within the defense market, we plan to manage the Systems segment with a cautiously optimistic outlook for fiscal 2014. In the Service and System Integration segment, we also have a cautiously optimistic outlook for fiscal 2014, in terms of revenue, where much will depend upon the level of overall growth in the private sector economy both domestically and in our European markets. We plan to focus our attention and resources in the Service and System Integration segment on higher-margin consulting and managed service business as we move forward. While this may put pressure on sales growth in fiscal 2014, we believe this strategy will achieve profitable growth for the long term.

The following table details our results of operations in dollars and as a percentage of sales for the years ended September 30, 2013 and 2012:

|   | September 30,<br>2013         | %<br>of sales | September 30,<br>2012 | %<br>of sales |    |
|---|-------------------------------|---------------|-----------------------|---------------|----|
|   | (Dollar amounts in thousands) |               |                       |               |    |
| Sales   | \$87,619                      | 100           | % \$84,807            | 100           | %  |
| Costs and expenses:                                       |                               |               |                       |               |    |
| Cost of sales   | 69,036                        | 79            | % 64,386              | 76            | %  |
| Engineering and development                               | 1,857                         | 2             | % 1,720               | 2             | %  |
| Selling, general and administrative                       | 16,025                        | 18            | % 15,847              | 19            | %  |
| Total costs and expenses                                  | 86,918                        | 99            | % 81,953              | 97            | %  |
| Income from proceeds of officer life insurance settlement | —                             | —             | % 2,115               | 3             | %  |
| Operating income  | 701                           | 1             | % 4,969               | 6             | %  |
| Other expense   | (12                           | ) —           | % (100                | ) —           | %  |
| Income before income taxes                                | 689                           | 1             | % 4,869               | 6             | %  |
| Income tax expense (benefit)                              | 321                           | —             | % (1,740              | ) (2          | )% |
| Net income  | \$368                         | 1             | % \$6,609             | 8             | %  |

#### Sales

The following table details our sales by operating segment for the years ended September 30, 2013 and 2012:

|  | Systems                       | Service and<br>System<br>Integration | Total    | % of<br>Total |   |
|--|-------------------------------|--------------------------------------|----------|---------------|---|
|  | (Dollar amounts in thousands) |                                      |          |               |   |
| For the Year Ended September 30, 2013: |                               |                                      |          |               |   |
| Product                                | \$5,483                       | \$60,361                             | \$65,844 | 75            | % |
| Services                               | 1,517                         | 20,258                               | 21,775   | 25            | % |
| Total                                  | \$7,000                       | \$80,619                             | \$87,619 | 100           | % |
| % of Total                             | 8                             | % 92                                 | % 100    | %             |   |
|  |                               |                                      |          |               |   |
|  |                               |                                      |          |               |   |
| For the Year Ended September 30, 2012: |                               |                                      |          |               |   |
| Product                                | \$4,214                       | \$55,369                             | \$59,583 | 70            | % |
| Services                               | 6,927                         | 18,297                               | 25,224   | 30            | % |
| Total                                  | \$11,141                      | \$73,666                             | \$84,807 | 100           | % |
| % of Total                             | 13                            | % 87                                 | % 100    | %             |   |



|                     | Systems  |    | Service and<br>System<br>Integration | Total   |    | %<br>increase |
|---------------------|----------|----|--------------------------------------|---------|----|---------------|
| Increase (Decrease) |          |    |                                      |         |    |               |
| Product             | \$1,269  |    | \$4,992                              | \$6,261 | 11 | %             |
| Services            | (5,410   | )  | 1,961                                | (3,449  | )  | (14)%         |
| Total               | \$(4,141 | )  | \$6,953                              | \$2,812 | 3  | %             |
| % increase          | (37      | )% | 9                                    | % 3     |    | %             |

As shown above, total revenues increased by approximately \$2.8 million, or 3%, for the year ended September 30, 2013 compared to the year ended September 30, 2012. Revenue in the Service and System Integration segment increased by approximately \$7.0 million, while revenues in the Systems segment decreased for the current year versus the prior year by approximately \$4.1 million.

Product revenues increased by approximately \$6.3 million, or 11%, for the year ended September 30, 2013 compared to the prior fiscal year. Product revenues in the Service and System Integration segment increased by approximately \$5.0 million while in the Systems segment product revenue increased by approximately \$1.3 million for the year ended September 30, 2013 versus the year ended September 30, 2012.

In the US division of the Service and System Integration segment, product sales increased by approximately \$14.1 million, sales in this segment's German division decreased by approximately \$8.2 million and in the UK division product sales decreased by approximately \$0.9 million.

In the US division, the increase in product sales was due in part to sales to new customers (customers to which no sales were made in the prior year), which totaled approximately \$5.0 million for the year ended September 30, 2013. In addition, sales increased to large existing customers in the IT hosting vertical by an aggregate of approximately \$13.6 million. These increases were partially offset by aggregate net decreases to existing customers across all other verticals of approximately \$4.5 million.

In Germany, the \$8.2 million decrease in product revenue was driven by decreased sales to the division's largest customer, a large UK-based wireless carrier, to which product sales decreased by approximately \$3.2 million. In addition, product sales to another of the division's largest customers from the previous year decreased by approximately \$5.3 million. Partially offsetting these decreases, new customer sales totaled approximately \$1.2 million. Sales to all other customers decreased by a net of approximately \$0.9 million. The decrease in product sales in the UK division was the result of weaker demand from our UK customer base in the current-year.

The increase in product revenues in the Systems segment of approximately \$1.3 million was due to an increase of \$1.4 million in sales of parts, components and spares to existing US defense department customers, and an increase of \$0.6 million due to hardware sales to a commercial customer. These increases were partially offset by a decrease in sales to our Japanese defense department customer of approximately \$0.7 million.

As shown in the table above, service revenues decreased by approximately \$3.4 million, or 14%. This decrease was made up of a decrease in the Systems segment of \$5.4 million and an increase in the Service and System Integration segment of approximately \$2.0 million. The decrease in the Systems segment service revenue was due to lower royalty revenue recorded in the year ended September 30, 2013 which was approximately \$0.8 million versus \$6.4 million for the year ended September 30, 2012. The increase in service revenues in the Service and System Integration segment was primarily from the German division, where service revenue increased by approximately \$1.2 million and an increase in the US division of approximately \$0.7 million. In Germany, the increase was driven by service sales to new customers of approximately \$0.8 million and favorable foreign exchange of approximately \$0.2 million. In the

US division, the increase in service revenues was from higher third party maintenance revenue.

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

|          | For the Year ended,<br>September 30,<br>2013 |     | September 30,<br>2012 |     | \$ Increase<br>(Decrease) | % Increase<br>(Decrease) |
|----------|--|-----|-----------------------|-----|---------------------------|--------------------------|
|          |  | %   |                       | %   |                           |                          |
|          | (Dollar amounts in thousands)                |     |                       |     |                           |                          |
| Americas | \$59,116                                     | 68  | % \$47,163            | 56  | % \$11,953                | 25                       |
| Europe   | 25,512                                       | 29  | % 34,053              | 40  | % (8,541                  | ) (25                    |
| Asia     | 2,991  | 3   | % 3,591               | 4   | % (600                    | ) (17                    |
| Totals   | \$87,619                                     | 100 | % \$84,807            | 100 | % \$2,812                 | 3                        |

The increase in Americas revenue for the year ended September 30, 2013 versus the year ended September 30, 2012 was from an increase in the US division of the Service and System Integration segment to customers in the Americas of approximately \$15.5 million, partially offset by decreases in sales to US customers in the Systems segment of approximately \$3.6 million.

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

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

The following table details our cost of sales, gross profit and gross margins by operating segment for the fiscal years ended September 30, 2013 and 2012:

|  | Systems                       | Service and<br>System<br>Integration | Total    | % of<br>Total |
|--|-------------------------------|--------------------------------------|----------|---------------|
|  | (Dollar amounts in thousands) |                                      |          |               |
| For the Year Ended September 30, 2013: |                               |                                      |          |               |
| Cost of Sales:                         |                               |                                      |          |               |
| Product                                | \$2,439                       | \$51,584                             | \$54,023 | 78            |
| Services                               | 270                           | 14,743                               | 15,013   | 22            |
| Total                                  | \$2,709                       | \$66,327                             | \$69,036 | 100           |
| % of Total                             | 4                             | % 96                                 | % 100    | %             |
| % of Sales                             | 39                            | % 82                                 | % 79     | %             |
| Gross Profit:                          |                               |                                      |          |               |
| Product                                | \$3,044                       | \$8,777                              | \$11,821 | 64            |
| Services                               | 1,247                         | 5,515                                | 6,762    | 36            |
| Total                                  | \$4,291                       | \$14,292                             | \$18,583 | 100           |
| % of Total                             | 23                            | % 77                                 | % 100    | %             |
| Gross Margins:                         |                               |                                      |          |               |
| Product                                | 56                            | % 15                                 | % 18     | %             |
| Services                               | 82                            | % 27                                 | % 31     | %             |
| Total                                  | 61                            | % 18                                 | % 21     | %             |

#### For the Year Ended September 30, 2012:

|                |         |          |          |     |
|----------------|---------|----------|----------|-----|
| Cost of Sales: |         |          |          |     |
| Product        | \$2,508 | \$47,718 | \$50,226 | 78  |
| Services       | 283     | 13,877   | 14,160   | 22  |
| Total          | \$2,791 | \$61,595 | \$64,386 | 100 |

Edgar Filing: CSP INC /MA/ - Form 10-K

|            |    |      |       |   |
|------------|----|------|-------|---|
| % of Total | 4  | % 96 | % 100 | % |
| % of Sales | 25 | % 84 | % 76  | % |

18

---

|                                    | Systems  | Service and<br>System<br>Integration | Total    | % of<br>Total |    |
|------------------------------------|----------|--------------------------------------|----------|---------------|----|
| Gross Profit:                      |          |                                      |          |               |    |
| Product                            | \$1,706  | \$7,651                              | \$9,357  | 46            | %  |
| Services                           | 6,644    | 4,420                                | 11,064   | 54            | %  |
| Total                              | \$8,350  | \$12,071                             | \$20,421 | 100           | %  |
| % of Total                         | 41       | % 59                                 | % 100    | %             |    |
| Gross Margins:                     |          |                                      |          |               |    |
| Product                            | 40       | % 14                                 | % 16     | %             |    |
| Services                           | 96       | % 24                                 | % 44     | %             |    |
| Total                              | 75       | % 16                                 | % 24     | %             |    |
| Increase (decrease)                |          |                                      |          |               |    |
| Cost of Sales:                     |          |                                      |          |               |    |
| Product                            | \$(69    | ) \$3,866                            | \$3,797  | 8             | %  |
| Services                           | (13      | ) 866                                | 853      | 6             | %  |
| Total                              | \$(82    | ) \$4,732                            | \$4,650  | 7             | %  |
| % Increase (decrease)              | (3       | )% 8                                 | % 7      | %             |    |
| % of Sales                         | 14       | % (2                                 | )% 3     | %             |    |
| Gross Profit:                      |          |                                      |          |               |    |
| Product                            | \$1,338  | \$1,126                              | \$2,464  | 26            | %  |
| Services                           | (5,397   | ) 1,095                              | (4,302   | ) (39         | )% |
| Total                              | \$(4,059 | ) \$2,221                            | \$(1,838 | ) (9          | )% |
| % increase (decrease)              | (49      | )% 18                                | % (9     | )%            |    |
| Change in Gross Margin percentage: |          |                                      |          |               |    |
| Product                            | 16       | % 1                                  | % 2      | %             |    |
| Services                           | (14      | )% 3                                 | % (13    | )%            |    |
| Total                              | (14      | )% 2                                 | % (3     | )%            |    |

Total cost of sales increased by approximately \$4.7 million when comparing the year ended September 30, 2013 versus the year ended September 30, 2012. A significant factor which caused this increase in cost of sales was the overall increase in sales as discussed previously, however whereas sales increased by 3%, cost of sales increased by 7%. The resulting lower gross profit margin ("GPM") of 21% for the year ended September 30, 2013 versus 24% for 2012 was due to several factors which are discussed below.

In the Systems segment, the overall GPM decreased from 75% to 61% as shown in the table above. This was because in fiscal year 2013 royalty revenue, which carries a 100% GPM, was \$0.8 million, or 11% of total Systems segment revenue, versus the prior year royalty revenue which was \$6.4 million or 57% of total Systems segment revenue. Partially offsetting the unfavorable GPM impact of the lower royalty revenue in the current year however, was the impact of higher product GPM in the current year versus the prior year. As shown in the table above, the GPM on product sales was 56% for the current year versus the prior year product GPM of 40%. This is due to the current year higher volume of production and product sales resulting in proportionately greater absorption of fixed factory overhead, therefore these fixed costs were proportionately lower versus production and sales volume, which resulted in the low GPM on product sales in the prior year.

In the Service and System Integration segment, the overall GPM was 18% for the year ended September 30, 2013 versus 16% for the prior year. Product GPM in the segment increased to 15% from 14% when comparing the year ended September 30, 2013 to the year ended September 30, 2012, while the segment's service GPM also increased

from 24% to 27%. The increase in the product GPM was due to smaller deal size and more favorable product mix in fiscal year 2013 versus fiscal 2012, while the increase in service GPM was due primarily to higher utilization of in-house service engineers in providing billable services in Germany, and higher third-party maintenance revenue for the current fiscal year versus the prior year.

## Engineering and Development Expenses

The following table details our engineering and development expenses by operating segment for the year ended September 30, 2013 and 2012:

|                                   | For the Year ended,<br>September 30,<br>2013 |     | September 30,<br>2012 |         | \$ Decrease | % Decrease  |
|-----------------------------------|--|-----|-----------------------|---------|-------------|-------------|
|                                   | % of<br>Total                                | %   | % of<br>Total         | %       |             |             |
| (Dollar amounts in thousands)     |  |     |                       |         |             |             |
| By Operating Segment:             |  |     |                       |         |             |             |
| Systems                           | \$1,857                                      | 100 | %                     | \$1,720 | 100         | % \$137 8 % |
| Service and System<br>Integration | —  | —   | %                     | —       | —           | —           |
| Total                             | \$1,857                                      | 100 | %                     | \$1,720 | 100         | % \$137 8 % |

The \$0.1 million increase in engineering and development expenses displayed above was due to higher engineering consulting expenditures in connection with the development of the next generation of MultiComputer products in the Systems segment.

## Selling, General and Administrative

The following table details our selling, general and administrative (“SG&A”) expense by operating segment for the years ended September 30, 2013 and 2012:

|                                   | For the Year ended,<br>September 30,<br>2013 |     | September 30,<br>2012 |          | \$ Increase | % Increase          |
|-----------------------------------|--|-----|-----------------------|----------|-------------|---------------------|
|                                   | % of<br>Total                                | %   | % of<br>Total         | %        |             |                     |
| (Dollar amounts in thousands)     |  |     |                       |          |             |                     |
| By Operating Segment:             |  |     |                       |          |             |                     |
| Systems                           | \$4,037                                      | 25  | %                     | \$5,515  | 35          | % \$(1,478 ) (27 )% |
| Service and System<br>Integration | 11,988                                       | 75  | %                     | 10,332   | 65          | % 1,656 16 %        |
| Total                             | \$16,025                                     | 100 | %                     | \$15,847 | 100         | % \$178 1 %         |

SG&A expenses increased in the Service and System Integration segment by approximately \$1.7 million when comparing the fiscal year ended September 30, 2013 versus the prior year. This increase was due primarily to higher commissions and other incentive compensation expense which increased by approximately \$0.7 million, due to the higher gross profit, and operating profit in the segment, higher salary expenses for additional headcount and promotions of approximately \$0.9 million.

The decrease in SG&A expense in the Systems segment was due in large part to a non-recurring reduction in the cash surrender value of officer life insurance of approximately \$0.9 million, related to a policy on our former chief executive, who died in fiscal 2012. In addition, retirement expense was lower by approximately \$0.4 million and bonus expense was lower by approximately \$0.5 million the year ended September 30, 2013, versus the prior year. The reductions in expenses were partially offset by higher legal expenses of approximately \$0.3 million in connection with a proxy challenge during the year ended September 30, 2013.

## Proceeds from officer life insurance settlement

In fiscal year 2012, we recognized approximately \$2.1 million for the settlement from a life insurance policy for our former chief executive officer, who died during fiscal 2012. No such settlements occurred during for the fiscal year ended September 30, 2013.

## Other Income/Expenses

The following table details our other income/expenses for the years ended September 30, 2013 and 2012:

|                              | For the Year ended,    |               | Increase   |
|------------------------------|------------------------|---------------|------------|
|                              | September 30,          | September 30, | (Decrease) |
|                              | 2013                   | 2012          |            |
|                              | (Amounts in thousands) |               |            |
| Interest expense             | \$(86                  | ) \$(85       | ) \$(1     |
| Interest income              | 32                     | 44            | (12        |
| Foreign exchange gain (loss) | (18                    | ) (60         | ) 42       |
| Other income (expense), net  | 60                     | 1             | 59         |
| Total other expense, net     | \$(12                  | ) \$(100      | ) \$88     |

Other income (expense), net, for the years ended September 30, 2013 and 2012 was not significant nor was the change from the prior year to the current year.

## Income Taxes

The Company recorded an income tax expense of approximately \$0.3 million, which reflected an effective tax expense rate of 47% for the year ended September 30, 2013, compared to income tax benefit of approximately \$1.7 million for the year ended September 30, 2012, which reflected an effective tax benefit rate of 36%.

As of September 30, 2013, management assessed the positive and negative evidence in the U.S operations, and estimated we will have sufficient future taxable income to utilize the existing deferred tax assets. Significant objective positive evidence included the cumulative profits that we realized over the most recent years. This evidence enhances our ability to consider other subjective evidence such as our projections for future growth. Other factors we considered are the likelihood for continued royalty income in future years, and our expectation that the Service and Systems Integration segment will continue to be profitable in future years. On the basis of this evaluation, as of September 30, 2013, we have concluded that our US deferred tax asset is more likely than not to be realized. It should be noted however, that the amount of the deferred tax asset realized could be adjusted in future years, if estimates of taxable income during the carryforward periods are reduced, or if objective negative evidence such as cumulative losses is present.

We realized a tax benefit for the year ended September 30, 2012, despite the fact that we had positive earnings before taxes for the year. This was because we reversed the U.S. valuation allowance of \$3.0 million on our deferred tax assets, which had been accumulated over the past several years, resulting in this overall tax benefit. The recording and ultimate reversal of valuation allowances for our deferred tax asset requires significant judgment associated with past and projected performance. In assessing the realizability of deferred tax assets, we consider our taxable future earnings and the expected timing of the reversal of temporary differences. In prior years, we recorded a valuation allowance which reduced the gross deferred tax asset to an amount that we believed was more likely than not to be realized because our inability to project future profitability beyond fiscal year 2012 in the U.S. and cumulative losses incurred in recent years in the United Kingdom represented sufficient negative evidence to record a valuation allowance against certain deferred tax assets.

We continue to maintain a full valuation allowance against our United Kingdom deferred tax assets as we have experienced cumulative losses and do not have any indication that the operation will be profitable in the future to an extent that will allow us to utilize much of our net operating loss carryforwards. To the extent that actual experience deviates from our assumptions, our projections would be affected and hence our assessment of realizability of our

deferred tax assets may change.

#### Liquidity and Capital Resources

Our primary source of liquidity is our cash and cash equivalents, which decreased by approximately \$1.9 million to \$18.6 million as of September 30, 2013 from \$20.5 million as of September 30, 2012. At September 30, 2013, cash equivalents consisted of money market funds which totaled \$3.5 million.

Significant sources of cash for the year ended September 30, 2013 included net income of approximately \$0.4 million, depreciation and amortization of approximately \$0.4 million, decrease in officer life insurance settlement receivable of

approximately \$2.2 million, a decrease in inventories of approximately \$1.4 million, and a decrease in other assets of approximately \$0.3 million. Significant uses of cash included a decrease in accounts payable and accrued expenses of approximately \$3.3 million, payment of dividends of approximately \$1.4 million, an increase in accounts receivable of approximately \$1.1 million and purchases of property and equipment of \$0.9 million.

Cash held by our foreign subsidiaries located in Germany and the United Kingdom totaled approximately \$6.6 million as of September 30, 2013 and \$9.8 million as of September 30, 2012. This cash is included in our total cash and cash equivalents reported above. We consider this cash to be permanently reinvested into these foreign locations because repatriating it would result in unfavorable tax consequences. Consequently, it is not available for activities that would require it to be repatriated to the U.S.

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

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

## Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our estimates, including those related to uncollectible receivables, inventory valuation, goodwill and intangibles, income taxes, deferred compensation, revenue recognition, retirement plans, restructuring costs and contingencies. We base our estimates on historical performance and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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

### Revenue Recognition

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

The Company recognizes revenue from software licenses when persuasive evidence of an arrangement exists, delivery of the product has occurred and the fee is fixed or determinable and collectability is probable, in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("FASC") Section 985-605-25 Software - Revenue Recognition ("FASC 985-605-25"). When delivery of services accompany software sales, and vendor specific objective evidence does not exist, and the only undelivered element is services that do not involve significant modification, or customization, of software, then the entire fee is recognized as the services are performed. If no pattern of performance is discernible, the fee is recognized straight line over the service period. In accordance with FASC 985-605-25, for tangible products containing software components and non-software components, we determine whether these elements function together to deliver the tangible product essential functionality. If the software and non-software components of the tangible product function together to deliver the tangible product's essential functionality, software revenue recognition guidance is not applied, but rather other appropriate revenue recognition guidance is followed.

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

In certain multiple-element revenue arrangements, the Company is obligated to deliver to its customers multiple products and/or services ("multiple elements"). In these transactions, the Company allocates the total revenue to be earned under the arrangement among the various elements based on the Company's best estimate of the standalone

selling price. The allocation is based on vendor specific objective evidence, third party evidence or estimated selling price when that element is sold separately. The Company recognizes revenue related to the delivered products or services only if the above revenue recognition criteria are met and the delivered element has standalone value. The Company follows Sections 605-25 Revenue Recognition - Multiple Element Arrangements ("FASC 605-25"). FASC 605-25 provides accounting principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and how the consideration should be allocated. This guidance provides for separate revenue recognition based upon management's estimate of the selling price for an undelivered item when there is no other means to determine the fair value of that undelivered item.

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

In many cases, our multiple-deliverable arrangements involve initial shipment of hardware (including tangible products that include software and non-software elements), software products and subsequent delivery of services which add value to the products that have been shipped. In some instances, services are performed prior to product shipment, but more typically services are performed subsequent to shipment of the hardware products. The timing of the delivery and performance of deliverables may vary case-by-case. In accordance with FASC 605-25, we evaluate whether we can determine Vendor Specific Objective Evidence ("VSOE") or third-party evidence to allocate revenue among the various elements in an arrangement. When VSOE or third-party evidence cannot be determined, we use estimated selling prices to allocate revenue to the various elements. Estimated selling prices are determined using the targeted gross margin for each element and calculating the gross revenue for each element that would have been required to achieve the targeted gross margin, and allocating revenue to each element based on those relative values. Typically, product revenue which may consist of hardware (including tangible products that include software and non-software elements) and/or software elements are recognized upon shipment, or when risk of loss passes to the customer. Services elements are typically recognized upon completion for fixed-price service arrangements, and as services are performed for time and materials service arrangements.

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

#### Systems Segment Revenue

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

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

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

#### Service and System Integration Segment Revenue

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

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

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

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

We sell certain third party service contracts, which are evaluated to determine whether the sale of such service revenue should be recorded as gross sales or net sales in accordance with the sales recognition criteria as required by FASC 605-45 Principal Agent Considerations. We must determine whether we act as a principal in the transaction and assume the risks and rewards of ownership or if we are simply acting as an agent or broker. Under gross sales recognition, the entire selling price is recorded in sales and our cost to the third-party service provider or vendor is recorded in cost of goods sold. Under net sales recognition, the cost to the third-party service provider or vendor is recorded as a reduction to sales resulting in net sales equal to the gross profit on the transaction and there are no costs of goods sold. We use the net sales recognition method for the third

party service contracts that we sell when we are not the primary obligor on the contract. We use the gross sales recognition for the third party service contracts that we sell when we act as principal and are the primary obligor.

#### Product Warranty Accrual

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

#### Engineering and Development Expenses

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

#### Income Taxes

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

In addition, we are required to recognize in the consolidated financial statements, those tax positions determined to be more-likely-than-not of being sustained upon examination, based on the technical merits of the positions as of the reporting date. If a tax position is not considered more-likely-than-not to be sustained based solely on its technical merits, no benefits of the position are recognized.

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

#### Intangible Assets

Intangible assets that are not subject to amortization are also required to be tested annually, or more frequently if events or circumstances indicate that the asset may be impaired. We did not have intangible assets with indefinite lives other than goodwill at any time during the two years ended September 30, 2013. Intangible assets subject to amortization are amortized over their estimated useful lives, generally three to ten years, and are carried at cost, less accumulated amortization. The remaining useful lives of intangible assets are evaluated on an annual basis. Intangible

assets subject to amortization are also tested for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. If the fair value of an intangible asset subject to amortization is determined to be less than its carrying value, then an impairment charge is recorded to write down that asset to its fair value.

#### Inventories

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

## Pension and Retirement Plans

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

We have defined benefit and defined contribution plans in the United Kingdom (the "U.K."), Germany and in the U.S. In the U.K. and Germany, the Company provides defined benefit pension plans for certain employees and former employees and defined contribution plans for the majority of the employees. The defined benefit plans in both the U.K. and Germany are closed to newly hired employees and have been for the two years ended September 30, 2013. In the U.S., the Company also provides defined contribution plans that cover most employees and supplementary retirement plans to certain employees and former employees who are now retired. These supplementary retirement plans are also closed to newly hired employees and have been for the two years ended September 30, 2013. These supplementary plans are funded through whole life insurance policies. The Company expects to recover all insurance premiums paid under these policies in the future, through the cash surrender value of the policies and any death benefits or portions thereof to be paid upon the death of the participant. These whole life insurance policies are carried on the balance sheet at their cash surrender values as they are owned by the Company and not assets of the defined benefit plans. In the U.S., the Company also provides for officer death benefits and post-retirement health insurance benefits through supplemental post-retirement plans to certain officers. The Company also funds these supplemental plans' obligations through whole life insurance policies on the officers.

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

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

## Inflation and Changing Prices

Management does not believe that inflation and changing prices had significant impact on sales, revenues or income (loss) during fiscal 2013 or 2012. There is no assurance that the Company's business will not be materially and adversely affected by inflation and changing prices in the future.

Item 8. Financial Statements and Supplementary Data

The consolidated financial statements are included herein.

|  | Page      |
|--|-----------|
| <u>Report of Independent Registered Public Accounting Firm</u>   | <u>33</u> |
| <u>Consolidated Balance Sheets as of September 30, 2013 and 2012</u>                                   | <u>34</u> |
| <u>Consolidated Statements of Operations for the years ended September 30, 2013 and 2012</u>           | <u>35</u> |
| <u>Consolidated Statements of Comprehensive Income for the years ended September 30, 2013 and 2012</u> | <u>36</u> |
| <u>Consolidated Statements of Shareholders' Equity for the years ended September 30, 2013 and 2012</u> | <u>37</u> |
| <u>Consolidated Statements of Cash Flows for the years ended September 30, 2013 and 2012</u>           | <u>38</u> |
| <u>Notes to Consolidated Financial Statements</u>  | <u>39</u> |

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures  
None.

## Item 9A. Controls and Procedures

### Evaluation of Controls and Procedures

**Disclosure Controls and Procedures.** The Company evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2013. Our chief executive officer, our chief financial officer and other members of our senior management team supervised and participated in this evaluation. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2013, the Company's chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective.

### Management's Report on Internal Control over Financial Reporting.

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

pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of a company;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of a company are being made only in accordance with authorizations of management and the board of directors of a company; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company's assets that could have a material effect on its financial statements.

Management has assessed the effectiveness of the Company's internal control over financial reporting as of September 30, 2013. In making its assessment of internal control, management used the criteria described in “Internal Control-Integrated Framework” issued by the Committee of Sponsoring Organizations (“COSO”) of the Treadway Commission. As a result of its assessment, management has concluded that the Company's internal control over financial reporting was effective as of September 30, 2013.

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

deteriorate.

This Annual Report on Form 10-K does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's assessment of the effectiveness of the Company's internal control over financial reporting as of September 30, 2013 was not subject to attestation by the Company's independent registered public accounting firm pursuant to rules of the SEC that call for the Company to provide only management's report in this Annual Report on Form 10-K.

Changes in Internal Control over Financial Reporting.

During the quarter ended September 30, 2013, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None.

28

---

## PART III

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

We incorporate the information required by this item by reference to the sections captioned “Nominees for Election”, “Our Board of Directors”, “Our Executive Officers”, “Section 16(a) Beneficial Ownership Reporting Compliance” and “Corporate Governance” in our Schedule 14A Proxy Statement for our 2014 Annual Meeting of Stockholders, to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2013.

## Item 11. Executive Compensation

We incorporate the information required by this item by reference to the sections captioned “Compensation of Executive Officers” and “Compensation of Non-Employee Directors” in our Schedule 14A Proxy Statement for our 2014 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2013.

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

## Securities Authorized for Issuance Under Equity Compensation Plans.

The equity compensation plans approved by our stockholders consist of the CSP, Inc. 1997 Incentive Stock Option Plan, 2003 Stock Incentive Plan and 2007 Stock Incentive Plan. In fiscal 2013 and 2012, the Company granted certain officers including its Chief Executive Officer and non-employee directors shares of non-vested common stock instead of stock options. The vesting periods for the officers', the Chief Executive Officer's and the directors' non-vested stock awards are four years, three years and one year, respectively. The following table sets forth information as of September 30, 2013 regarding the total number of securities outstanding under these stock option plans.

| Plan Category  | (a)   | (b)   | (c)   |
|--|---|---|---|
|  | Number of securities to be issued upon exercise of outstanding options, warrants and rights, and non-vested shares issued | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
| Equity compensation plans approved by security holders (1) | 262,393   | \$ 3.10   | 184,033   |

(1) Includes 154,717 non-vested shares issued.

We incorporate additional information required by this Item by reference to the section captioned “Security Ownership of Certain Beneficial Owners and Management” in our Schedule 14A Proxy Statement for our 2014 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2013.

## Item 13. Certain Relationships and Related Transactions and Director Independence

We incorporate the information required by this item by reference to the section captioned “Corporate Governance” in our Schedule 14A Proxy Statement for our 2014 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2013.

Item 14. Principal Accountant Fees and Services

We incorporate the information required by this item by reference to the section captioned “Fees for Professional Services” and “Pre-approval Policies and Procedures” in our Schedule 14A Proxy Statement for our 2014 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of our fiscal year ended September 30, 2013.

PART IV

Item 15. Exhibits and Financial Statement Schedules

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

Consolidated Balance Sheets as of September 30, 2013 and 2012

Consolidated Statements of Operations for the years ended September 30, 2013 and 2012

Consolidated Statements of Comprehensive Income for the years ended September 30, 2013 and 2012.

Consolidated Statements of Shareholders' Equity for the years ended September 30, 2013 and 2012

Consolidated Statements of Cash Flows for the years ended September 30, 2013 and 2012

Notes to Consolidated Financial Statements

(2) Financial Statement Schedules

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

30

---

## (3) Exhibits

| Exhibit No. | Description  | Filed with this Form 10-K | Incorporated by Reference |                   | Exhibit No.. |
|-------------|--|---------------------------|---------------------------|-------------------|--------------|
|             |  |                           | Form                      | Filing Date       |              |
| 3.1         | Articles of Organization and amendments thereto  |                           | 10-K                      | December 26, 2007 | 3.1          |
| 3.2         | By-laws, as amended December 13, 2012  |                           | 10-K                      | December 20, 2012 | 3.1          |
| 10.1        | Form of Employee Invention and Non-Disclosure Agreement  |                           | 10-K                      | November 22, 1996 | 10.3         |
| 10.2        | CSPI Supplemental Retirement Income Plan   |                           | 10-K                      | December 29, 2008 | 10.2         |
| 10.6*       | 1997 Incentive Stock Option Plan, as amended   |                           | DEF 14A                   | December 1, 1997  | A            |
| 10.8*       | 2003 Stock Incentive Plan  |                           | DEF 14A                   | December 23, 2003 | B            |
| 10.9*       | 2007 Stock Incentive Plan  |                           | DEF 14A                   | March 30, 2007    | B            |
| 10.10*      | 2013 Variable Compensation (Executive Bonus) and Base Programs dated November 8, 2012  | X                         |                           |                   |              |
| 10.11*      | Death Benefit and Retirement Benefit Agreement between the Company and Victor Dellovo dated September 13, 2013   | X                         |                           |                   |              |
| 10.12*      | Form of Change of Control Agreement with Gary W. Levine, Walter Pastucha and William E. Bent Jr. each dated January 11, 2008                                     |                           | 10-K                      | December 22, 2009 | 10.11        |
| 10.13*      | Form of Change of Control Agreement with Robert A. Stellato, Andrew Shieh, Robert Gove, Peter Haebler, Kevin Magee and Stephen Pfeil each dated January 11, 2008 |                           | 10-K                      | December 22, 2009 | 10.11        |
| 10.14*      | Employment Agreement with Victor Dellovo dated April 11, 2003  |                           | 10-K                      | December 22, 2009 | 10.11        |
| 21.1        | Subsidiaries   | X                         |                           |                   |              |
| 23.1        | Consent of McGladrey LLP, Independent Registered Public Accounting Firm  | X                         |                           |                   |              |
| 31.1        | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   | X                         |                           |                   |              |
| 31.2        | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   | X                         |                           |                   |              |
| 32.1        | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                   | X                         |                           |                   |              |
| 101.INS**   | XBRL Instance  |                           |                           |                   |              |
| 101.SCH**   | XBRL Taxonomy Schema   |                           |                           |                   |              |
| 101.CAL**   | XBRL Taxonomy Extension Calculation  |                           |                           |                   |              |
| 101.DEF**   | XBRL Taxonomy Extension Definition   |                           |                           |                   |              |
| 101.LAB**   | XBRL Taxonomy Extension Labels   |                           |                           |                   |              |
| 101.PRE**   | XBRL Taxonomy Extension Presentation   |                           |                           |                   |              |

\*Management contract or compensatory plan.

XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 or the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.



SIGNATURES

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

CSP INC.

By: /s/ Victor Dellovo  
 Victor Dellovo  
 Chief Executive Officer and President

Date: December 24, 2013

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

| Name   | Title  | Date              |
|--|--|-------------------|
| /s/ Victor Dellovo<br>Victor Dellovo                     | Chief Executive Officer, President and<br>Director       | December 24, 2013 |
| /s/ Gary W. Levine<br>Gary W. Levine                     | Chief Financial Officer<br>(Principal Financial Officer) | December 24, 2013 |
| /s/Robert A. Stellato<br>Robert A. Stellato              | Vice President of Finance<br>(Chief Accounting Officer)  | December 24, 2013 |
| /s/ J. David Lyons<br>J. David Lyons                     | Director   | December 24, 2013 |
| /s/ C. Shelton James<br>C. Shelton James                 | Director   | December 24, 2013 |
| /s/ Robert M. Williams<br>Robert M. Williams             | Director   | December 24, 2013 |
| /s/ Raymond Charles Blackmon<br>Raymond Charles Blackmon | Director   | December 24, 2013 |
| /s/ Marilyn T. Smith<br>Marilyn T. Smith                 | Director   | December 24, 2013 |
| /s/ Robert Bunnett<br>Robert Bunnett                     | Director   | December 24, 2013 |

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
CSP Inc. and subsidiaries

We have audited the accompanying consolidated balance sheets of CSP Inc. and subsidiaries as of September 30, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of CSP Inc. and subsidiaries as of September 30, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ McGladrey LLP

Boston, Massachusetts  
December 24, 2013

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

|  | September 30,<br>2013 | September 30,<br>2012 |
|--|-----------------------|-----------------------|
| <b>ASSETS</b>  |                       |                       |
| Current assets:  |                       |                       |
| Cash and cash equivalents  | \$ 18,619             | \$ 20,493             |
| Accounts receivable, net of allowances of \$242 and \$243  | 13,529                | 12,145                |
| Officer life insurance settlement receivable   | —                     | 2,172                 |
| Inventories  | 4,791                 | 6,276                 |
| Refundable income taxes  | 624                   | 121                   |
| Deferred income taxes  | 1,313                 | 1,284                 |
| Other current assets   | 2,042                 | 2,215                 |
| Total current assets   | 40,918                | 44,706                |
| Property, equipment and improvements, net  | 1,420                 | 991                   |
| Other assets:  |                       |                       |
| Intangibles, net   | 410                   | 492                   |
| Deferred income taxes  | 1,771                 | 2,373                 |
| Cash surrender value of life insurance   | 2,481                 | 2,181                 |
| Other assets   | 225                   | 323                   |
| Total other assets   | 4,887                 | 5,369                 |
| Total assets   | \$ 47,225             | \$ 51,066             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                       |                       |
| Current liabilities:   |                       |                       |
| Accounts payable and accrued expenses  | \$ 10,503             | \$ 13,574             |
| Deferred revenue   | 3,816                 | 3,693                 |
| Pension and retirement plans   | 746                   | 717                   |
| Income taxes payable   | 60                    | 184                   |
| Total current liabilities  | 15,125                | 18,168                |
| Pension and retirement plans   | 8,660                 | 9,431                 |
| Deferred income taxes  | —                     | —                     |
| Other long term liabilities  | 405                   | 426                   |
| Total liabilities  | 24,190                | 28,025                |
| Commitments and contingencies  |                       |                       |
| Shareholders' equity:  |                       |                       |
| Common stock, \$.01 par value per share; authorized, 7,500 shares; issued and outstanding 3,496 and 3,399 shares, respectively | 35                    | 34                    |
| Additional paid-in capital   | 11,137                | 10,875                |
| Retained earnings  | 17,728                | 18,744                |
| Accumulated other comprehensive loss   | (5,865)               | (6,612)               |
| Total shareholders' equity   | 23,035                | 23,041                |
| Total liabilities and shareholders' equity   | \$ 47,225             | \$ 51,066             |

See accompanying notes to consolidated financial statements.



CSP INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Amounts in thousands, except for per share data)

|   | For the year ended    |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2013 | September 30,<br>2012 |
| Sales:  |                       |                       |
| Product   | \$65,844              | \$59,583              |
| Services  | 21,775                | 25,224                |
| Total sales   | 87,619                | 84,807                |
| Cost of sales:  |                       |                       |
| Product   | 54,023                | 50,226                |
| Services  | 15,013                | 14,160                |
| Total cost of sales                                       | 69,036                | 64,386                |
| Gross profit  | 18,583                | 20,421                |
| Operating expenses:                                       |                       |                       |
| Engineering and development                               | 1,857                 | 1,720                 |
| Selling, general and administrative                       | 16,025                | 15,847                |
| Total operating expenses                                  | 17,882                | 17,567                |
| Income from proceeds of officer life insurance settlement | —                     | 2,115                 |
| Operating income  | 701                   | 4,969                 |
| Other (expense):  |                       |                       |
| Foreign exchange (loss)                                   | (18                   | ) (59                 |
| Other (expense), net                                      | 6                     | (41                   |
| Total other (expense), net                                | (12                   | ) (100                |
| Income before income taxes                                | 689                   | 4,869                 |
| Income tax expense (benefit)                              | 321                   | (1,740                |
| Net income  | \$368                 | \$6,609               |
| Net income attributable to common stockholders            | \$361                 | \$6,496               |
| Net income per share – basic                              | \$0.11                | \$1.93                |
| Weighted average shares outstanding – basic               | 3,389                 | 3,362                 |
| Net income per share – diluted                            | \$0.10                | \$1.91                |
| Weighted average shares outstanding – diluted             | 3,441                 | 3,405                 |

See accompanying notes to consolidated financial statements.

CSP INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Amounts in thousands)

|   | For the year ended<br>September 30,<br>2013 | September 30,<br>2012 |   |
|---|---|-----------------------|---|
| Net income  | \$368                                       | \$6,609               |   |
| Other comprehensive income (loss):                            |   |                       |   |
| Unrealized actuarial gain (loss) on minimum pension liability | 630   | (664                  | ) |
| Foreign currency translation gain (loss)                      | 117   | (45                   | ) |
| Other comprehensive income (loss)                             | 747   | (709                  | ) |
| Total comprehensive income                                    | \$1,115                                     | \$5,900               |   |

See accompanying notes to consolidated financial statements.

CSP INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY  
For the Year Ended September 30, 2013:  
(Amounts in thousands)

|   | Shares | Amount | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>other<br>comprehensive<br>loss | Total<br>Shareholders'<br>Equity |
|---|--------|--------|----------------------------------|----------------------|---|----------------------------------|
| Balance as of September 30, 2011                  | 3,417  | \$34   | \$10,880                         | \$12,885             | \$(5,903)                                     | \$17,896                         |
| Comprehensive loss:                               |        |        |                                  |                      |   |                                  |
| Net income  | —      | —      | —                                | \$6,609              | —   | 6,609                            |
| Other comprehensive loss                          | —      | —      | —                                | —                    | (709)   | (709)                            |
| Stock-based compensation                          | —      | —      | 17                               | —                    | —   | 17                               |
| Purchase of common stock                          | (28)   | —      | (97)                             | —                    | —   | (97)                             |
| Restricted stock shares issued                    | 10     | —      | 75                               | —                    | —   | 75                               |
| Cash dividends on common stock (\$0.22 per share) | —      | —      | —                                | (750)                | —   | (750)                            |
| Balance as of September 30, 2012                  | 3,399  | 34     | 10,875                           | 18,744               | (6,612)                                       | 23,041                           |
| Comprehensive income (loss):                      |        |        |                                  |                      |   |                                  |
| Net income  | —      | —      | —                                | 368                  | —   | 368                              |
| Other comprehensive gain                          | —      | —      | —                                | —                    | 747   | 747                              |
| Stock-based compensation                          | —      | —      | 4                                | —                    | —   | 4                                |
| Purchase of common stock                          | —      | —      | —                                | —                    | —   | —                                |
| Restricted stock issuance                         | 56     | 1      | 144                              | —                    | —   | 145                              |
| Exercise of stock options                         | 41     | —      | 114                              | —                    | —   | 114                              |
| Cash dividends on common stock (\$0.40 per share) | —      | —      | —                                | (1,384)              | —   | (1,384)                          |
| Balance as of September 30, 2013                  | 3,496  | \$35   | \$11,137                         | \$17,728             | \$(5,865)                                     | \$23,035                         |

See accompanying notes to consolidated financial statements.

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

|   | For the year ended    |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2013 | September 30,<br>2012 |
| Cash flows from operating activities:   |                       |                       |
| Net income  | \$368                 | \$6,609               |
| Adjustments to reconcile net income to net cash used in operating activities: |                       |                       |
| Depreciation and amortization   | 438                   | 378                   |
| Amortization of intangibles   | 82                    | 82                    |
| Loss on disposal of fixed assets, net   | (3                    | ) —                   |
| Foreign exchange loss   | 18                    | 59                    |
| Non-cash changes in accounts receivable                                       | (2                    | ) (54                 |
| Non-cash changes in inventory   | 63                    | 210                   |
| Stock-based compensation expense on stock options and restricted stock awards | 149                   | 92                    |
| Deferred income taxes   | 600                   | (2,855                |
| Increase (decrease) in cash surrender value of life insurance                 | (100                  | ) 881                 |
| Changes in operating assets and liabilities:                                  |                       |                       |
| (Increase) decrease in accounts receivable                                    | (1,135                | ) 825                 |
| (Increase) decrease in officer life insurance settlement receivable           | 2,172                 | (2,172                |
| Decrease in inventories   | 1,436                 | 286                   |
| (Increase) decrease in refundable income taxes                                | (496                  | ) 101                 |
| (Increase) decrease in other assets   | 347                   | (652                  |
| Increase (decrease) in accounts payable and accrued expenses                  | (3,250                | ) 1,604               |
| Increase (decrease) in deferred revenue                                       | (7                    | ) 824                 |
| Decrease in pension and retirement plans liability                            | (304                  | ) (116                |
| Increase (decrease) in income taxes payable                                   | (127                  | ) 63                  |
| Increase (decrease) in other long term liabilities                            | (22                   | ) 141                 |
| Net cash provided by operating activities                                     | 227                   | 6,306                 |
| Cash flows from investing activities:   |                       |                       |
| Life insurance premiums paid  | (200                  | ) (143                |
| Proceeds from the sale of fixed assets  | 17                    | —                     |
| Purchases of property, equipment and improvements                             | (858                  | ) (551                |
| Net cash used in investing activities   | (1,041                | ) (694                |
| Cash flows from financing activities:   |                       |                       |
| Dividends paid  | (1,384                | ) (750                |
| Proceeds from issuance of shares under employee stock purchase plan           | 114                   | —                     |
| Purchase of common stock  | —                     | (97                   |
| Net cash used in financing activities   | (1,270                | ) (847                |
| Effects of exchange rate on cash  | 210                   | (146                  |
| Net increase (decrease) in cash and cash equivalents                          | (1,874                | ) 4,619               |
| Cash and cash equivalents, beginning of period                                | 20,493                | 15,874                |
| Cash and cash equivalents, end of period                                      | \$18,619              | \$20,493              |
| Supplementary cash flow information:  |                       |                       |
| Cash paid for income taxes  | \$434                 | \$1,056               |

|  |      |      |
|--|------|------|
| Cash paid for interest                                       | \$85 | \$85 |
| See accompanying notes to consolidated financial statements. |      |      |

CSP INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEAR ENDED SEPTEMBER 30, 2012 AND 2011

Organization and Business

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

1. Summary of Significant Accounting Policies

Principles of Consolidation

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

Foreign Currency Translation

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

Cash Equivalents

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

Research and Development Expense

For the year ended September 30, 2013, our expenses for research and development were approximately \$1.9 million compared to approximately \$1.7 million for fiscal year 2012. Expenditures for research and development are expensed as they are incurred.

Fair Value Measurements

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

Level 1

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

Level 2

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

### Level 3

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

### Impairment of Long-Lived Assets

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

### Intangible Assets

Intangible assets that are not subject to amortization are also required to be tested annually, or more frequently if events or circumstances indicate that the asset may be impaired. We did not have intangible assets with indefinite lives at any time during the two years ended September 30, 2013. Intangible assets subject to amortization are amortized on a straight-line basis over their estimated useful lives, generally three to ten years, and are carried at cost, less accumulated amortization. The remaining useful lives of intangible assets are evaluated on an annual basis. Intangible assets subject to amortization are also tested for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. If the fair value of an intangible asset subject to amortization is determined to be less than its carrying value, then an impairment charge is recorded to write down that asset to its fair value.

### Inventories

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

### Property, Equipment and Improvements

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

### Trade Accounts Receivable and Allowance for Doubtful Accounts

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

#### Pension and Retirement Plans

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

We have defined benefit and defined contribution plans in the United Kingdom (the "U.K."), Germany and in the U.S. In the U.K. and Germany, the Company provides defined benefit pension plans for certain employees and former employees and

defined contribution plans for the majority of the employees. The defined benefit plans in both the U.K. and Germany are closed to newly hired employees and have been for the two years ended September 30, 2013. In the U.S., the Company also provides defined contribution plans that cover most employees and supplementary retirement plans to certain employees and former employees who are now retired. These supplementary retirement plans are also closed to newly hired employees and have been for the two years ended September 30, 2013. These supplementary plans are funded through whole life insurance policies. The Company expects to recover all insurance premiums paid under these policies in the future, through the cash surrender value of the policies and any death benefits or portions thereof to be paid upon the death of the participant. These whole life insurance policies are carried on the balance sheet at their cash surrender values as they are owned by the Company and not assets of the defined benefit plans. In the U.S., the Company also provides for officer death benefits and post-retirement health insurance benefits through supplemental post-retirement plans to certain officers. The Company also funds these supplemental plans' obligations through whole life insurance policies on the officers.

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

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

#### Revenue Recognition

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

The Company recognizes revenue from software licenses when persuasive evidence of an arrangement exists, delivery of the product has occurred and the fee is fixed or determinable and collectability is probable, in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("FASC") Section 985-605-25 Software - Revenue Recognition ("FASC 985-605-25"). When delivery of services accompany software sales, and vendor specific objective evidence does not exist, and the only undelivered element is services that do not involve significant modification, or customization, of software, then the entire fee is recognized as the services are performed. If no pattern of performance is discernible, the fee is recognized straight line over the service period. In accordance with FASC 985-605-25, for tangible products containing software components and non-software components, we determine whether these elements function together to deliver the tangible product essential functionality. If the software and non-software components of the tangible product function together to deliver the tangible product's essential functionality, software revenue recognition guidance is not applied, but rather other appropriate revenue recognition guidance is followed.

The Company also offers training, maintenance agreements and support services. The Company has established fair value on its training, maintenance and support services based on prices charged in separate sales to customers at prices

established and published in its standard price lists. These prices are not discounted. Revenue from these service obligations under maintenance contracts is deferred and recognized on a straight-line basis over the contractual period, which is typically 3 to 12 months, if all other revenue recognition criteria have been met. Support services provided on a time and material basis are recognized as provided if all of the revenue recognition criteria have been met for that element and the support services have been provided. Training revenue is recognized when performed.

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

The Company follows Sections 605-25 Revenue Recognition - Multiple Element Arrangements ("FASC 605-25"). FASC 605-25 provides accounting principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and how the consideration should be allocated. This guidance provides for separate revenue recognition based upon management's estimate of the selling price for an undelivered item when there is no other means to determine the fair value of that undelivered item.

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

In many cases, our multiple-deliverable arrangements involve initial shipment of hardware (including tangible products that include software and non-software elements), software products and subsequent delivery of services which add value to the products that have been shipped. In some instances, services are performed prior to product shipment, but more typically services are performed subsequent to shipment of the hardware products. The timing of the delivery and performance of deliverables may vary case-by-case. In accordance with FASC 605-25, we evaluate whether we can determine Vendor Specific Objective Evidence ("VSOE") or third-party evidence to allocate revenue among the various elements in an arrangement. When VSOE or third-party evidence cannot be determined, we use estimated selling prices to allocate revenue to the various elements. Estimated selling prices are determined using the targeted gross margin for each element and calculating the gross revenue for each element that would have been required to achieve the targeted gross margin, and allocating revenue to each element based on those relative values. Typically, product revenue which may consist of hardware (including tangible products that include software and non-software elements) and/or software elements are recognized upon shipment, or when risk of loss passes to the customer. Services elements are typically recognized upon completion for fixed-price service arrangements, and as services are performed for time and materials service arrangements.

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

#### Systems Segment Revenue

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

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

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

#### Service and System Integration Segment Revenue

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

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

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

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

We sell certain third party service contracts, which are evaluated to determine whether the sale of such service revenue should be recorded as gross sales or net sales in accordance with the sales recognition criteria as required by accounting principles generally accepted in the U.S. We must determine whether we act as a principal in the transaction and assume the

risks and rewards of ownership or if we are simply acting as an agent or broker. Under gross sales recognition, the entire selling price is recorded in sales and our cost to the third-party service provider or vendor is recorded in cost of goods sold. Under net sales recognition, the cost to the third-party service provider or vendor is recorded as a reduction to sales resulting in net sales equal to the gross profit on the transaction and there are no costs of goods sold. We use the net sales recognition method for the third party service contracts that we sell when we are not the primary obligor on the contract. We use the gross sales recognition for the third party service contracts that we sell when we act as principal and are the primary obligor.

#### Product Warranty Accrual

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

#### Engineering and Development Expenses

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

#### Income Taxes

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

In addition, we are required to recognize in the consolidated financial statements, those tax positions determined to be more-likely-than-not of being sustained upon examination, based on the technical merits of the positions as of the reporting date. If a tax position is not considered more-likely-than-not to be sustained based solely on its technical merits, no benefits of the position are recognized.

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

#### Earnings per Share of Common Stock

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

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

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

|  | For the year ended                           |                    |
|--|--|--------------------|
|  | September 30, 2013                           | September 30, 2012 |
|  | (Amounts in thousands except per share data) |                    |
| Net income   | \$368  | \$6,609            |
| Less: Net income attributable to nonvested common stock  | 7  | 113                |
| Net income attributable to common stockholders   | \$361  | \$6,496            |
| Weighted average total shares outstanding - basic  | 3,458  | 3,421              |
| Less: weighted average non-vested shares outstanding   | 69   | 59                 |
| Weighted average number of common shares outstanding - basic                                   | 3,389  | 3,362              |
| Potential common shares from non-vested stock awards and the assumed exercise of stock options | 52   | 43                 |
| Weighted average common shares outstanding - diluted   | 3,441  | 3,405              |
| Net income per share - basic   | \$0.11                                       | \$1.93             |
| Net income per share - diluted   | \$0.10                                       | \$1.91             |

All anti-dilutive securities, including stock options, are excluded from the diluted income per share computation. For the year ended September 30, 2013, 133 thousand options were excluded from the diluted income per share calculation because their inclusion would have been anti-dilutive. For the year ended September 30, 2012, approximately 197 thousand options were excluded from the diluted income per share calculation because their inclusion would have been anti-dilutive.

#### Use of Estimates

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

#### Stock-Based Compensation

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

Because stock-based compensation expense recognized in the Consolidated Statements of Operations for the fiscal years ended September 30, 2013 and 2012 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures and will be revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Stock-based compensation expense recognized for the fiscal years ended September 30, 2013 and 2012 consisted of stock-based compensation expense related to options and nonvested stock granted pursuant to the Company's stock incentive and employee stock purchase plans of approximately \$149 thousand and \$92 thousand, respectively.

#### Concentrations of Credit Risk

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

#### Subsequent Events

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

## New Accounting Pronouncements and Tax Legislation

In July 2013, the FASB issued Accounting Standards Update 2013-11 Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (“ASU 2013-11”). ASU 2013-11 requires that to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. For example, an entity should not evaluate whether the deferred tax asset expires before the statute of limitations on the tax position or whether the deferred tax asset may be used prior to the unrecognized tax benefit being settled.

ASU 2013-11 is effective for fiscal years and interim periods within those years beginning after December 15, 2013. The Company will adopt this standard for the quarter ending December 31, 2014. The Company has not determined what impact the adoption of this standard will have on the consolidated financial statements.

In February 2013, the FASB issued Accounting Standards Update 2013-02 Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (“ASU 2013-02”). ASU 2013-02 requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts.

ASU 2013-02 is effective for reporting periods beginning after December 15, 2013. The Company will adopt this standard for the quarter ending December 31, 2014. The Company has not determined what impact the adoption of this standard will have on the consolidated financial statements.

In September 2013, the Internal Revenue Service released the final tangible property regulations for Sections 162(a) and 263(a) of the Internal Revenue Code, regarding the deduction and capitalization of amounts paid to acquire, produce, or improve tangible property. The final regulations replace temporary regulations that were issued in December 2011 and are effective for tax years beginning January 1, 2014, with early adoption permitted for tax years beginning January 1, 2012. The final regulations are effective for the Company for its tax year beginning October 1, 2014, and the Company is currently evaluating the impact of the final regulations on its consolidated financial statements.

## 2. Inventories

Inventories consist of the following:

|  | September 30,<br>2013 | September 30,<br>2012 |
|--|-----------------------|-----------------------|
|--|-----------------------|-----------------------|

|                 | (Amounts in thousands) |         |
|-----------------|------------------------|---------|
| Raw materials   | \$1,587                | \$941   |
| Work-in-process | 404                    | 1,407   |
| Finished goods  | 2,800                  | 3,928   |
| Total           | \$4,791                | \$6,276 |

Finished goods includes inventory that has been shipped, but for which all revenue recognition criteria has not been met, of approximately \$0.5 million and \$1.4 million as of September 30, 2013 and September 30, 2012, respectively.

Total inventory balances in the table above are shown net of reserves for obsolescence of approximately \$4.6 million and \$4.4 million as of September 30, 2013 and September 30, 2012, respectively.

## 3. Accumulated Other Comprehensive Loss

The components of Accumulated Other Comprehensive Loss are as follows:

|                                  | Effect of Foreign<br>Currency<br>Translation<br>(Amounts in thousands) | Minimum Pension<br>Liability | Accumulated Other<br>Comprehensive<br>Loss |
|----------------------------------|--|------------------------------|--|
| Balance as of September 30, 2011 | \$(2,228   | ) \$(3,675                   | ) \$(5,903 )                               |
| Change in Period                 | (45  | ) (591                       | ) (636 )                                   |
| Tax effect of change in period   | —  | (73                          | ) (73 )                                    |
| Balance as of September 30, 2012 | \$(2,273   | ) \$(4,339                   | ) \$(6,612 )                               |
| Change in Period                 | 117  | 667                          | 784  |
| Tax effect of change in period   | —  | (37                          | ) (37 )                                    |
| Balance as of September 30, 2013 | \$(2,156   | ) \$(3,709                   | ) \$(5,865 )                               |

The changes in the minimum pension liability are net of amortization of net gain of \$18 thousand in 2013 and net loss of \$182 thousand in 2012 included in net periodic pension cost.

## 4. Income Taxes

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

|                                  | For the Years Ended September<br>30, |           |   |
|----------------------------------|--------------------------------------|-----------|---|
|                                  | 2013                                 | 2012      |   |
|                                  | (Amounts in thousands)               |           |   |
| Income (loss) before income tax: |                                      |           |   |
| U.S.                             | \$809                                | \$4,382   |   |
| Foreign                          | (120                                 | ) 487     |   |
|                                  | \$689                                | \$4,869   |   |
| Income tax expense (benefit):    |                                      |           |   |
| Current:                         |                                      |           |   |
| Federal                          | \$(308                               | ) \$1,088 |   |
| State                            | 62                                   | 58        |   |
| Foreign                          | (3                                   | ) 40      |   |
|                                  | (249                                 | ) 1,186   |   |
| Deferred:                        |                                      |           |   |
| Federal                          | 601                                  | (2,734    | ) |
| State                            | (41                                  | ) (274    | ) |
| Foreign                          | 10                                   | 82        |   |
|                                  | 570                                  | (2,926    | ) |
|                                  | \$321                                | \$ (1,740 | ) |

As of September 30, 2013, management assessed the positive and negative evidence in the U.S operations, and estimated we will have sufficient future taxable income to utilize the existing deferred tax assets. Significant objective positive evidence included the cumulative profits that we realized over the most recent years. This evidence enhances our ability to consider other subjective evidence such as our projections for future growth. Other factors we considered are the likelihood for continued royalty income in future years, and our expectation that the Service and Systems Integration segment will continue to be profitable in future years. On the basis of this evaluation, as of September 30, 2013, we have concluded that our US deferred tax asset is more likely than not to be realized. It should be noted however, that the amount of the deferred tax asset realized could be adjusted in future years, if estimates of taxable income during the carryforward periods are reduced, or if objective negative evidence in the form of cumulative losses is present.

We realized a tax benefit for the year ended September 30, 2012, despite the fact that we had positive earnings before taxes for the year. This was because we reversed the U.S. valuation allowance of \$3.0 million on our deferred tax assets, which had been accumulated over the past several years, resulting in this overall tax benefit. The recording and ultimate reversal of valuation allowances for our deferred tax asset requires significant judgment associated with past and projected performance. In assessing the realizability of deferred tax assets, we consider our taxable future earnings and the expected timing of the reversal of temporary differences. In prior years, we recorded a valuation allowance which reduced the gross deferred tax asset to an amount that we believed was more likely than not to be realized because our inability to project future profitability beyond fiscal year 2012 in the U.S. and cumulative losses incurred in recent years in the United Kingdom represented sufficient negative evidence to record a valuation allowance against certain deferred tax assets.

We continue to maintain a full valuation allowance against our United Kingdom deferred tax assets as we have experienced cumulative losses and do not have any indication that the operation will be profitable in the future to an extent that will allow us to utilize much of our net operating loss carryforwards. To the extent that actual experience deviates from our assumptions, our projections would be affected and hence our assessment of realizability of our deferred tax assets may change.

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

|   | For the Years Ended September 30, |        |      |          |         |    |
|---|-----------------------------------|--------|------|----------|---------|----|
|   | 2013                              |        | 2012 |          |         |    |
|   | (Dollar amounts in thousands)     |        |      |          |         |    |
| Computed “expected” tax expense                 | \$234                             | 34.0   | %    | \$1,656  | 34.0    | %  |
| Increases (reductions) in taxes resulting from: |                                   |        |      |          |         |    |
| State income taxes, net of federal tax benefit  | 1                                 | 0.3    | %    | (236     | ) (4.9  | )% |
| Foreign operations                              | 40                                | 5.8    | %    | (176     | ) (3.6  | )% |
| Change in valuation allowance                   | —                                 | —      | %    | (2,762   | ) (56.8 | )% |
| Permanent differences                           | (22                               | ) (3.2 | )%   | (388     | ) (8.0  | )% |
| Stock-based compensation                        | 158                               | 22.9   | %    | 4        | 0.1     | %  |
| Foreign net operating loss                      | (15                               | ) (2.2 | )%   | 107      | 2.2     | %  |
| Uncertain tax liability adjustment              | (61                               | ) (8.9 | )%   | 37       | 0.8     | %  |
| Research & Development Credit                   | (50                               | ) (7.3 | )%   | —        | —       | %  |
| Other items                                     | 36                                | 5.2    | %    | 18       | 0.4     | %  |
| Income tax expense (benefit)                    | \$321                             | 46.6   | %    | \$(1,740 | ) (35.8 | )% |

For the years ended September 30, 2013 and 2012, temporary differences, which give rise to deferred tax assets (liabilities), are as follows:

|  | September 30,<br>2013  | September 30,<br>2012 |
|--|------------------------|-----------------------|
|  | (Amounts in thousands) |                       |
| Deferred tax assets:                               |                        |                       |
| Pension  | \$1,539                | \$1,911               |
| Goodwill   | 606                    | 723                   |
| Other reserves and accruals                        | 498                    | 625                   |
| Inventory reserves and other                       | 703                    | 713                   |
| State credits, net of federal benefit              | 34                     | 79                    |
| Federal and state net operating loss carryforwards | 45                     | 30                    |
| Foreign net operating loss carryforwards           | 1,804                  | 1,815                 |
| Foreign tax credits                                | 7                      | 7                     |
| Depreciation and amortization                      | 109                    | 61                    |
| Gross deferred tax assets                          | 5,345                  | 5,964                 |
| Less: valuation allowance                          | (2,261                 | ) (2,307              |
| Realizable deferred tax asset                      | 3,084                  | 3,657                 |
| Gross deferred tax liabilities                     | —                      | —                     |
| Net deferred tax assets                            | \$3,084                | \$3,657               |

The deferred tax valuation allowance decreased by approximately \$50 thousand, as shown above. In assessing the realizability of deferred tax assets, the Company considers its taxable future earnings and the expected timing of the reversal of temporary differences. Accordingly, the Company has recorded a valuation allowance which reduces the gross deferred tax asset to an amount which management believes will more likely than not be realized. The valuation allowance was determined by assessing both positive and negative evidence whether it is more likely than not that deferred tax assets are realizable. Such assessment is done on a jurisdiction-by-jurisdiction basis. The Company's inability to project future profitability beyond fiscal year 2013 and the cumulative losses incurred in recent years in the U.K. represent sufficient negative evidence to record a valuation allowance against certain deferred tax assets.

As of September 30, 2013 and 2012, the Company had U.S. net operating loss carryforwards for state tax purposes of approximately \$1.2 million which are available to offset future taxable income through 2030.

As of September 30, 2013, the Company had U.K. net operating loss carryforwards of approximately \$8.9 million that have an indefinite life with no expiration.

Undistributed earnings of the Company's foreign subsidiaries amounted to approximately \$3.3 million and \$3.4 million at September 30, 2013 and 2012, respectively. The Company's policy is that its undistributed foreign earnings are indefinitely reinvested and, accordingly, no U.S. federal and state deferred tax liabilities have been recorded.

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

As of September 30, 2013, the total amount of uncertain tax liabilities was \$0.6 million, all of which would affect our effective tax rate if recognized. We recognize interest and potential penalties accrued related to unrecognized tax benefits in our provision for income taxes.

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

|  | For the Year Ended<br>September 30, 2013<br>(Amounts in thousands) | For the Year Ended<br>September 30, 2012 |
|--|--|--|
| Balance, beginning of year                     | \$611  | \$472                                    |
| Increases in tax positions in the current year | 39   | 104                                      |
| Settlements                                    | (105   | ) —                                      |
| Lapse in statute of limitations                | —  | (2                                       |
| Accrued penalties and interest                 | 44   | 37                                       |
| Balance, end of period                         | \$589  | \$611                                    |

We file income tax returns in the U.S. federal jurisdictions and various state and foreign jurisdictions. The Company has reviewed the tax positions taken on returns filed domestically and in its foreign jurisdictions for all open years, generally fiscal 2010 through 2013, and believes that tax adjustments in any audited year will not be material, except for the uncertain tax position described above.

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

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

|  | September 30,<br>2013  | September 30,<br>2012 |
|--|------------------------|-----------------------|
|  | (Amounts in thousands) |                       |
| Leasehold improvements                         | \$370                  | \$370                 |
| Equipment                                      | 8,009                  | 7,178                 |
| Automobiles                                    | 67                     | 118                   |
|  | 8,446                  | 7,666                 |
| Less accumulated depreciation and amortization | (7,026                 | ) (6,675              |
| Property, equipment and improvements, net      | \$1,420                | \$991                 |

The Company uses the straight-line method over the estimated useful lives of the assets to record depreciation expense. Depreciation expense was \$438 thousand and \$378 thousand for the years ended September 30, 2013 and 2012, respectively.

## 6. Acquired Intangible Assets

As of September 30, 2013 and 2012, intangible assets are as follows:

|                           | September 30, 2013   |       |                             |       | September 30, 2012   |       |                             |       |
|---------------------------|--|-------|-----------------------------|-------|--|-------|-----------------------------|-------|
|                           | Weighted<br>Average<br>Remaining<br>Amortization<br>Period<br>(Amounts in thousands) | Gross | Accumulated<br>Amortization | Net   | Weighted<br>Average<br>Remaining<br>Amortization<br>Period | Gross | Accumulated<br>Amortization | Net   |
| Customer list             | 5 years  | \$820 | \$410                       | \$410 | 6 years  | \$820 | \$328                       | \$492 |
| Non-Compete<br>agreements | —  | 93    | 93                          | —     | —  | 93    | 93                          | —     |
| Total                     | 5 years  | \$913 | \$503                       | \$410 | 6 years  | \$913 | \$421                       | \$492 |

Amortization expense on these intangible assets was \$82 thousand and \$82 thousand for fiscal 2013 and 2012, respectively.

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

| Fiscal year ending September 30: | (Amounts in thousands) |
|----------------------------------|------------------------|
| 2014                             | \$82                   |
| 2015                             | 82                     |
| 2016                             | 82                     |
| 2017                             | 82                     |
| 2018                             | 82                     |
| Total                            | \$410                  |

## 7. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consist of the following:

|   | September 30,          |          |
|---|------------------------|----------|
|   | 2013                   | 2012     |
|   | (Amounts in thousands) |          |
| Accounts payable                                    | \$6,940                | \$9,458  |
| Commissions   | 209                    | 225      |
| Compensation and fringe benefits                    | 2,202                  | 2,593    |
| Professional fees and shareholders' reporting costs | 450                    | 572      |
| Taxes, other than income                            | 316                    | 316      |
| Warranty  | 109                    | 146      |
| Current portion of capital lease                    | —                      | 13       |
| Other   | 277                    | 251      |
|   | \$10,503               | \$13,574 |

## 8. Stock Options and Awards

In 1997, the Company adopted the 1997 Stock Option Plan (the "1997 Plan"), and authorized 199,650 shares of common stock to be reserved for issuance pursuant to the 1997 Plan. The 1997 plan expired in 2007. Because the 1997 Plan has expired, no further awards will be issued under this plan. In 2003, the Company adopted the 2003 Stock Incentive Plan (the "2003 Plan") and authorized 200,000 shares of common stock to be reserved for issuance pursuant to

the 2003 Plan. As of September 30, 2013, there were 76,750 shares available to be granted under the 2003 Plan. In 2007, the Company adopted the 2007 Stock Incentive Plan (the “2007 Plan”) and authorized 250,000 shares of common stock to be reserved for issuance pursuant to the 2007 Plan. As of September 30, 2013, there were 107,283 shares available to be granted under the 2007 Plan. In 2003, the Company issued non-qualified stock options to non-officer employees hired as part of an acquisition. These options were granted at their fair value on the date of grant. These options vested over a period of four years and expire ten years from the date of grant. Under all of the stock incentive plans, both incentive stock options and non-qualified stock options may be

granted to officers, key employees and other persons providing services to the Company. The 2003 Plan and 2007 Plan also provide for awards of nonvested shares of common stock. All of the Company's stock incentive plans have a ten year life. The total number of available shares under all plans for future awards was 184,033 as of September 30, 2013.

Options issued under any of the stock option plans are not affected by termination of the plan. The Company issues stock options at their fair market value on the date of grant. Vesting of stock options granted pursuant to the Company's stock incentive plans is determined by the Company's compensation committee. Generally, options granted to employees vest over four years and expire ten years from the date of grant. Options granted to non-employee directors have historically included cliff vesting after six months from the date of grant and expire three years from the date of grant. In fiscal 2011, 2012 and 2013, the Company granted certain officers including its Chief Executive Officer and non-employee directors shares of nonvested common stock instead of stock options. The vesting periods for the officers', the Chief Executive Officer's and the directors' nonvested stock awards are four years, three years and one year, respectively.

We measure and recognize compensation expense for all stock-based payment awards made to employees and directors including employee stock options and awards of nonvested stock based on estimated fair values, as described in note 1. Stock-based compensation expense incurred and recognized for the years ended September 30, 2013 and 2012 related to stock options and nonvested stock granted to employees and non-employee directors under the Company's stock incentive and employee stock purchase plans totaled approximately \$149 thousand and \$92 thousand, respectively. The classification of the cost of share-based compensation, in the statements of operations, is consistent with the nature of the services being rendered in exchange for the share based payment. The following table summarizes stock-based compensation expense in the Company's consolidated statements of operations:

|                                     | Year ended             |                       |
|-------------------------------------|------------------------|-----------------------|
|                                     | September 30,<br>2013  | September 30,<br>2012 |
|                                     | (Amounts in thousands) |                       |
| Cost of sales                       | \$ 1                   | \$ —                  |
| Engineering and development         | 4                      | 5                     |
| Selling, general and administrative | 144                    | 87                    |
| Total                               | \$ 149                 | \$ 92                 |

For the year ended September 30, 2013, the Company granted 7,500 nonvested shares to certain key employees, 36,000 nonvested shares to certain officers, which includes 30,000 shares granted to the Chief Executive Officer and 13,750 nonvested shares to its non-employee directors. For the year ended September 30, 2012, the Company granted 1,750 stock options to certain key employees, 28,000 nonvested shares to certain officers including its Chief Executive Officer and 10,000 nonvested shares to its non-employee directors.

The Company measures the fair value of nonvested stock awards based upon the market price of its common stock as of the date of grant. The Company uses the Black-Scholes option-pricing model to value stock options. The Black-Scholes model requires the use of a number of assumptions including volatility of the Company's stock price, the weighted average risk-free interest rate and the weighted average expected life of the options, at the time of grant. The expected dividend yield is equal to the dividend per share declared, divided by the closing share price on the date the options were granted. All equity compensation awards granted for the year ended September 30, 2013 were non-vested stock awards. The table below summarizes the assumptions used to value the options that were issued for fiscal year 2012:

Year ended

|                          | September 30,<br>2013 | September 30,<br>2012 |
|--------------------------|-----------------------|-----------------------|
| Expected volatility      | —%                    | 52%                   |
| Expected dividend yield  | —%                    | 2.92%                 |
| Risk-free interest rate  | —%                    | 1.32%                 |
| Expected term (in years) | 0.00                  | 7.25                  |

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

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

The expected terms of employee stock options represent weighted-average periods that the stock options are expected to remain outstanding. They are based upon the historical average of the actual terms that stock options were outstanding, or are expected to be outstanding. Management believes this historical data is representative of the expected term of options granted for the years ended September 30, 2013 and 2012.

As stock-based compensation expense recognized in the consolidated statements of operations is based on awards ultimately expected to vest, expense for grants beginning upon adoption on October 1, 2005 has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The forfeiture rates for the years ended September 30, 2013 and 2012 were based on actual forfeitures.

No cash was used to settle equity instruments granted under share-based payment arrangements in any of the years in the two-year period ended September 30, 2013.

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

|   | Number<br>of Shares | Weighted<br>average<br>exercise<br>price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|---|---------------------|--|---|---|
| Outstanding at September 30, 2011                 | 245,425             | \$7.13                                   | —   | —   |
| Granted   | 1,750               | \$3.43                                   | —   | —   |
| Expired   | (750 )              | \$4.79                                   | —   | —   |
| Forfeited   | —                   | —  | —   | —   |
| Exercised   | —                   | —  | —   | —   |
| Outstanding at September 30, 2012                 | 246,425             | \$7.11                                   | —   | —   |
| Granted   | —                   | —  | —   | —   |
| Expired   | (97,500 )           | \$8.46                                   | —   | —   |
| Forfeited   | —                   | —  | —   | —   |
| Exercised   | (41,249 )           | 2.77                                     | —   | —   |
| Outstanding at September 30, 2013                 | 107,676             | \$7.56                                   | 2.89 Years  | \$88  |
| Exercisable at September 30, 2013                 | 104,925             | \$7.67                                   | 2.77 Years  | \$78  |
| Vested and expected to vest at September 30, 2013 | 107,676             | \$7.56                                   | 2.89 Years  | \$88  |

There were no stock options granted in the year ended September 30, 2013. The weighted average grant date fair value of stock options granted during the year ended September 30, 2012 was \$3.43. The aggregate intrinsic value of stock options exercised during the year ended September 30, 2013 was \$218 thousand. There were no stock options exercised in fiscal 2012.

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

|  | Number of<br>nonvested<br>shares | Weighted<br>Average<br>grant date<br>Fair<br>Value | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|--|----------------------------------|--|---|---|
| Nonvested shares outstanding at September 30, 2011 | 55,849                           | \$3.86   | —   | —   |
| Activity in 2012:                                  |                                  |  |   |   |
| Granted  | 38,000                           | \$3.56   | —   | —   |
| Vested   | (27,766)                         | ) \$3.87   | —   | —   |
| Forfeited  | (29,333)                         | ) —  | —   | —   |
| Nonvested shares outstanding at September 30, 2012 | 36,750                           | \$3.68   | —   | —   |
| Activity in 2013:                                  |                                  |  |   |   |
| Granted  | 57,250                           | \$5.80   | —   | —   |
| Vested   | (18,000)                         | ) \$3.79   | —   | —   |
| Forfeited  | (2,500)                          | ) 6.63   | —   | —   |
| Nonvested shares outstanding at September 30, 2013 | 73,500                           | \$5.21   | 2.18 Years  | \$520   |
| Vested at September 30, 2013                       | 81,217                           | \$3.67   | 0.26 Years  | \$574   |
| Vested and expected to vest at September 30, 2013  | 154,717                          | \$4.40   | 1.17 Years  | \$1,094   |

As of September 30, 2013 there was \$267 thousand of total unrecognized compensation cost related to nonvested share-based compensation arrangements (including stock option and nonvested stock awards) granted under the company's stock incentive plans. This cost is expected to be expensed over a weighted average period of approximately 2.27 years. The total fair value of shares vested during the years ended September 30, 2013 and 2012 was \$76 thousand and \$141 thousand, respectively.

## 9. Pension and Retirement Plans

We have defined benefit and defined contribution plans in the U.K., Germany and in the U.S. In the U.K. and Germany, the Company provides defined benefit pension plans for certain employees and former employees and defined contribution plans for the majority of the employees. The defined benefit plans in both the U.K. and Germany are closed to newly hired employees and have been for the two years ended September 30, 2013. In the U.S., the Company also provides defined contribution plans that cover most employees and supplementary retirement plans to certain employees and former employees who are now retired. These supplementary retirement plans are also closed to newly hired employees and have been for the two years ended September 30, 2013. These supplementary plans are funded through whole life insurance policies. The Company expects to recover all insurance premiums paid under these policies in the future, through the cash surrender value of the policies and any death benefits or portions thereof to be paid upon the death of the participant. These whole life insurance policies are carried on the balance sheet at their cash surrender values as they are owned by the Company and not assets of the defined benefit plans. In the U.S., the Company also provides for officer death benefits and post-retirement health insurance benefits through supplemental post-retirement plans to certain officers. The Company also funds these supplemental plans' obligations through whole life insurance policies on the officers.

### Defined Benefit Plans

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

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

The domestic supplemental retirement plans have life insurance policies which are not considered plan assets but were purchased by the Company as a vehicle to fund the costs of the plan. These insurance policies are included in the balance sheet at their cash surrender value, net of policy loans, aggregating \$1.8 million and \$1.8 million as of September 30, 2013 and 2012,

respectively. The loans against the policies have been taken out by the Company to pay the premiums. The costs and benefit payments for these plans are paid through operating cash flows of the Company to the extent that they can not be funded through the use of the cash values in the insurance policies. The Company expects that the recorded value of the insurance policies will be sufficient to fund all of the Company's obligations under these plans.

#### Assumptions:

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

|                                 | Domestic      |        | International |        |   |  |
|---------------------------------|---------------|--------|---------------|--------|---|--|
|                                 | September 30, |        | September 30, |        |   |  |
|                                 | 2013          | 2012   | 2013          | 2012   |   |  |
| Discount rate:                  | 5.00          | % 4.00 | % 4.40        | % 4.05 | % |  |
| Expected return on plan assets: | —             | % —    | % 4.80        | % 4.70 | % |  |
| Rate of compensation increase:  | —             | % —    | % 1.00        | % 1.00 | % |  |

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

|                                 | Domestic      |        | International |        |   |  |
|---------------------------------|---------------|--------|---------------|--------|---|--|
|                                 | September 30, |        | September 30, |        |   |  |
|                                 | 2013          | 2012   | 2013          | 2012   |   |  |
| Discount rate:                  | 4.75          | % 5.25 | % 4.05        | % 5.04 | % |  |
| Expected return on plan assets: | —             | % —    | % 5.40        | % 5.40 | % |  |
| Rate of compensation increase:  | —             | % —    | % 1.12        | % 1.12 | % |  |

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

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

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

|  | Years Ended September 30 |         |          |         |          |         |
|--|--------------------------|---------|----------|---------|----------|---------|
|  | 2013                     |         |          | 2012    |          |         |
|  | Foreign                  | U.S.    | Total    | Foreign | U.S.     | Total   |
|  | (amounts in thousands)   |         |          |         |          |         |
| <b>Pension:</b>  |                          |         |          |         |          |         |
| Service cost   | \$59                     | \$—     | \$59     | \$61    | \$10     | \$71    |
| Interest cost  | 683                      | 64      | 747      | 708     | 84       | 792     |
| Expected return on plan assets   | (410 )                   | —       | (410 )   | (462 )  | —        | (462 )  |
| <b>Amortization of:</b>  |                          |         |          |         |          |         |
| Prior service gains  | —                        | —       | —        | —       | —        | —       |
| Amortization of net (gain)/loss  | 141                      | 24      | 165      | 82      | 30       | 112     |
| Net periodic benefit cost  | \$473                    | \$88    | \$561    | \$389   | \$124    | \$513   |
| <b>Post Retirement:</b>  |                          |         |          |         |          |         |
| Service cost   | \$—                      | \$—     | \$—      | \$—     | \$—      | \$—     |
| Interest cost  | —                        | 35      | 35       | —       | 71       | 71      |
| Expected return on plan assets   | —                        | —       | —        | —       | —        | —       |
| <b>Amortization of:</b>  |                          |         |          |         |          |         |
| Prior service costs/(gains)  | —                        | —       | —        | —       | —        | —       |
| Amortization of net (gain)/loss  | —                        | (183 )  | (183 )   | —       | 70       | 70      |
| Net periodic benefit cost  | \$—                      | \$(148) | \$(148)  | \$—     | \$141    | \$141   |
| <b>Pension:</b>  |                          |         |          |         |          |         |
| Increase (decrease) in minimum liability included in other comprehensive income (loss) | \$(688 )                 | \$(104) | \$(792 ) | \$1,367 | \$(14 )  | \$1,353 |
| <b>Post Retirement:</b>  |                          |         |          |         |          |         |
| Increase (decrease) in minimum liability included in other comprehensive income (loss) | —                        | 127     | 127      | —       | (762 )   | (762 )  |
| <b>Total:</b>  |                          |         |          |         |          |         |
| Increase (decrease) in minimum liability included in comprehensive income (loss)       | \$(688 )                 | \$23    | \$(665 ) | \$1,367 | \$(776 ) | \$591   |

The following table presents an analysis of the changes in 2013 and 2012 of the benefit obligation, the plan assets and the funded status of the plans:

|   | Years Ended September 30 |             |             |             |             |             |
|---|--------------------------|-------------|-------------|-------------|-------------|-------------|
|   | 2013                     |             |             | 2012        |             |             |
|   | Foreign                  | U.S.        | Total       | Foreign     | U.S.        | Total       |
|   | (Amounts in thousands)   |             |             |             |             |             |
| <b>Pension:</b>                                 |                          |             |             |             |             |             |
| Change in projected benefit obligation (“PBO”): |                          |             |             |             |             |             |
| Balance beginning of year                       | \$ 16,575                | \$ 1,605    | \$ 18,180   | \$ 14,107   | \$ 1,759    | \$ 15,866   |
| Service cost                                    | 59                       | —           | 59          | 61          | 10          | 71          |
| Interest cost                                   | 683                      | 64          | 747         | 708         | 84          | 792         |
| Changes in actuarial assumptions                | (508 )                   | (76 )       | (584 )      | 1,863       | 13          | 1,876       |
| Foreign exchange impact                         | 235                      | —           | 235         | 271         | —           | 271         |
| Benefits paid                                   | (393 )                   | (222 )      | (615 )      | (435 )      | (261 )      | (696 )      |
| Projected benefit obligation at end of year     | \$ 16,651                | \$ 1,371    | \$ 18,022   | \$ 16,575   | \$ 1,605    | \$ 18,180   |
| Changes in fair value of plan assets:           |                          |             |             |             |             |             |
| Fair value of plan assets at beginning of year  | \$ 8,914                 | \$ —        | \$ 8,914    | \$ 7,598    | \$ —        | \$ 7,598    |
| Actual gain (loss) on plan assets               | 475                      | —           | 475         | 1,004       | —           | 1,004       |
| Company contributions                           | 451                      | 222         | 673         | 441         | 261         | 702         |
| Foreign exchange impact                         | 26                       | —           | 26          | 306         | —           | 306         |
| Benefits paid                                   | (393 )                   | (222 )      | (615 )      | (435 )      | (261 )      | (696 )      |
| Fair value of plan assets at end of year        | \$ 9,473                 | \$ —        | \$ 9,473    | \$ 8,914    | —           | \$ 8,914    |
| Funded status                                   | \$ (7,178 )              | \$ (1,371 ) | \$ (8,549 ) | \$ (7,661 ) | \$ (1,605 ) | \$ (9,266 ) |
| Unamortized net loss                            | —                        | —           | —           | —           | —           | —           |
| Net amount recognized                           | \$ (7,178 )              | \$ (1,371 ) | \$ (8,549 ) | \$ (7,661 ) | \$ (1,605 ) | \$ (9,266 ) |
| <b>Post Retirement:</b>                         |                          |             |             |             |             |             |
| Change in projected benefit obligation (“PBO”): |                          |             |             |             |             |             |
| Balance beginning of year                       | \$ —                     | \$ 882      | \$ 882      | \$ —        | \$ 1,498    | \$ 1,498    |
| Service cost                                    | —                        | —           | —           | —           | —           | —           |
| Interest cost                                   | —                        | 35          | 35          | —           | 71          | 71          |
| Changes in actuarial assumptions                | —                        | (60 )       | (60 )       | —           | —           | —           |
| Foreign exchange impact                         | —                        | —           | —           | —           | (687 )      | (687 )      |
| Benefits paid                                   | —                        | —           | —           | —           | —           | —           |
| Projected benefit obligation at end of year     | \$ —                     | \$ 857      | \$ 857      | \$ —        | \$ 882      | \$ 882      |
| Changes in fair value of plan assets:           |                          |             |             |             |             |             |
| Fair value of plan assets at beginning of year  | —                        | —           | —           | —           | —           | —           |
| Actual gain/(loss) on plan assets               | —                        | —           | —           | —           | —           | —           |
| Company contributions                           | —                        | —           | —           | —           | —           | —           |
| Foreign exchange impact                         | —                        | —           | —           | —           | —           | —           |
| Benefits paid from plan assets                  | —                        | —           | —           | —           | —           | —           |
| Fair value of plan assets at end of year        | \$ —                     | \$ —        | \$ —        | \$ —        | \$ —        | \$ —        |
| Funded status                                   | \$ —                     | \$ (857 )   | \$ (857 )   | \$ —        | \$ (882 )   | \$ (882 )   |
| Unamortized net loss                            | —                        | —           | —           | —           | —           | —           |
| Net amount recognized                           | \$ —                     | \$ (857 )   | \$ (857 )   | \$ —        | \$ (882 )   | \$ (882 )   |

The amounts recognized in the consolidated balance sheet consist of:

|   | Years Ended September 30 |            |             | 2012        |            |             |
|---|--------------------------|------------|-------------|-------------|------------|-------------|
|   | 2013                     |            |             | 2012        |            |             |
|   | Foreign                  | U.S.       | Total       | Foreign     | U.S.       | Total       |
|   | (Amounts in thousands)   |            |             |             |            |             |
| <b>Pension:</b>                           |                          |            |             |             |            |             |
| Accrued benefit liability                 | \$(7,178 )               | \$(1,371 ) | \$(8,549 )  | \$(7,661 )  | \$(1,605 ) | \$(9,266 )  |
| Deferred tax                              | (188 )                   | 29         | (159 )      | (233 )      | 6          | (227 )      |
| Accumulated other comprehensive income    | 3,895                    | 1          | 3,896       | 4,540       | 82         | 4,622       |
| Net amount recognized                     | \$(3,471 )               | \$(1,341 ) | \$(4,812 )  | \$(3,354 )  | \$(1,517 ) | \$(4,871 )  |
| <b>Post Retirement:</b>                   |                          |            |             |             |            |             |
| Accrued benefit liability                 | \$—                      | \$(857 )   | \$(857 )    | \$—         | \$(882 )   | \$(882 )    |
| Deferred tax                              | —                        | 239        | 239         | —           | 269        | 269         |
| Accumulated other comprehensive income    | —                        | (186 )     | (186 )      | —           | (283 )     | (283 )      |
| Net amount recognized                     | \$—                      | \$(804 )   | \$(804 )    | \$—         | \$(896 )   | \$(896 )    |
| <b>Total pension and post retirement:</b> |                          |            |             |             |            |             |
| Accrued benefit liability                 | \$(7,178 )               | \$(2,228 ) | \$(9,406 )  | \$(7,661 )  | \$(2,487 ) | \$(10,148 ) |
| Deferred tax                              | (188 )                   | 268        | 80          | (233 )      | 275        | 42          |
| Accumulated other comprehensive income    | 3,895                    | (185 )     | 3,710       | 4,540       | (201 )     | 4,339       |
| Net amount recognized                     | \$(3,471 )               | \$(2,145 ) | \$(5,616 )  | \$(3,354 )  | \$(2,413 ) | \$(5,767 )  |
| <b>Accumulated Benefit Obligation:</b>    |                          |            |             |             |            |             |
| Pension                                   | \$(16,541 )              | \$(1,371 ) | \$(17,912 ) | \$(16,469 ) | \$(1,605 ) | \$(18,074 ) |
| Post Retirement                           | —                        | (857 )     | (857 )      | —           | (882 )     | (882 )      |
| Total accumulated benefit obligation      | \$(16,541 )              | \$(2,228 ) | \$(18,769 ) | \$(16,469 ) | \$(2,487 ) | \$(18,956 ) |

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

Accrued benefit liability reported as:

|                                      | September 30,          |          |
|--------------------------------------|------------------------|----------|
|                                      | 2013                   | 2012     |
|                                      | (Amounts in thousands) |          |
| Current accrued benefit liability    | \$746                  | \$717    |
| Noncurrent accrued benefit liability | 8,660                  | 9,431    |
| Total accrued benefit liability      | \$9,406                | \$10,148 |

As of September 30, 2013 and 2012 the amounts included in accumulated other comprehensive income, consisted of deferred net losses totaling approximately \$3.7 million and \$4.3 million, respectively.

The amount of net deferred gain expected to be recognized as a component of net periodic benefit cost for the year ending September 30, 2013, is approximately \$62 thousand.

#### Contributions

The Company expects to contribute \$0.7 million to its pension plans for fiscal 2013.



## Estimated Future Benefit Payments

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

| Fiscal year ending September 30: | (Amounts in thousands) |
|----------------------------------|------------------------|
| 2014                             | \$712                  |
| 2015                             | 761                    |
| 2016                             | 792                    |
| 2017                             | 786                    |
| 2018                             | 763                    |
| Thereafter                       | 4,486                  |

## Plan Assets

At September 30, 2013, our pension plan in the U.K. was the only plan with assets, holding investments of approximately \$9.5 million. Pension plan assets are managed by a fiduciary committee. The Company's investment strategy for pension plan assets is to maximize the long-term rate of return on plan assets within an acceptable level of risk while maintaining adequate funding levels. Local regulations, local funding rules, and local financial and tax considerations are part of the funding and investment process. In deciding on the investments to be held, the trustees take into account the risk of possible fluctuations in income from, and market values of, the assets as well as the risk of departing from an asset profile which broadly matches the liability profile. The committee has invested the plan assets in a single pooled fund with an authorized investment company (the "Fund"). The Fund selected by the trustees is consistent with the plan's overall investment principles and strategy described herein. There are no specific targets as to asset allocation other than those contained within the Fund that is managed by the authorized investment company.

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

| Asset Category    | Fair Values as of<br>September 30, 2013<br>Fair Value Measurements Using Inputs<br>Considered as |         |          |           | September 30, 2012<br>Fair Value Measurements Using Inputs Considered<br>as |         |          |           |
|-------------------|--|---------|----------|-----------|---|---------|----------|-----------|
|                   | Total<br>(Thousands)   | Level I | Level II | Level III | Total   | Level I | Level II | Level III |
| Cash on deposit   | \$452  | 452     | \$—      | \$—       | \$392   | \$392   | \$—      | \$—       |
| Pooled Funds      | 9,021  | —       | 9,021    | —         | 8,522   | —       | 8,522    | —         |
| Total Plan Assets | \$9,473  | \$452   | \$9,021  | \$—       | \$8,914   | \$392   | \$8,522  | \$—       |

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

The Company uses the Net Asset Value ("NAV") to determine the fair value of the underlying investments which (a) do not have readily determinable fair value; and (b) prepare their financial statements consistent with the measurement principles of an investment company. The Fund is not exchange traded. The Fund is not subject to any redemption notice periods or restrictions and can be redeemed on a daily basis. No gates or holdbacks or dealing suspensions are being applied to the Fund. The Fund is of perpetual duration.

#### Defined Contribution Plans

The Company has defined contribution plans in domestic and international locations under which the Company matches a portion of the employee's contributions and may make discretionary contributions to the plans. The Company's contributions were \$185 thousand and \$172 thousand for the years ended September 30, 2013 and 2012, respectively.

## 10. Lines of Credit

As of September 30, 2013 and September 30, 2012, the Company maintained lines of credit notes that allow for borrowings of up to \$2.5 million. Availability under these facilities is reduced by outstanding borrowings thereunder. The interest rates on outstanding borrowings range from Prime plus 1% to London Inter-Bank Offer Rate (“LIBOR”) plus 2.5%, with a floor of 4%. Borrowings under the credit agreements are required to be repaid on demand by the lender in some cases, upon termination of the agreements or may be prepaid by the Company without penalty. The credit agreements contain various covenants including financial covenants which require the Company to maintain various financial ratios at prescribed levels.

In addition to the terms described above, the Company maintains an inventory line of credit in connection with one of the credit lines included in the description above. The inventory line of credit may be used by the Company to purchase inventory from approved vendors with payment terms which exceed those offered by the vendors. No interest accrues under the inventory line of credit. The amounts outstanding under the inventory line of credit as of September 30, 2013 was approximately \$2.4 million and \$3.1 million as of September 30, 2012. These amounts are included in accounts payable in the consolidated financial statements.

## 11. Commitments and Contingencies

### Leases

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

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

| Fiscal year ending September 30: | (Amounts in thousands) |
|----------------------------------|------------------------|
| 2014                             | \$789                  |
| 2015                             | 516                    |
| 2016                             | 273                    |
| 2017                             | 43                     |
| 2018                             | —                      |
| Thereafter                       | —                      |
|                                  | \$1,621                |

Occupancy expenses under the operating leases approximated \$1.0 million in 2013 and \$1.1 million in 2012.

### Common Stock Repurchase

From time to time the Company's Board of Directors passes resolutions to authorize the Company to purchase shares of its outstanding common stock. Pursuant to such resolutions, the Company repurchased approximately 28 thousand shares of its outstanding common stock during the year ended September 30, 2012. The Company did not repurchase any shares during the year ended September 30, 2013. As of September 30, 2013 the Company is authorized to repurchase an additional 201 thousand shares pursuant to such resolutions.



## 12. Segment Information

The following table presents certain operating segment information.

| For the Years Ended September 30, | Systems<br>Segment<br>(Amounts in thousands) | Service and System Integration Segment |                   |          | Total    | Consolidated<br>Total |
|-----------------------------------|--|--|-------------------|----------|----------|-----------------------|
|                                   |  | Germany                                | United<br>Kingdom | U.S.     |          |                       |
| 2013                              |  |  |                   |          |          |                       |
| Sales:                            |  |  |                   |          |          |                       |
| Product                           | \$5,483                                      | \$8,666                                | \$581             | \$51,114 | \$60,361 | \$65,844              |
| Service                           | 1,517  | 14,975                                 | 1,409             | 3,874    | 20,258   | 21,775                |
| Total sales                       | 7,000  | 23,641                                 | 1,990             | 54,988   | 80,619   | 87,619                |
| Profit from operations            | (1,603)                                      | ) 154                                  | (141)             | ) 2,291  | 2,304    | 701                   |
| Assets                            | 15,377                                       | 13,094                                 | 3,170             | 15,584   | 31,848   | 47,225                |
| Capital expenditures              | 340  | 232                                    | 8                 | 278      | 518      | 858                   |
| Depreciation and amortization     | 155  | 183                                    | 13                | 169      | 365      | 520                   |
| 2012                              |  |  |                   |          |          |                       |
| Sales:                            |  |  |                   |          |          |                       |
| Product                           | \$4,214                                      | \$16,846                               | \$1,484           | \$37,039 | \$55,369 | \$59,583              |
| Service                           | 6,927  | 13,730                                 | 1,434             | 3,133    | 18,297   | 25,224                |
| Total sales                       | 11,141                                       | 30,576                                 | 2,918             | 40,172   | 73,666   | 84,807                |
| Profit (loss) from operations     | 3,230  | 598                                    | 57                | 1,084    | 1,739    | 4,969                 |
| Assets                            | 18,451                                       | 14,058                                 | 3,504             | 15,053   | 32,615   | 51,066                |
| Capital expenditures              | 222  | 197                                    | 27                | 105      | 329      | 551                   |
| Depreciation and amortization     | 111  | 167                                    | 26                | 156      | 349      | 460                   |

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

The following table details the Company's sales by operating segment for fiscal years September 30, 2013 and 2012. The Company's sales by geographic area based on the location of where the products were shipped or services rendered are as follows:

| 2013                           | Americas               | Europe   | Asia    | Total    | % of<br>Total |   |
|--------------------------------|------------------------|----------|---------|----------|---------------|---|
|                                | (Amounts in thousands) |          |         |          |               |   |
| Systems                        | \$4,031                | \$12     | \$2,957 | \$7,000  | 8             | % |
| Service and System Integration | 55,085                 | 25,500   | 34      | 80,619   | 92            | % |
| Total                          | \$59,116               | \$25,512 | \$2,991 | \$87,619 | 100           | % |
| % of Total                     | 68                     | % 29     | % 3     | % 100    | %             |   |
| 2012                           |                        |          |         |          |               |   |
| Systems                        | \$7,584                | \$—      | \$3,557 | \$11,141 | 13            | % |
| Service and System Integration | 39,579                 | 34,053   | 34      | 73,666   | 87            | % |
| Total                          | \$47,163               | \$34,053 | \$3,591 | \$84,807 | 100           | % |
| % of Total                     | 56                     | % 40     | % 4     | % 100    | %             |   |

Substantially all Americas amounts are United States.

60

---

Long-lived assets by geographic location at September 30, 2013 and 2012 were as follows:

|               | September 30,<br>2013  | September 30,<br>2012 |
|---------------|------------------------|-----------------------|
|               | (Amounts in thousands) |                       |
| North America | \$1,287                | \$994                 |
| Europe        | 543                    | 489                   |
| Totals        | \$1,830                | \$1,483               |

Deferred tax assets by geographic location at September 30, 2013 and 2012 were as follows:

|               | September 30,<br>2013  | September 30,<br>2012 |
|---------------|------------------------|-----------------------|
|               | (Amounts in thousands) |                       |
| North America | \$2,553                | \$3,106               |
| Europe        | 531                    | 551                   |
| Totals        | \$3,084                | \$3,657               |

The following table lists customers from which the Company derived revenues in excess of 10% of total revenues for the years ended September 30, 2013 and 2012.

|            | For the year ended<br>September 30, 2013 |                  | September 30, 2012 |                  |   |
|------------|--|------------------|--------------------|------------------|---|
|            | Amount                                   | % of<br>Revenues | Amount             | % of<br>Revenues |   |
|            | (Amounts in millions)                    |                  |                    |                  |   |
| Customer A | \$15.7                                   | 18               | % \$12.6           | 15               | % |
| Customer B | \$13.4                                   | 15               | % \$14.7           | 17               | % |
| Customer C | \$10.5                                   | 12               | % \$2.6            | 3                | % |

### 13. Fair Value Measures

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

|                                     | Fair Value Measurements Using |         |         | Total<br>Balance |
|-------------------------------------|-------------------------------|---------|---------|------------------|
|                                     | Level 1                       | Level 2 | Level 3 |                  |
|                                     | As of September 30, 2013      |         |         |                  |
|                                     | (Amounts in thousands)        |         |         |                  |
| Assets:                             |                               |         |         |                  |
| Money Market funds                  | \$3,503                       | \$—     | \$—     | \$3,503          |
| Total assets measured at fair value | \$3,503                       | \$—     | \$—     | \$3,503          |
|                                     | As of September 30, 2012      |         |         |                  |
|                                     | (Amounts in thousands)        |         |         |                  |
| Assets:                             |                               |         |         |                  |
| Money Market funds                  | \$3,498                       | \$—     | \$—     | \$3,498          |
| Total assets measured at fair value | \$3,498                       | \$—     | \$—     | \$3,498          |



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

The Company had no liabilities measured at fair value as of September 30, 2013 or September 30, 2012. The Company had no assets or liabilities measured at fair value on a non recurring basis as of September 30, 2013 or September 30, 2012.

#### 14. Dividend

On January 12, 2012, our Board of Directors declared a cash dividend of \$0.10 per share which was paid on February 3, 2012 to stockholders of record as of January 27, 2012, the record date. On August 7, 2012, our board of directors declared a cash dividend of \$0.12 per share which was paid on August 31, 2012 to stockholders of record as of August 23, 2012, the record date.

On December 10, 2012, our board of directors declared a cash dividend of \$0.20 per share payable on December 28, 2012 to stockholders of record as of December 20, 2012, the record date. On May 8, 2013, our board of directors declared a cash dividend of \$0.10 per share which was paid on June 3, 2013 to stockholders of record as of May 24, 2013, the record date. On August 7, 2013, our board of directors declared a cash dividend of \$0.10 per share which was paid on August 30, 2013 to stockholders of record as of August 21, 2013, the record date.

On December 17, 2013, our board of directors declared a cash dividend of \$0.10 per share payable on January 7, 2014 to stockholders of record as of December 27, 2013, the record date.

#### 15. Subsequent Events

The Company has evaluated subsequent events through the date of this filing.

On November 4, 2013, the Company purchased the assets of Myricom, Inc. (“Myricom”), a manufacturer of high performance interconnect computing devices and software. The Company paid \$0.5 million in cash in exchange for the assets that were acquired in the transaction. The Myricom purchase price allocation has not yet been finalized due to the timing of the closing of the acquisition. The final determination of fair value for assets and liabilities will be completed as soon as the information necessary to complete the analysis is obtained.