

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K

(Mark One)

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

For the fiscal year ended September 30, 2008

OR

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

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

Commission file number 1-13550

**HAUPPAUGE DIGITAL, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**11-3227864**  
(I.R.S Employer  
Identification No.)

**91 Cabot Court, Hauppauge, New York**  
(Address of principal executive offices)

**11788**  
(Zip Code)

Issuer's telephone number, including area code (631) 434-1600

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

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
<b>Common Stock, \$.01 par value</b>	<b>The NASDAQ Stock Market</b>

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

**None**  
(Title of class)

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 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 twelve (12) months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety (90) days

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 "small reporting company" in Rule 12b-2 of the Exchange Act. (Check One):

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller reporting company

(Do not check box if 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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of the close of business on March 31, 2008 was approximately \$26,508,750 based upon the last price reported on such date on the NASDAQ Global Market. Non-affiliates include all stockholders other than officers, directors and 5% stockholders of the registrant.

As of December 10, 2008, the number of shares of Common Stock, \$0.01 par value, outstanding was 10,035,660.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Part III of this Annual Report on Form 10-K incorporates by reference information from the registrant's definitive Proxy Statement for its Annual Meeting of Stockholders to be held during 2009.

## **PART I**

### **Special Note Regarding Forward Looking Statements**

This Annual Report on Form 10-K contains forward-looking statements as that term is defined in the federal securities laws. The events described in forward-looking statements contained in this Annual Report on Form 10-K may not occur. Generally these statements relate to business plans or strategies, projected or anticipated benefits or other consequences of our plans or strategies, projected or anticipated benefits from acquisitions to be made by us, or projections involving anticipated revenues, earnings or other aspects of our operating results. The words “may,” “will,” “expect,” “believe,” “anticipate,” “project,” “plan,” “intend,” “estimate,” and “continue,” and their opposites and similar expressions are intended to identify forward-looking statements. We caution you that these statements are not guarantees of future performance or events and are subject to a number of uncertainties, risks and other influences (including, but not limited to, those set forth in “Item 1A–Risk Factors”), many of which are beyond our control, that may influence the accuracy of the statements and the projections upon which the statements are based. Any one or more of these uncertainties, risks and other influences could materially affect our results of operations and whether forward looking statements made by us ultimately prove to be accurate. Our actual results, performance and achievements could differ materially from those expressed or implied in these forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether from new information, future events or otherwise. All cautionary statements made in this Annual Report on Form 10-K should be read as being applicable to all related forward-looking statements wherever they appear.

## **ITEM 1. BUSINESS**

### **OVERVIEW**

We are a developer of analog and digital TV tuner and other products for the personal computer market. Through our Hauppauge Computer Works, Inc. and Hauppauge Digital Europe Sarl subsidiaries, we design, develop, manufacture and market analog, digital and other types of TV tuners and other devices that allow PC users to watch television on a PC screen in a resizable window. Most of our products also enable the recording of TV shows to a PC’s hard disk, digital video editing, video conferencing, receiving of digital TV data transmissions, and the display of digital media stored on a computer to a TV set via a home network. We were incorporated in Delaware in August 1994 and are headquartered in Hauppauge, New York. We have administrative offices in Luxembourg, Ireland and Singapore and have sales offices in Germany, London, Paris, The Netherlands, Sweden, Italy, Spain, Singapore, Taiwan and California.

### **RECENT DEVELOPMENTS**

Effective December 24, 2008, pursuant to an Asset Purchase Agreement, dated as of October 25, 2008, as amended by that certain Amendment No. 1 to the Asset Purchase Agreement (the “Amendment”) (together with the Amendment, the “Asset Purchase Agreement”), PCTV Systems, Sarl, a Luxembourg company (“Buyer”) and a wholly-owned subsidiary of ours, acquired certain assets and properties (the “Acquired Assets”) of Avid Technology, Inc. (“Avid”), a Delaware corporation, Pinnacle Systems, Inc., a California corporation (“Pinnacle”), Avid Technology GmbH, a limited liability company organized under the laws of Germany, Avid Development GmbH, a limited liability company organized under the laws of Germany, and Avid Technology International BV (collectively, the “Sellers”). The purchase price consisted of \$2,500,000 payable in cash; \$2,500,000 payable pursuant to Promissory Note, dated December 24, 2008, made payable by the Buyer to Avid (the “Note”) and the assumption of certain liabilities. In connection with the transaction, the Buyer or one

or more of its affiliates are employing certain employees and occupying certain facilities located in Braunschweig, Germany. Pursuant to the terms of the Asset Purchase Agreement, it is contemplated that we and the Buyer will also receive certain audited historical financial statements of the Sellers. The Acquired Assets are used by the Sellers in the business of, among other things, the development, manufacture and sale of personal devices containing a television tuner for receiving over-the-air, satellite and/or cable television signals that are used in conjunction with personal computers for personal television viewing.

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

In connection with the transactions contemplated by the Asset Purchase Agreement, the Buyer, Hauppauge Digital Europe Sarl (“HDES”), and Hauppauge Computer Works, Inc. (“HCW”), each a wholly-owned subsidiary of ours (collectively, the “Subsidiaries”) and the Sellers entered into a Transition Services Agreement, dated December 24, 2008 (the “TSA”), pursuant to which, among other things, the parties agreed to provide each other with certain services relating to infrastructure and systems, order processing and related matters and systems transition and related matters (the “Services”), as set forth in detail in the TSA. The fees for such Services are set forth in the TSA. The term of the TSA shall be until the earlier to occur of (i) 18 months following the Closing or (ii) termination of the last of the Services to be provided pursuant to the TSA. The TSA may be terminated by the Subsidiaries at any time upon thirty (30) days prior written notice to the Sellers and may be terminated with respect to any particular Service to be provided pursuant to the TSA upon ten (10) days prior written notice to Seller.

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

In connection with the transactions contemplated by the Asset Purchase Agreement, Avid, Pinnacle and the

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

## **OUR STRATEGY**

Since our entry into the PC video market in 1991, management believes that we have become a leader in bringing TV content to PCs by focusing on five primary strategic fronts:

- innovating and diversifying our products
- introducing new and desirable features in our products
- expanding our domestic and international sales and distribution channels
- forging strategic relationships with key industry players
- outsourcing our production to contract manufacturers

As more people are looking to PCs for a total entertainment experience, we believe that our products are able to enhance the capabilities of the PC to enable it to become a one-stop integrated entertainment system. We feel our current products and products we may introduce in the future have the potential to be ubiquitous in PC-based home entertainment systems.

Our engineering group works on updating our current products to add new and innovative features that the marketplace seeks, while remaining vigilant in keeping our manufacturing costs low and trying to ensure that our products are compatible with new operating systems. This work is done in addition to our research and development efforts in designing, planning and building new products. During fiscal 2008 our engineering department introduced the HD PVR High-Definition video recorder for use in the North American and European markets, the WinTV-HVR-1950 and WinTV-HVR-2250 for the North American market and the WinTV-HVR-2200 MC, WinTV-HVR-900H and WinTV-NOVA-TD for the European market. During fiscal 2007 our engineering department introduced seven new products, the WinTV-HVR-1250, WinTV-HVR1500, WinTV-HVR-1600 and WinTV-HVR1800 for the North American market, and the WinTV-HVR-1200, WinTV-HVR-1400 and WinTV-HVR-1750 for the European market. All of these products are designed to run under the Microsoft Vista operating system in addition to Windows XP. The products for North America are designed to support the NTSC analog cable TV standard plus over-the-air ATSC high definition TV and clear QAM digital cable TV.

We believe that strategic relationships with key suppliers, PC manufacturers, technology providers, and internet and e-commerce solutions providers give us important advantages in developing new technologies and marketing our products. By jointly working with, and sharing our engineering expertise with a variety of other companies, we seek to leverage our investment in research and development and minimize time to market.

Our domestic and international sales and marketing team cultivates a variety of distribution channels comprised of computer and electronic retailers, computer products distributors and PC manufacturers. Electronic retailers include retail stores, web stores and third-party catalogs, both print and on-line, among others. We work closely with our retailers to enhance sales through joint advertising campaigns and promotions. We believe that developing our international presence contributes to our strategic position, allowing us to benefit from investments in product development, and more firmly establishing our Hauppauge®, WinTV® and MediaMVP™ brand names in the international marketplace. We currently have nine sales offices in countries outside of the U.S. and a sales and R&D facility in Taiwan to service the growing Asian market.

We seek to maintain and improve our profit margins by, among other things, outsourcing our production to contract manufacturers suited to accommodate the type and volume of our needs. We also leverage international supplier relationships to assist us in receiving competitive prices for the component parts we buy. We believe this two-tiered approach allows us to be the lowest cost / highest quality producer in our marketplace. This approach enables us to focus our human and financial resources on developing, marketing and distributing our products. Successfully engineering products to have low production costs and commonality of parts along with the use of single platforms for multiple models are additional important ways that we believe our design and build strategy contributes to our financial performance.

## **PRODUCTS**

Our products fall under three product categories:

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

See “Item 7- Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the Consolidated Financial Statements comprising part of this Annual Report on Form 10-K for additional information relating to our operating segments.

### Analog TV Tuners

Our analog TV tuner products enable, among other things, a PC user to watch analog cable TV in a resizable window on a PC. Although we continue selling analog TV tuners in regions outside of the United States, we have stopped developing pure analog TV tuners, concentrating our engineering resources on digital TV tuners and combination analog and digital TV tuners, which is detailed in the section entitled “Digital TV Tuners”.

Our WinTV analog TV tuner products include cable-ready TV tuners with automatic channel scan and a video digitizer which allows the user to capture still and motion video images. Some of our analog TV tuner products allow the user to listen to FM radio, video-conference over the internet (with the addition of a camera or camcorder), and control these functions with a handheld remote control. In Europe, our WinTV® analog TV tuner products can be used to receive teletext data broadcasts, which allow the reception of digital data that is transmitted along with the “live” TV signal.

Some WinTV analog TV tuner products are available as external devices which connect to the PC through the USB port. The USB models are encased in an attractive case making USB models freely portable from PC to PC and from one desktop, laptop or notebook computer to another.

Our WinTV-PVR TV recording products include all of the basic features of our analog TV tuner products, such as TV on the PC screen, channel changing and volume adjustment. They also add the ability to record TV shows to disk using a built-in high quality hardware MPEG 2 encoder. This technology allows a typical desktop computer system to record up to hundreds of hours of video to disk, limited only by the size of the disk (or storage medium). In addition, the WinTV-PVR user can pause a live TV show, and then resume watching the TV show at a later time. The maximum amount of recording time and the maximum amount of paused TV is dependent upon the hard disk space available on the PC.

The WinTV-PVR user can record a TV show to the hard disk using a TV scheduler and then play the recording back, edit it, and record the show onto a CD-ROM or DVD-ROM, using a CD or DVD writer, for playback on a

home or portable DVD player or on a PC. The user can re-size the window during viewing, recording or playback. Our WinTV-PVR products also provide for instant replay and are available in both internal and external USB models.

An added feature to the WinTV-PVR-150, WinTV®-PVR-250, WinTV-PVR-500 and WinTV-PVR-USB2 is that they support Microsoft®'s Windows® XP Media Center Edition. Microsoft's Windows XP Media Center Edition integrates digital entertainment experiences including "live" television, PVR, digital music, digital video, DVDs and pictures. Users can pause, jump forward or watch "live" TV, record a program or a whole series, and manage digital music, home movies, videos, photos and DVDs on the PC. Users can also access and control this new entertainment device with a large, easy-to-use-on-screen menus and the Media Center Remote Control.

We provide Microsoft certified Media Center drivers for these products to PC manufacturers and value added resellers for integration into their Windows XP Media Center PC systems.

With the global shift to digital TV broadcasts, the sales of our analog family products have been declining and we expect this decline to continue during the transition from analog to digital broadcasts.

#### Digital TV and Combination Analog plus Digital TV Tuner Products

Our digital TV tuner products enable, among other things, a PC user to watch digital television in a resizable window on a PC or laptop screen. There are many different digital TV standards throughout the world, and we develop products to receive on a PC many of these digital TV broadcasts. Examples of digital TV broadcasts we can receive on our TV tuner products include: over-the-air high definition ATSC, clear QAM digital cable, DVB-T, DVB-S, DVB-S2 and DVB-C. To support these digital TV broadcasts, we are experiencing an on-going transition from analog TV tuners to either digital only or combination analog plus digital TV tuners. In fiscal 2007 we discontinued development of pure analog TV tuners, thereby concentrating our resources on digital TV Tuner products.

Our WinTV-NOVA products are European and Asian digital only TV tuners for PCs. They support the various forms of digital TV and come in either an internal or external form factor.

Our WinTV-NOVA-T is a DVB-T digital terrestrial tuner for our European markets which allows for the viewing of digital terrestrial TV and listening to digital radio on a PC. The product also allows recording of digital TV and radio to a hard drive. This product is available as either a PCI card or an external USB device.

Our WinTV-NOVA-T-500 is a dual tuner DVB-T tuner for our European markets which uses "Diverstiry Technology" and allows for the viewing of digital terrestrial program while recording another program. The product also allows recording of two digital TV programs simultaneously or watching one channel while recording another.

Our WinTV-NOVA-T-USB2 is an external high performance DVB-T digital TV tuner, with dual tuners for both recording of two digital TV programs simultaneously or watching one channel while recording another.

Our WinTV-NOVA-T stick is a pocket sized external DVB-T tuner for our European markets which allows for the viewing of digital terrestrial TV and the listening of digital radio on a PC or laptop. The product also allows recording of digital TV and radio to a hard drive. The product's pocket size and UPC plug in capability is good for use in laptops while traveling.

Our WinTV-NOVA-TD stick, introduced during fiscal 2008, is a pocket sized external DVB-T tuner for our

European markets employs “Diversity Technology” with the use of two antennas to maximize the reception for the viewing of digital terrestrial TV on a PC or laptop. The product also allows recording of digital TV to a hard drive in high quality MPEG-2 format. The product’s pocket size and UPC plug in capability is good for use in laptops while traveling.

Our WinTV-HVR products are combinations of both digital TV and analog TV tuners in one board or USB ‘box’.

Our WinTV-HVR-900-Stick is a pocket sized external tuner for our European markets which allows for the viewing of digital terrestrial and analog terrestrial TV on a PC or laptop. Allows the recording of digital and analog programs to a hard drive in high quality MPEG-2 format. The product’s pocket size and UPC plug in capability is good for use in laptops while traveling.

Our WinTV-HVR-950-Stick is a pocket sized external tuner for our North American markets which allows for the viewing of ATSC high definition TV and NTSC cable TV on a PC or laptop. The product also allows recording of digital and analog programs to a hard drive in high quality MPEG-2 format. The product’s pocket size and UPC plug in capability is good for use in laptops while traveling.

Our WinTV-HVR-1100 and WinTV-HVR-1300 are PCI based tuners for our European markets which allow for the viewing of digital terrestrial and analog terrestrial TV on a PC in addition to the ability to listen to FM radio and DVB-T radio. These products also allow the recording of digital and analog programs to a hard drive in high quality MPEG-2 format. The WinTV-HVR-1300 is a higher performance of the two models, in that it includes a hardware MPEG-2 encoder for recording analog TV directly to a PC’s hard disk.

Our WinTV-HVR-1400, introduced during fiscal 2007, is a dual tuner ExpressCard/54 for our European markets which allow for the viewing of digital and analog TV on a laptop. This product also allows the recording of digital programs to a hard drive in high quality MPEG-2 format and the recording of analog programs using a Soft PVR!MPEG-2 encoder.

Our WinTV-HVR-1600, introduced during fiscal 2007, is dual tuner PCI tuner for our North American market which allow for the viewing of ATSC high definition TV and NTSC cable TV on a PC. The HVR-1600 allows the recording of all ATSC formats, including the 1080i format. This product also allows the recording of digital and analog programs to a hard drive in high quality MPEG-2 format. The WinTV-HVR-1600 also supports viewing and recording clear QAM channels and includes a remote control and IR blaster which changes the channels on your satellite or cable TV set top box.

Our WinTV-HVR-1800, introduced during fiscal 2007, is a dual tuner single slot PCI express tuner for our North American markets which allow for the viewing of ATSC high definition TV, QAM TV and NTSC cable TV on a PC. These products also allow the recording of digital and analog programs to a hard drive in high quality MPEG-2 format. The WinTV-HVR-1800 allows viewing and recording of all ATSC formats, including the 1080i format.

Our WinTV-HVR-3000 is a tri-mode TV tuner PCI based tuner for our European markets which allows for the viewing of digital terrestrial(DVB-T), satellite (DVB-S) and analog cable TV on a PC in addition to the ability to listen to FM radio and DVB-T radio. The product also allows the recording of digital, satellite and analog programs to a hard drive.

Our WinTV-HVR-4000 is a quad-mode TV tuner PCI based tuner for our European markets which allows for the viewing of digital terrestrial (DVB-T), satellite (DVB-S), high definition digital satellite (DVB-S2) and analog cable TV on a PC in addition to the ability to listen to FM radio and DVB-T radio. The product also

allows the recording of digital, satellite and analog programs to a hard drive, in addition to having the ability to listen to FM, digital DVB or DVB-S satellite radio.

Our WinTV-NOVA-S is a low cost DVB-S tuner for our European markets which allows for the viewing of satellite based digital programming on a PC. The product also allows for recording and playback of digital TV, using the high quality MPEG 2 format, and for listening to digital radio.

Our HD PVR is a High-Definition video recorder for making real-time compressed recordings at resolutions up to 1080i. The HD-PVR records component video from cable TV and satellite set top boxes. With a built-in IR blaster the HD-PVR can automatically change TV channels for scheduled recordings. Audio is recorded using AAC or Dolby Digital. The HD-PVR recording format can be used to burn Blu-ray DVD disks. The HD PVRs recording quality allows personal archival of high definition TV programs from any component video HD set top box. The HD PVR also has standard definition composite and S-Video inputs which allows you to record your old home video tapes into an AVCHD format for creating Blu-ray DVD recordings.

Our WinTV-HVR-1950 is a high performance external TV tuner for your PC or laptop. The WinTV-HVR-1950 allows you to watch, pause and record analog cable TV, clear QAM digital cable TV, or ATSC over-the-air digital TV at up to 1080i resolution. The product comes with a remote control and IR blaster. The product contains a built-in hardware MPEG-2 encoder for use when recording analog video.

Our WinTV-HVR-2250 is a dual tuner PCI-express card. With dual built in tuners you can either watch one channel while recording another or you can record two channels at once. The HVR-2250 allows you to record analog cable TV shows to your PC's hard disk with our built-in high quality MPEG-2 hardware encoder. You can also record high definition digital ATSC and clear QAM digital cable TV to disk.

Our WinTV-HVR-2200 MC is a compact, low profile, dual tuner, PCI-Express card that fits in all the latest Microsoft Vista Home Premium and Ultimate PCs with a PCI-Express 1x slot. The WinTV-HVR-2200 MC comes with both full height and half height brackets to accommodate the requirements of normal PC's or an extra slim PC. The WinTV-HVR-2200 MC allows you to watch Freeview digital TV (DVB-T) or analog TV on your PC screen while recording a different channel on the second tuner, pause analog or digital TV with instant replay, skip, fast forward and rewind, record digital TV programs in original MPEG-2 quality and record analog TV to disk in high quality MPEG-2 quality with the hardware MPEG-2 encoder.

#### Other Non TV Tuner Products

##### (i)Media MVP™

Our MediaMVP™ is a Linux-based digital media device, and is one of a new class of PC products which link TV sets and PCs. Media, such as music, digital pictures, and digital videos, are transmitted from the PC, where they are stored, to the MediaMVP™, where they are converted from a digital format into an analog format, enabling playback on a TV connected to the MediaMVP™. MediaMVP™ was introduced to the market in fiscal 2003, and the first shipments to customers were made at the start of our 2004 fiscal year.

Our MediaMVP™ enables a user to watch and listen to PC-based videos, music and pictures on a TV set through a home network. The MediaMVP™ connects to TV sets or home theater systems and, via an Ethernet network, plays back MP3 music, MPEG-1 and MPEG-2 videos, JPEG and GIF digital pictures that have been recorded and stored on a PC. The MediaMVP™ decodes this media and then outputs video through composite and S-Video connections for high quality video on TV sets and high quality audio through stereo audio output connectors to TV sets or home theater systems.

Our MediaMVP™ also provides an on-TV-screen display of media directory listings. It receives commands from the supplied remote control, and sends these commands to the PC server. The TV menus are created on the PC server, sent over the Ethernet LAN and displayed by the MediaMVP™'s browser. The MediaMVP™'s remote control allows a user to pause, fast forward and rewind through videos, plus pause music and picture shows. A user can adjust the audio volume from MediaMVP™'s remote control, avoiding the need to use the TV's remote control. The MediaMVP™ is also available in a wired or wireless version.

#### (ii) Video Capture Products

Our ImpactVCB Video Capture Board ("ImpactVCB") is a low cost PCI board for high performance access to digitized video. Designed for PC-based video conferencing and video capture in industrial applications, the ImpactVCB features "live" video-in-a-window, still image capture and drivers for Windows® 2000, Windows® XP, Windows® NT and Windows® 98. There are third party drivers and applications for use with the Linux operating system.

Our USB Live is an easy way to watch video, grab images and video conference on the PC with the addition of a camera. It plugs into the PC's USB port for easy installation and brings video into users' PCs from their camcorder or VCR. Users can create video movies, save still and motion video images onto their hard disk with our software, and video conference over the internet with the addition of a camera or camcorder.

#### (iii) Software Recording Products

Our "Wing" software enables the user to record TV shows on a personal computer for playback on the Sony Playstation Portable (PSP), Apple iPod and other portable video players. Wing can also convert existing TV recordings to the PSP and iPod formats. With the emergence and popularity of portable video players, our Wing product provides an easy solution for recording live TV shows for playback on these devices.

#### (iv) WinTV-CI Common Interface Module

Our WinTV-CI common interface module when coupled with a WinTV card, CAM and SmartCard subscription allows the user to watch popular pay TV channels, such as movies and sporting events on a user's WinTV application.

#### (v) Xfones Wireless Headphones for PC's and Macs:

Our Xfones wireless headphones allow users to listen to the audio produced by their PC or Mac through a wireless over the ear headphone. The Xfone has the ability to broadcast to more than one headphone allowing multiple users to listen to the audio from their PC or Mac.

#### (vi) PCTV products

Our PCTV products allow Windows or Macintosh users to view television programming on their computers. Our PCTV line consists of a family of USB sticks with a small and convenient form factor well-suited for use with laptops and PCI-based cards more appropriate for desktop users, in addition to PCI cards for use in desktop computers.. PCTV products are slated to be positioned as our high end product offering. We believe that the positioning of the PCTV product line will be complimentary to our existing WinTV line and will broaden our product offerings.

## **TECHNOLOGY**

## Analog TV Technology

We have developed four generations of products which convert analog video into digital video since our first such product was introduced in 1991.

The first generation of WinTV® products put the TV image on the PC screen using chroma keying, requiring a dedicated “feature connector cable” between the WinTV® and the VGA (video) board. Our initial customers were mostly professional PC users, such as financial market professionals who needed to be able to view stock market related TV shows while spending many hours on their PCs, who found having TV in a window on their desktop useful and entertaining.

In 1993, we invented a technique called “smartlock”, which eliminated the need for the “feature connector cable.” In 1994, we introduced the WinTV®-Celebrity generation of TV tuner boards based on this smartlock technology, greatly improving customer satisfaction. At the time, our CinemaPro series of WinTV® boards then used smartlock and other techniques to further reduce cost and improve performance.

In June 1996, we introduced the WinTV®-PCI line of TV tuner boards for PCs. These boards were developed to eliminate the relatively expensive smartlock circuitry and memory used on the WinTV®-Celebrity and CinemaPro products. The WinTV®-PCI used a technique called “PCI Push” and was designed to be used in the then emerging Intel® Pentium® market. These Pentium®-based PCs had a new type of system expansion “bus”, called the PCI bus, which allowed data to be moved at a much higher rate than the older ISA bus, which the previous WinTV® generations used. The “PCI Push” technique moves the video image 30 times per second (in Europe the image is moved 25 times per second) over the PCI bus. In addition to being less expensive to manufacture, the WinTV®-PCI had higher digital video movie capture performance than the previous generations, capturing video at up to 30 quarter screen frames per second. With this higher performance capture capability, the WinTV®-PCI found new uses in video conferencing, video surveillance and internet streaming video applications.

The fourth generation analog TV tuners are the WinTV®-PVR models which were first developed during fiscal 2000 and introduced to the market in early fiscal 2001. The WinTV®-PVRs include both internal PCI and external USB TV tuners which are designed to add the ability to record TV shows to a PC’s hard disk. The core technology in the WinTV®-PVR products is a hardware MPEG encoder, which compresses analog video from a TV tuner or external video source into an MPEG format in real time. MPEG is the compression format used on DVDs and for the transmission of digital TV. This MPEG encoder is a purchased chip, to which we add our driver and application software to create the recording and program pause functions. Our WinTV®2000 application was enhanced to add the functions needed to record, pause and play back TV on a PC screen.

## Digital TV Technology

Our WinTV®-D board, developed during the 1999 fiscal year and delivered to the market in the beginning of fiscal 2000, was the first ATSC digital TV tuner for the North American market which allowed PCs to receive, display and record over-the-air digital TV signals, in addition to watching conventional analog TV. ATSC digital television is the digital TV standard for North America which is replacing analog television in the United States and Canada. In the U.S., by February 2009, all analog television transmissions will cease and afterward only digital TV transmissions will be broadcast over-the-air. Since our first ATSC digital TV tuner delivered in 2000, we have introduced about 8 new digital TV tuners for use in North America.

In fiscal 1999, we also introduced the WinTV®-DVB board for the European market. This board brings European digital TV to PCs, and is based on the Digital Video Broadcast standard. Both the WinTV®-D and the WinTV®-DVB have the ability to receive special data broadcasts which some broadcasters may send along with the digital TV signal, in addition to displaying digital TV in a resizable window. Data broadcasts on digital

TV are transmitted at several million bits per second. Our proprietary software can decode and display some of these special data broadcasts. We may work on standardized reception and display software, if such broadcasts become standardized.

The software to control the digital TV reception is based on our WinTV®-2000 software, which was developed during fiscal 1999 and has had a major update in 2006. Over the three fiscal years ended September 30, 2008, we have further developed the digital TV reception capabilities of our digital family of products and as of September 30, 2008 we have 15 products for DVB-T terrestrial, DVB-S and DVB-S2 satellite, ATSC and clear QAM digital TV reception.

Our MediaMVP™ contains our newest technology. Based on the Linux operating system, the MediaMVP™ works in a client/server system with a PC, communicating with the PC ‘server’ and receiving digital media from the PC and displaying the media on a TV set. The core technology to the MediaMVP™ comprises the configuration and enhancements to the Linux operating system, the user interface displayed on the TV set, and the technology to transmit digital media reliably over the local area network. The MediaMVP™ is also available in a wired or wireless version.

## **RESEARCH AND DEVELOPMENT**

Our development efforts are focused on extending the range and features of the our existing products and developing additional externally attached TV products and additional high-definition digital TV products. We intend to develop more highly integrated versions of hardware products to further improve performance and price points, and new versions of software to add features, improve ease of use, and provide support for new operating systems.

As of December 24, 2008, we had three research and development operations: one based in our Hauppauge, New York headquarters, one based in Taiwan, ROC and one in Braunschweig, Germany. The New York and Taiwan R&D operations are aimed at extending the range and features of our digital/analog products, developing additional externally attached TV products, additional high-definition digital TV products and portable digital players. The Braunschweig, Germany PCTV research and engineering facility will be responsible for the updating and enhancement of the current PCTV line in addition to developing PCTV products.

The technology underlying our products and certain other products in the computer industry, in general, is subject to rapid change, including the potential introduction of new types of products and technologies, which may have a material adverse impact upon our business. See, “Item 1A -- Risk Factors”.

We maintain an ongoing research and development program. Our future success, of which there can be no assurances, will depend, in part, on our ability to respond quickly to technological advances by developing and introducing new products, successfully incorporating such advances in existing products, and obtaining licenses, patents, or other proprietary technologies to be used in connection with new or existing products. We continue to invest in research and development. We spent approximately \$3,884,000, \$3,480,000 and \$3,165,000 for research and development expenses for the years ended September 30, 2008, 2007 and 2006, respectively. There can be no assurance that our future research and development will be successful or that we will be able to foresee, and respond to, advances in technological developments and to successfully develop other products. Additionally, there can be no assurances that the development of technologies and products by competitors will not render our products or technologies non-competitive or obsolete. See “Item 1A- Risk Factors.”

## **PRODUCTION AND SUPPLIERS**

We design the hardware for most models of the WinTV, and MediaMVP products, and also write the operating software to be used in conjunction with many versions of the popular Microsoft Windows and Apple Macintosh operating systems, including Windows Vista. During fiscal 2008, we subcontracted the manufacturing and assembly of most of these products to four independent third parties at facilities in various Asian countries. We monitor and test the quality of the completed products at any one of our facilities in the U.S. (Hauppauge, New York), Singapore, and Ireland before packaging the products and shipping them to our customers. We also buy finished products, such as the WinTV-Nova-T digital stick, some models of WinTV-HVR hybrid stick, WinTV-CI module and XPhones from other companies, add Hauppauge software and sell under our name or on a private label basis.

In order to maintain continuity in production during the integration period of our PCTV product line, we intend to retain the services of two contract manufacturers who manufactured and assembled PCVT products for Avid Technology, Inc. These two contract manufacturers are located in Asia. We and Avid Technology, Inc. also entered into an Inventory and Product Return Agreement. “See Item 1. Business Recent Developments”.

Certain component parts, such as TV tuners, video decoder chips and software compression chips, plus certain assembled products, such as the WinTV-HVR stick products that are essential to our business, are available from a single source or limited sources. Other essential component parts that are generally available from multiple sources may be obtained by us from only a single source or limited sources because of pricing concerns. See “Item 1A-Risk Factors.”

Components are subject to industry wide availability and pricing pressures. Any availability limitations, interruption in supplies, or price increases could have a material adverse effect on our business, operating results and financial condition. In addition, our new products may initially utilize custom components obtained from only one source. See “Item 1A-Risk Factors.” We typically attempt to evaluate and qualify additional suppliers for these components.

Where a product utilizes a new component, initial capacity constraints of the supplier of that component may exist until such time as the supplier's yields have matured.

Components are normally acquired through purchase orders, either issued by us or by our contract manufacturers, typically covering our requirements for a 60-120 day period from the date of issue. Purchased assembled products are normally covered by longer term purchase orders.

If the supply of a key component, or a purchased assembled product, were to be delayed or curtailed, or in the event a key manufacturing vendor delays shipment of completed products to us or our contract manufacturer, our ability to ship products in desired quantities, and in a timely manner, will be adversely affected. Our business, operating results and financial condition will likely be adversely affected, depending on the time required to obtain sufficient quantities from the original source or, if possible, to identify and obtain sufficient quantities from an alternative source. See “Item 1A-Risk Factors.” We attempt to mitigate these potential risks by working closely with our key suppliers on product introduction plans, strategic inventories, coordinated product introductions, and internal and external manufacturing schedules and levels.

We have, from time to time, experienced significant price increases and limited availability of certain components. Similar occurrences in the future could have a material adverse effect on our business, operating results and financial condition. See “Item 1A-Risk Factors.”

During fiscal 2008, 2007 and 2006, other than for purchased pre-assembled products, all WinTV and MediaMVP manufacturing was performed by four unrelated contract manufacturers in Asia, which produce products for our domestic, Asian and European markets. Product design specifications are provided by our

engineering team to ensure proper assembly. Contract manufacturing is primarily done on a consignment basis, in which we provide all the significant component parts and we pay for assembly charges and for certain additional parts for each board produced. Some products are purchased on a turnkey basis, in which all components and labor are provided by the manufacturer, and the manufacturing price includes parts and assembly costs. We monitor the quality of the finished product produced by our contract manufacturers. As of September 30, 2008, we had four qualified contract manufacturers located in Malaysia, Indonesia and China, who are capable of producing our products to our standards. If demand were to increase dramatically, we believe additional production could be absorbed by these qualified contract manufacturers. For fiscal 2008, 2007 and 2006, we did not engage any contract manufacturers in Europe.

Manufacturing for the PCTV division is currently done by two turn key manufacturers located in China.

## **CUSTOMER SERVICE AND TECHNICAL SUPPORT**

We maintain customer service and technical support departments in our Hauppauge, New York headquarters, as well as in the U.K., Germany, France, Italy, Scandinavia, Taiwan and in Singapore. Technical support is provided to help with installation problems or pre-sale and post-sale questions on our products, while customer service provides repair service in accordance with our warranty policy free of charge for product that is within the warranty period.

The PCTV division provides customer service through two third party service providers.

## **CUSTOMERS AND MARKETS**

We primarily market our products to the personal computer market, including both Microsoft Windows and Apple Macintosh based systems. To reach this market, we sell to a network of computer retailers in the U.S., Europe and Asia and through computer products distributors and manufacturers. To attract new users to our products, from time to time we run special promotions and participate in cooperative advertising with computer retailers. We actively participate in trade shows to educate and train key computer retail marketing personnel. Most of our sales and marketing budget is aimed at the consumer market.

Apart from the typical home user, we also target business users. One example of a business application is in the securities brokerage industry where our product is primarily used to display financial TV shows in a window on a broker's PC screen while the PC continues to receive financial information. We have sold our WinTV® products on a direct corporate sales basis to two large financial services information providers for incorporation into their workstations, and several independent financial institutions. This market segment is typically project-based.

We also offer our products to PC manufacturers that either embed a WinTV® product in a PC that they sell, or sell the WinTV® as an accessory to the PC.

### Sales Channels for Our Products

We primarily sell through a sales channel which consist of retailers, PC manufacturers and distributors. We have no exclusive distributors and retailers. For fiscal 2008, we had one customer, Hon Hai Precision Industry Co. LTD, that accounted for approximately 16% of our sales. For fiscal 2007, we had two customers, Hon Hai Precision Industry Co. LTD and Asustek Computer Inc., which accounted for approximately 24% and 14%, respectively, of our sales. For fiscal 2006, we had no single customer which accounted for more than 10% of our net sales.

We intend to offer the PCTV products as our high end line and intend to sell through similar retail and distribution channels as our Win TV products.

### Marketing and Sales

We market our products both domestically and internationally through our sales offices in the U.S. (New York and California), Germany, the United Kingdom, France, Taiwan and Singapore, plus through independent sales representative offices in the Netherlands, Spain, Scandinavia, Poland and Italy. For the fiscal years ended September 30, 2008, 2007 and 2006, approximately 48%, 56% and 46% of our net sales were made within the U.S., respectively, while approximately 52%, 44% and 54% were made outside the United States, respectively.

More information on our geographic segments can be obtained from “Item 7-Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and the notes to the “Consolidated Financial Statements” which comprise part of this Annual Report on Form 10-K.

From time to time, we advertise our products in a number of consumer computer magazines. We also participate in retailers’ market promotion programs, such as store circulars and promotions and retail store displays. These in-store promotional programs, magazine advertisements, plus a public relations program aimed at editors of key PC computer magazines and an active website on the internet, are the principal means of getting our product introduced to end users. Our sales in computer retail stores are closely related to the effectiveness of these programs, along with the technical capabilities of the products. We also list our products in catalogs of various mail order companies and attend trade shows.

We intend to absorb the marketing and sales of our PCTV line into our existing sales and marketing structure. It is anticipated that our existing sales personnel will handle the generating of sales orders and the PCTV line will follow marketing and advertising programs that are similar to our WinTV programs.

We currently have fifteen sales people located in Europe, three sales people in the Far East and two sales people in the U.S. located in New York and California. In addition to our sales people we also utilize the services of 7 manufacturer representatives in the United States and 10 manufacturer representatives in Europe.

See “Item 7-Management’s Discussion and Analysis of Financial Condition and Results of Operations” with reference to a discussion on the impact seasonality has on our sales.

### **FOREIGN CURRENCY FLUCTUATIONS**

For each of the fiscal years ended September 30, 2008, 2007 and 2006 at least 40% of our sales were generated by our European subsidiary and were invoiced and collected in local currency, which is primarily the Euro. On the supply side, since we predominantly deal with North American and Asian suppliers and contract manufacturers, approximately 90% of the our inventory required to support our European sales is purchased and paid in U.S. Dollars.

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

See “Item 1A-Risk Factors”, “Item 7-Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Item 7A-Quantitative and Qualitative Disclosures About Market Risks” with reference to the impact of foreign currency exchange fluctuations.

## **COMPETITION**

Our business is subject to significant competition. Competition exists from larger companies that possess substantially greater technical, financial, human, sales and marketing resources than we do. The dynamics of competition in this market involve short product life cycles, declining selling prices, evolving industry standards and frequent new product introductions. We compete against companies such as ATI Technologies Inc., a division of AMD Corp., and a number of Asian and European companies. . Our MediaMVP™ product competes in the consumer electronics market, where competition comes from Sony Corp., Toshiba Corporation, Cisco Systems Inc. and others.

We believe that competition from new entrants into our market will increase as the market for television in a PC expands. There can be no assurance that we will not experience increased competition in the future. Such increased competition may have a material adverse affect on our ability to successfully market our products. Competition is expected to remain intense and, as a result, we may lose some of our market share to our competitors. Further, we believe that the market for our products will continue to be price competitive and thus we could continue to experience lower selling prices, lower gross profit margins and reduced profitability levels for such products than in the past. “Item 1A-Risk Factors”.

Though management believes that the delivery of TV via the internet will become more popular in the future, we believe that TV delivered via cable, broadcast or satellite will continue to dominate the way consumers watch live television. Since our products connect directly to cable, broadcast and satellite tuners, we view our products as the preferred way to watch and record TV on the PC.

## **PATENTS, COPYRIGHTS AND TRADEMARKS**

With the proliferation of new products and rapidly changing technology, there is a significant volume of patents and other intellectual property rights held by third parties with regard to our market. There are a number of companies that hold patents for various aspects of the technologies incorporated in some of the PC and TV industries' standards. Given the nature of our products and development efforts, there are risks that claims associated with such patents or intellectual property rights could be asserted by third parties against us. We expect that parties seeking to gain competitive advantages will increase their efforts to enforce any patent or intellectual property rights that they may have. The holders of patents from which we may have not obtained licenses may take the position that we are required to obtain a license from them.

If a patent holder refuses to offer such a license or offers such a license on terms unacceptable to us, there is a risk of incurring substantial litigation or settlement costs regardless of the merits of the allegations or which party eventually prevails. If we do not prevail in a litigation suit, we may be required to pay significant damages and/or cease sales and production of infringing products and accordingly, may incur significant defense costs. Additionally, we may need to attempt to design around a given technology, although there can be no assurances that this would be possible or economical.

We currently use technology licensed from third parties in certain products. Our business, financial condition and operating results could be adversely affected by a number of factors relating to these third-party technologies, including:

- failure by a licensor to accurately develop, timely introduce, promote or support the technology
- delays in shipment of products
- excess customer support or product return costs due to problems with licensed technology and
- termination of our relationship with such licensors

We may not be able to adequately protect our intellectual property through patent, copyright, trademark and

other means of protection. If we fail to adequately protect our intellectual property, our intellectual property rights may be misappropriated by others, invalidated or challenged, and our competitors could duplicate our technology or may otherwise limit any competitive technological advantage we may have. Due to the rapid pace of technological change, we believe our success is likely to depend more upon continued innovation, technical expertise, marketing skills and customer support and service rather than upon legal protection of our proprietary rights. However, we shall aggressively assert our intellectual property rights when necessary.

Even though we independently develop most of our products and copyright the operating software which our products use, our success will depend, in a large part, on our ability to innovate, obtain or license patents, protect trade secrets and operate without infringing on the proprietary rights of others. We maintain copyrights on certain of our designs and software programs, but currently we have no patent on the WinTV® board or other products.

The trade marks “Hauppauge®”, “SoftPVR®”, “HardPVR®”, “MediaMVP®” and , "WinTV®", have been registered with the United States Patent and Trademark Office.

See “Item 1A-Risk Factors” and “Item 7-Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

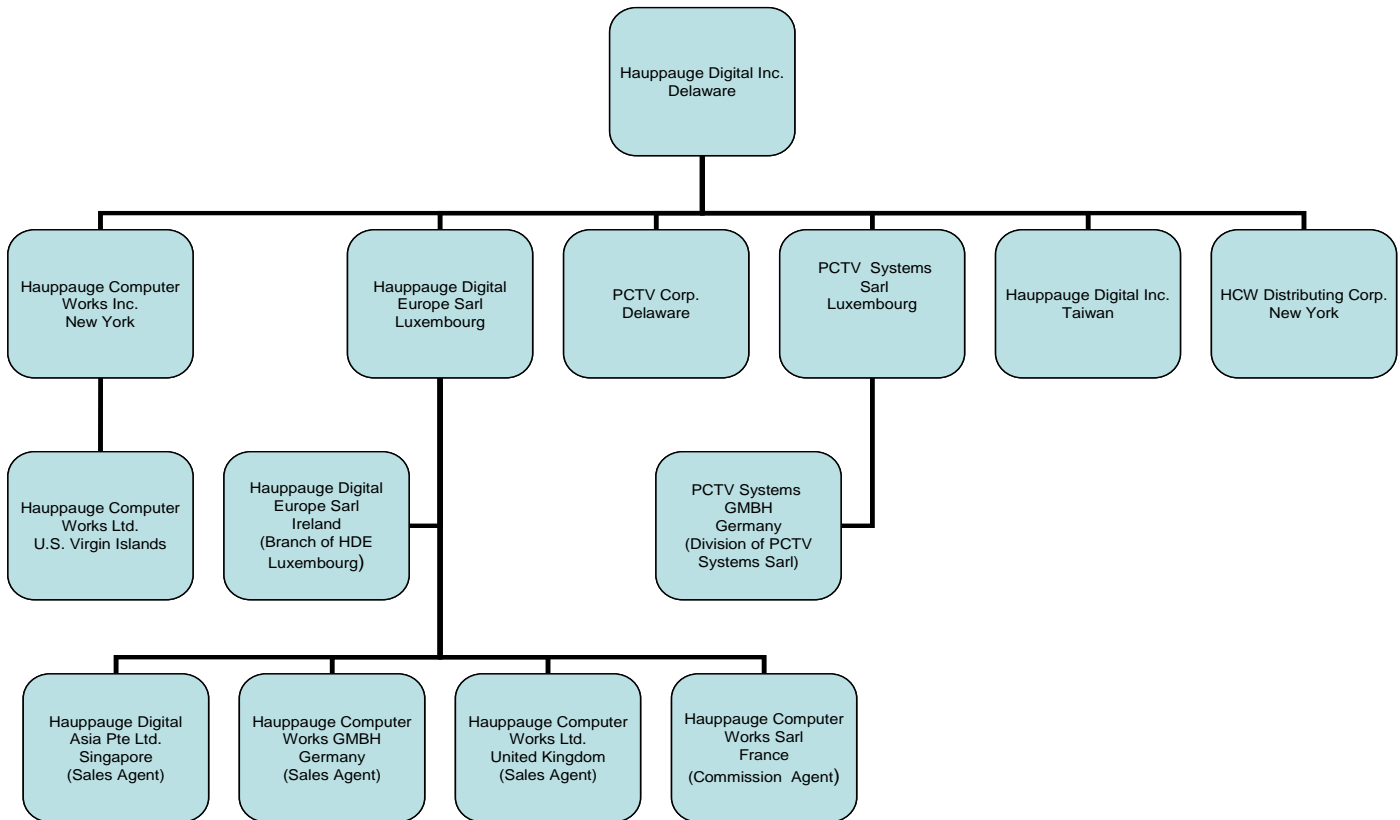
## **EMPLOYEES**

As of September 30, 2008, we employed 158 people domestically and internationally, including our executive officers, all of which are employed on a full-time basis, and none of which are represented by a union. With the acquisition of the PCTV product line we added 25 employees, primarily consisting of engineers and product support personnel, in Braunschweig, Germany.

## **CORPORATE STRUCTURE**

Hauppauge Digital Inc. was incorporated in the state of Delaware on August 2, 1994. Listed below is a chart depicting our corporate structure.

### **Corporate Organization Chart**



Hauppauge Digital Inc. was incorporated in Delaware and is the parent holding company. Our subsidiaries function as follows:

Hauppauge Computer Works, Inc., incorporated in New York, is our United States operating company. It has locations in Hauppauge, New York and Danville, California. The Hauppauge, New York location functions as our company headquarters and houses the executive offices and is responsible for some or all of the following functions:

- Sales
- Technical Support
- Research and development
- Warehousing and shipping
- Finance and Administrative
- Inventory planning and forecasting

Hauppauge Digital Europe Sarl, incorporated in Luxembourg, is our European subsidiary. It has the following wholly-owned subsidiaries:

- Hauppauge Digital Asia Pte Ltd (incorporated in Singapore)
- Hauppauge Computer Works, GmbH (incorporated in Germany)
- Hauppauge Computered Works Limited (incorporated in the United Kingdom)
- Hauppauge Computer Works (incorporated in France)

The subsidiaries above function as sales and commission agents, and are primarily responsible for some or all of the following functions:

- Directing and overseeing European sales, marketing and promotional efforts
- Procuring sales and servicing customers
- Sales administration
- Technical support
- Product and material procurement support
- Contract manufacturer and production support

In addition to Hauppauge Digital Europe Sarl's wholly owned subsidiaries, Hauppauge Digital Europe Sarl also has a branch office in Blanchardstown, Ireland, which functions as our European distribution center and is responsible for some or all of our following functions:

- Warehousing of product
- Shipment of product
- Repair center
- European logistics center

Hauppauge Digital Taiwan was incorporated during fiscal 2004 in Taiwan, ROC and is responsible for some or all of the following functions:

- Sales administration for Asia and China
- Research and development activities

PCTV Systems Sarl (Luxembourg) is a wholly owned subsidiary of Hauppauge Digital Inc. The company was created to be the holding company of certain assets and properties acquired from of Avid Technology, Inc., Pinnacle Systems, Inc., Avid Technology GmbH, Avid Development GmbH and Avid Technology International BV. PCTV Systems GMBH is a division of PCTV Systems Luxembourg. Located in Germany, PCTV Systems GMBH is responsible for PCTV research and development.

Hauppauge Computer Works, Inc. is in turn the holding company of a foreign sales corporation, Hauppauge Computer Works, Ltd (incorporated in the U.S. Virgin Islands).

HCW Distributing Corp., incorporated in New York, is an inactive company

Our executive offices are located at 91 Cabot Court, Hauppauge, New York 11788, and our telephone number at that address is (631) 434-1600. Our internet address is <http://www.hauppauge.com>.

## **ITEM 1A. RISK FACTORS**

Our operating results and financial condition are subject to various risks and uncertainties, including those described below, that could adversely affect our business, operating results and financial condition, any of which could negatively affect the trading price of our Common Stock. Because of the following factors, as well as other variables affecting our business, operating results and financial condition, past performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends for future periods.

**If TV technology for the PC, or our implementation of this technology, is not accepted, we will not be able to sustain or expand our business.**

Our future success depends on the growing use and acceptance of TV and video applications for PCs. The

market for these applications is still evolving, and may not develop to the extent necessary to enable us to further expand our business. We have invested, and continue to invest, significant time and resources in the development of new products for this market.

Our:

- dependence on sales of TV and video products for the PC
- lack of market diversification
- concentration on the North American and European market for the majority of our sales
- potential inability to remain ahead of the development of competing technologies

could each have a material adverse effect on our business, operating results and financial condition if we are unable to address any of the factors listed above.

**We rely upon sales of a small number of product lines, and the failure of any one product line to be successful in the market could substantially reduce our sales.**

We currently rely upon sales from our existing product lines of internal and external products to generate a majority of our sales. While we continue to develop additional products within these and other product lines, there can be no assurance that we will be successful in doing so. Consequently, if the existing or future products are not successful, sales could decline substantially, which would have a material adverse effect on our business, operating results and financial condition.

**We rely heavily on the success of dealers and PC manufacturers to market, sell and distribute our products. If these channels are not effective in distributing our products, our sales could be reduced.**

These resellers and manufacturers may not effectively promote or market our products or they may experience financial difficulties and even close operations. Our sales channels are not contractually obligated to sell our products, and they typically sell on an “as needed” basis. Therefore, they may, at any time:

- refuse to promote our products
- discontinue the use of our products in favor of a competitor's product

Also, with a distribution channel standing between us and the actual end user, we may not be able to accurately gauge current demand and anticipate future demand for our products. For example, dealers and manufacturers may place large initial orders for a new product just to keep their stores and products stocked with the newest TV tuners and not because there is a significant demand for them.

**We operate in a highly competitive market, and many of our competitors have much greater resources, which may make it difficult for us to remain competitive.**

Our business is subject to significant competition. Competition exists from larger companies that possess substantially greater technical, financial, human, sales and marketing resources than we do. The dynamics of competition in this market involve short product life cycles, declining selling prices, evolving industry standards and frequent new product introductions. We compete against companies such as ATI Technologies Inc., a division of AMD Corp.. Our MediaMVP™ product competes in the consumer electronics market, where competition comes from Sony Corp., Toshiba Corporation, Cisco Systems Inc. and others.

We believe that competition from new entrants will increase as the market for digital video in a PC expands. There can be no assurance that we will not experience increased competition in the future. Such increased

competition may have a material adverse affect on our ability to successfully market our products. Competition is expected to remain intense and, as a result, we may lose some of our market share to our competitors. Further, we believe that the market for our products will continue to be price competitive and thus we could continue to experience lower selling prices, lower gross profit margins and reduced profitability levels for such products than in the past.

**Rapid technological changes and short product life cycles in our industry could harm our business.**

The technology underlying our products and other products in the computer industry, in general, is subject to rapid change, including the potential introduction of new types of products and technologies, which may have a material adverse impact upon our business, operating results and financial condition. We will need to maintain an ongoing research and development program, and our potential future success, of which there can be no assurances, will depend, in part, on our ability to respond quickly to technological advances by developing and introducing new products, successfully incorporating such advances in existing products, and obtaining licenses, patents, or other proprietary technologies to be used in connection with new or existing products. We expended approximately \$3,884,000, \$3,480,000 and \$3,165,000 for research and development expenses for the fiscal years ended September 30, 2008, 2007 and 2006, respectively. There can be no assurance that our research and development will be successful or that we will be able to foresee and respond to such advances in technological developments and to successfully develop additional products. Additionally, there can be no assurances that the development of technologies and products by competitors will not render our products or technologies non-competitive or obsolete.

If TV or video capabilities are included in PCs or in operating systems, it could result in a reduction in the demand for add-on TV and video devices. Although we believe that our software is a competitive strength, as operating systems such as Windows move to integrate and standardize software support for video capabilities, we will be challenged to further differentiate our products. Our operating results and ability to retain our market share are also dependent on continued growth in the underlying markets for PC, TV and video products.

**We may not be able to timely adopt emerging industry standards, which may make our products unacceptable to potential customers, delay our product introductions or increase our costs.**

Our products must comply with a number of current industry standards and practices established by various international bodies. Failure to comply with evolving standards, including video compression standards, TV transmission standards, and PC interface standards, will limit acceptance of our products by the market. If new standards are adopted in the industry, we will be required to adopt those standards in our products. It may take a significant amount of time to develop and design products incorporating these new standards, and we may not succeed in doing so. We may also become dependent upon products developed by third parties and have to pay royalty fees, which may be substantial, to the developers of the technology that constitutes the newly adopted standards.

**We are dependent upon foreign markets for sales of our products, primarily the European market, and adverse changes in these markets could reduce our sales.**

Our future performance will likely be dependent, in large part, on our ability to continue to compete successfully in the European markets, where a large portion of our current and potential customers are located. Our ability to compete in these markets will depend on many factors, including:

- the economic conditions in these regions
- the value of the euro versus the U.S. dollar

- the stability of the political environment in these regions
- adverse changes in the relationships between major countries in these regions
- the state of trade relations among these regions and the United States
- restrictions on trade in these regions
- the imposition or changing of tariffs by the countries in these regions on products of the type that we sell
- changes in the regulatory environment in these regions
- export restrictions and export license requirements
- restrictions on the export of critical technology
- our ability to develop PC TV products that meet the varied technical requirements of customers in each of these regions
- our ability to maintain satisfactory relationships with our foreign customers and distributors
- changes in freight rates
- our ability to enforce agreements and other rights in the countries in these regions
- difficulties in staffing and managing international operations
- difficulties assessing new and existing international markets and credit risks
- potential insolvency of international customers and difficulty in collecting accounts

If we are unable to address any of these factors, it could have a material adverse effect on our business, operating results and financial condition.

**We are heavily dependent upon foreign manufacturing facilities for our products, primarily facilities in Asia, which exposes us to additional risks.**

The majority of our products are built at contract manufacturing facilities in Asia. Our ability to successfully build products at overseas locations will depend on several factors, including:

- the economic conditions in these regions
- the acceptance of the U.S. dollar as the currency to purchase manufactured products
- the stability of the political environment in these regions
- adverse changes in the relationships between major countries in these regions
- the state of trade relations among these regions and the United States
- restrictions on trade in these regions
- the imposition or changing of tariffs by the countries in these regions on products of the type that we sell
- changes in the regulatory environment in these regions
- import restrictions and import license requirements
- our ability to maintain satisfactory relationships with our foreign manufacturers
- changes in freight rates
- difficulties in staffing and managing international operations
- potential insolvency of vendors and difficulty in obtaining materials

If we are unable to address any of these factors, it could have a material adverse effect on our business, operating results and financial condition.

**Foreign currency exchange fluctuations could adversely affect our results.**

For the three fiscal years ended September 30, 2008, 2007 and 2006 at least 40 % of our sales were generated

by our European subsidiary and were invoiced and collected in local currency, which was primarily the Euro. On the supply side since we predominantly deal with North American and Asian suppliers and contract manufacturers, approximately 90% of our inventory required to support our European sales are purchased and paid in U.S. Dollars.

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

See “Item 7--Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Item 7A – Quantitative and Qualitative Disclosures About Market Risk” with reference to the impact of foreign currency exchange fluctuations.

**We may be unable to develop new products that meet customer requirements in a timely manner.**

Our success is dependent on our ability to continue to introduce new products with advanced features, functionality and performance that our customers demand. We may not be able to introduce new products on a timely basis, that are accepted by the market, and that sell in quantities sufficient to make the products viable for the long-term. Sales of new products may negatively impact sales of existing products. In addition, we may have difficulty establishing our products' presence in markets where it does not currently have significant brand recognition.

**We may experience declining margins.**

For several years we have experienced declining gross margins due to the following factors, among others:

- larger sales mix of lower margin products
- changes in foreign currency exchange rates
- allowances for excess inventory
- increases in costs charged by contract manufacturers
- increases in duty and tariff rates
- increases in shipping costs
- lower average selling prices
- increases in material acquisition costs and
- different gross margins for like products in different markets

Consequently, as margins may decline, our profitability will be more dependent upon effective cost management controls. There can be no assurances that such cost and management controls can be implemented and maintained, and if implemented, that they will be successful.

**We have experienced, and expect to continue to experience, intense downward pricing pressure on our products, which could substantially impair our operating performance.**

We are experiencing, and are likely to continue to experience, downward pricing pressure on our products. As a result, we have experienced, and we expect to continue to experience, declining average sales prices for our products. Increases in the number of units that we are able to sell and reductions in per unit costs may not be sufficient to offset reductions in per unit sales prices, in which case our net income would be reduced and we could incur losses. Since we typically negotiate supply arrangements far in advance of delivery dates, we may need to commit to price reductions for our products before we are aware of how, or if, these cost reductions can be obtained. As a result, any current or future price reduction commitments and our inability to respond to increased price competition could have a material adverse effect on our business, operating results and financial

condition.

**Our cost reduction and operational efficiency programs may not achieve the intended results**

Changing economic and business conditions may dictate that we undertake a plan of cost and operational efficiency reductions. We cannot be certain that these programs will achieve their intended results. Additionally, these programs may be misplaced or insufficient for purposes of positioning us for future growth, in which case our long-term competitive position may suffer. Failure of these programs, if any, could have a material adverse effect on our business, operating results and financial condition.

**We are dependent upon contract manufacturers for our production. If these manufacturers do not meet our requirements, either in volume or quality, then we could be materially harmed.**

During fiscal 2008, we subcontracted the manufacturing and assembly of our products to four independent third parties at facilities in various Asian countries. We expect to be using two new subcontract manufacturers located in Asia for our PCTV product line.

Relying on subcontractors involves a number of significant risks, including:

- loss of control over the manufacturing process
- potential absence of adequate production capacity
- potential delays in production lead times
- unavailability of certain process technologies
- reduced control over delivery schedules, manufacturing yields, quality and costs, and
- unexpected increases in component costs

We may need to hold more inventory than is immediately required to compensate for potential manufacturing disruptions.

If our significant subcontractors become unable or unwilling to continue to manufacture these products in required volumes, we will have to identify qualified alternate subcontractors. Additional qualified subcontractors may not be available, or may not be available on a timely or cost competitive basis. Any interruption in the supply of, or increase in, the cost of the products manufactured by third party subcontractors could have a material adverse effect on our business, operating results and financial condition.

**We are dependent upon single or limited source suppliers for our components and assembled products. If these suppliers do not meet the demand, either in volume or quality, then we could be materially harmed.**

If the supply of a key component or assembled product, such as the WinTV-HVR-900 and the WinTV-Nova-T-Stick were to be delayed or curtailed or in the event a key manufacturing or sole vendor delays shipment of such components or completed products, our ability to ship products in desired quantities and in a timely manner would be adversely affected. Our business, operating results and financial condition could also be adversely affected, depending on the time required to obtain sufficient quantities from the original source or, if possible, to identify and obtain sufficient quantities from an alternative source. We attempt to mitigate these potential risks by working closely with our key suppliers on product introduction plans, strategic inventories, coordinated product introductions, and internal and external manufacturing schedules and levels. We are also seeking out alternative sources for assembled products, making us less dependent on a single or limited source.

We may need to hold more inventory than is immediately required to compensate for potential component shortages or discontinuation. This could lead to an increase in the costs of manufacturing or assembling our

products.

If any single or limited source supplier becomes unable or unwilling to continue to supply these components or assembled products in required volumes, we will have to identify and qualify acceptable replacements or redesign our products with different components. Additional sources may not be available, or product redesign may not be feasible on a timely basis. Any interruption in the supply of or increase in the cost of the components and assembled products provided by single or limited source suppliers could have a material adverse effect on our business, operating results and financial condition.

**We may incur excessive expenses if we are unable to accurately forecast sales of our products.**

We generally ship products within one to four weeks after receipt of orders. Therefore, our sales backlog is typically minimal. Accordingly, our expectations of future net sales and our product manufacturing and materials planning are based largely on our own estimates of future demand and not on firm customer orders.

If we obtain orders in excess of our internal forecasts, we may be unable to timely increase production to meet demand which could have a material adverse effect on our business, operating results and financial condition. If our net sales do not meet expectations, our business, operating results and financial condition would be adversely affected, we may be burdened with excess inventory, and we may be subject to excess costs or inventory write-offs.

**We may experience a reduction in sales if we are unable to respond quickly to changes in the market for our products.**

Our net sales can be affected by changes in the quantity of products that our distributor and PC manufacturer customers maintain in their inventories. We may be directly and rapidly affected by changes in the market, including the impact of any slowdown or rapid increase in end user demand. Despite efforts to reduce distribution channel inventory exposure, distribution partners and PC manufacturer customers may still choose to alter their inventory levels, which could cause a reduction in our net sales; this could have a material adverse effect on our business, operating results and financial condition.

**We may accumulate inventory to minimize the impact of shortages from manufacturers and suppliers, which may result in obsolete inventory that we may need to write off resulting in losses.**

Managing our inventory is complicated by fluctuations in the demand for our products as well as the issues of using contract manufacturers and procuring components from suppliers mentioned above. As we must plan to have sufficient quantities of products available to satisfy our customers' demands, we sometimes accumulate inventory for a period of time to minimize the impact of possible insufficient capacity or availability of components from our manufacturers and suppliers. Although we expect to sell the inventory within a short period of time, products may remain in inventory for extended periods of time and may become obsolete because of the passage of time and the introduction of new products or new components within existing products. In these situations, we would be required to write off obsolete inventory which could have a material adverse effect on our business, operating results and financial condition.

**We may need financing, and may not be able to raise financing on favorable terms, if at all, which could limit our ability to grow and increase our costs.**

We anticipate that we may need to raise additional capital in the future to continue our long term expansion plans, to respond to competitive pressures or to respond to unanticipated requirements. We cannot be certain that we will be able to obtain additional financing on commercially reasonable terms, if at all. Our failure or

inability to obtain financing on acceptable terms could require us to limit our plans for expansion, incur indebtedness that has high rates of interest or substantial restrictive covenants, issue equity securities that will dilute existing stockholders' holdings or discontinue a portion of our operations, each of which could have a material adverse effect on our business, operating results and financial condition.

**We may become involved in costly intellectual property disputes.**

With the proliferation of new products and rapidly changing technology, there is a significant volume of patents and other intellectual property rights held by third parties. There are a number of companies that hold patents for various aspects of the technologies incorporated in some of the PC and TV industries' standards. Given the nature of our products and development efforts, there are risks that claims associated with such patents or intellectual property rights could be asserted by third parties against us. We expect that parties seeking to gain competitive advantages will increase their efforts to enforce any patent or intellectual property rights that they may have. The holders of patents from which we may have not obtained licenses may take the position that it is required to obtain a license from them.

If a patent holder refuses to offer such a license or offers such a license on terms unacceptable to us, there is a risk of incurring substantial litigation or settlement costs regardless of the merits of the allegations, or which party eventually prevails. If we do not prevail in a litigation suit, we may be required to pay significant damages and/or to cease sales and production of infringing products and accordingly, may incur significant defense costs. Additionally, we may need to attempt to design around a given technology, although there can be no assurances that this would be possible or economical.

We currently use technology licensed from third parties in certain products. Our business, financial condition and operating results could be adversely affected by a number of factors relating to these third-party technologies, including:

- failure by a licensor to accurately develop, timely introduce, promote or support the technology
- delays in shipment of products
- excess customer support or product return costs due to problems with licensed technology
- termination of our relationship with such licensors

**We may be unable to enforce our intellectual property rights.**

We may not be able to adequately protect our intellectual property through patent, copyright, trademark and other means of protection. If we fail to adequately protect our intellectual property, our intellectual property rights may be misappropriated by others, invalidated or challenged, and our competitors could duplicate our technology or may otherwise limit any competitive technological advantage we may have. Due to the rapid pace of technological change, we believe our success is likely to depend more upon continued innovation, technical expertise, marketing skills and customer support and service rather than upon legal protection of our proprietary rights. However, we intend to aggressively assert our intellectual property rights when necessary.

Even though we typically develop our products independently, our success, of which there can be no assurances, will depend, in a large part, on our ability to innovate, obtain or license patents, protect trade secrets, copyrights and trademarks, and draw upon our proprietary technology without infringing on the proprietary rights of others. We maintain copyrights on our designs and software programs, but currently we have no patent on the WinTV® board as we believe that such technology cannot be patented.

We have no patents issued or pending that relate to our technology. We are subject to a number of risks relating

to intellectual property rights, including the following:

- the means by which we seek to protect our proprietary rights may not be adequate to prevent others from misappropriating our technology or from independently developing or selling technology or products with features based on or similar to our products
- our products may be sold in foreign countries that provide less protection to intellectual property than is provided under U.S. laws
- our intellectual property rights may be challenged, invalidated, violated or circumvented and may not provide us with any competitive advantage

**We may not be able to attract and retain qualified managerial and other skilled personnel.**

Our success, of which there can be no assurances, depends, in part, on our ability to identify, attract, motivate and retain qualified managerial, technical and sales personnel. Our success, of which there can be no assurances, is dependent on our ability to manage effectively the enhancement and introduction of existing and new products and the marketing of such products. We are particularly dependent on our ability to identify, attract, motivate and retain qualified managers, engineers and salespersons. The loss of the services of a significant number of engineers or sales people or one or more senior officers or managers could be disruptive to product development efforts or business relationships and could seriously harm our business.

**We depend on a limited number of key personnel, and the loss of any of their services could adversely affect our future growth and profitability and could substantially interfere with our operations.**

Our products are complex and our market is evolving. The success of our business depends in large part upon the continuing contributions of our management and technical personnel. The loss of the services of any of our key officers or employees could adversely affect our future growth and profitability and could have a material adverse effect on our business, operating results and financial condition.

Our dependence upon our key officers and employees is increased by the fact that they are responsible for our sales and marketing efforts as well as our overall operations. We do not have key person life insurance policies covering any of our employees other than Mr. Plotkin, our President, Chairman of the Board, Chief Executive Officer and Chief Operating Officer. The insurance coverage that we have on him may be insufficient to compensate us for the loss of his services.

**We may not be able to effectively integrate businesses or assets that we acquire**

We may identify and pursue acquisitions of complementary companies and strategic assets, such as customer bases, products and technology. However, there can be no assurance that we will be able to identify suitable acquisition opportunities.

If any such opportunity involves the acquisition of a business, we cannot be certain that:

- we will successfully integrate the operations of the acquired business with our own
- all the benefits expected from such integration will be realized
- management's attention will not be diverted or divided, to the detriment of current operations
- amortization of acquired intangible assets will not have a negative effect on operating results or other aspects of our business
- delays or unexpected costs related to the acquisition will not have a detrimental effect on our business, operating results and financial condition
- customer dissatisfaction with, or performance problems at, an acquired company will not have an

- adverse effect on our reputation
- respective operations, management and personnel will be compatible

In most cases, acquisitions will be consummated without seeking and obtaining stockholder approval, in which case stockholders will not have an opportunity to consider and vote upon the merits of such an acquisition. Although we will endeavor to evaluate the risks inherent in a particular acquisition, there can be no assurance that we will properly ascertain or assess such risks.

**We may not be able to obtain audited financial statements related to the assets we acquired.**

We are subject to rules under the Securities Exchange Act of 1934, as amended, Exchange Act rules which require us to file a Current Report on Form 8-K including audited financial statements with respect to the acquisition of assets of the PCTV business we acquired from Avid technology, Inc. and certain of its affiliates within 74 days of the acquisition closing date. Failure to obtain these audited financial statements will cause us to be delinquent with the filing of the 8-K. Our agreement with Avid contemplates that we should receive such audited financial statements on a timely basis. Failure to obtain these audited financial statements could have a material adverse effect on our business, operating results and financial condition.

**Our products could contain defects, which could result in delays in recognition of sales, loss of sales, loss of market share, or failure to achieve market acceptance, or claims against us.**

We develop complex products for TV and video processing. Despite testing by our engineers, subcontractors and customers, errors may be found in existing or future products. This could result in, among other things, a delay in recognition of sales, loss of sales, loss of market share, failure to achieve market acceptance or substantial damage to our reputation. We could be subject to material claims by customers, and may need to incur substantial expenses to correct any product defects. We do not have product liability insurance to protect against losses caused by defects in our products, and we also do not have "errors and omissions" insurance. As a result, any payments that we may need to make to satisfy our customers may be substantial and may result in a substantial charge to earnings.

**We may experience fluctuations in our future operating results, which will make predicting our future results difficult.**

Historically, our quarterly and annual operating results have varied significantly from period to period, and we expect that our results will continue to do so. These fluctuations result from a variety of factors, including:

- market acceptance of our products
- changes in order flow from our customers, and their inability to forecast their needs accurately
- the timing of our new product announcements and of announcements by our competitors
- increased competition, including changes in pricing by us and our competitors
- delays in deliveries from our limited number of suppliers and subcontractors; and
- difficulty in implementing effective cost management constraints

As our sales are primarily to the consumer market, we have experienced certain seasonal revenue trends. Our peak sales quarter, due to holiday season sales of computer equipment, is typically our first fiscal quarter (October to December), followed by our second fiscal quarter (January to March). In addition, our international sales, mostly in the European market, were 52%, 44% and 54% of sales for the fiscal years ended September 30, 2008, 2007 and 2006 respectively. Our fiscal fourth quarter sales (July to September) can be potentially impacted by the reduction of activity experienced in Europe during the July and August summer holiday period.

Accordingly, any sales or net income in any particular period may be lower than the sales and net income in a preceding or comparable period. Period-to-period comparisons of our results of operations may not be meaningful, and should not be relied upon as indications of our future performance. In addition, our operating results may be below the expectations of securities analysts and investors in future periods. Failure to meet such expectations, should such an event occur, will likely cause our share price to decline.

**Our Common Stock price is highly volatile.**

The market price of our Common Stock has been, and may continue to be, subject to a high degree of volatility. Numerous factors may have a significant impact on the market price of our Common Stock, including:

- general conditions in the PC and TV industries
- product pricing
- new product introductions
- market growth forecasts
- technological innovations
- mergers and acquisitions
- announcements of quarterly operating results
- overall U.S. and international economic health
- stability of the U.S. and international securities markets

In addition, stock markets have experienced extreme price volatility and broad market fluctuations in recent years. This volatility has had a substantial effect on the market price of securities issued by many high technology companies in many cases for reasons unrelated to the operating performance of the specific companies. The price of our Common Stock has experienced volatility not necessarily related to our performance.

**Our Amended and Restated By-Laws and the Rights Agreement in which we are party to may have anti-takeover effects, limiting the ability of outside stockholders to seek control of management, and any premium over market price that an acquirer might otherwise pay may be reduced and any merger or takeover may be delayed.**

Effective August 16, 2001, the Board of Directors unanimously approved Amended and Restated By-Laws for us (the “By-Laws”). The By-Laws do not permit stockholders to call a special meeting of stockholders and consequently, an expensive proxy contest cannot occur other than in connection with the annual meeting of stockholders. The By-Laws also impose strict requirements for shareholder proposals and nominations of prospective Board members other than those nominated by or at the discretion of the Board of Directors. These amendments may collectively or individually impact a person’s decision to purchase voting securities in our Company and may have anti-takeover effects in that any merger or takeover may be delayed. Accordingly, any premium over market price that an acquirer might otherwise pay may be reduced.

On July 19, 2001, the Board of Directors declared a dividend distribution of one Right for each outstanding share of our Common Stock to stockholders of record at the close of business on August 5, 2001. Each Right entitles the registered holder to purchase from us one Common Share at a purchase price of \$11.00 per share, subject to adjustment and terms set out in the Rights Agreement between us and Continental Stock Transfer & Trust Company, as Rights Agent. The Rights may have certain anti-takeover effects. The Rights will cause substantial dilution to a person or group that attempts to acquire us in a manner which causes the Rights to become discount Rights unless the offer is conditional on a substantial number of Rights being acquired. Accordingly, any premium over market price that an acquirer might otherwise pay may be reduced.

**No dividends and none anticipated.**

We have never paid any cash dividends on our Common Stock and do not contemplate or anticipate paying any cash dividends on our Common Stock in the foreseeable future. It is currently anticipated that earnings, if any, will be used to finance the development and expansion of the business. In addition, the Note contains restrictions on the payment of dividends, among other things. See Item 1. Business – “Recent Developments”.

### **We may not be able to effectively integrate the PCTV Systems operation**

In In regard to the acquisition of the assets of the PCTV Systems operation, we may not be able to successfully integrate the operations of the Acquired Assets with our own and realize benefits expected from such integration. In addition:

- management's attention may be diverted or divided to the detriment of current operations
- amortization of acquired intangible assets may have a negative effect on operating results or other aspects of our business
- delays or unexpected costs related to the acquisition may have a detrimental effect on our business, operating results and financial condition
- customer dissatisfaction with, or performance problems with respect to, the Acquired Assets may have an adverse effect on our reputation
- operations, management and personnel may not be compatible

### **The financing of the purchase of the PCTV assets and the cash needed to fund our PCTV operation's working capital needs may subject us to liquidity issues**

Our cash requirements during fiscal 2009 include the cash required to finance the purchase of the PCTV assets from Avid Technology, Inc. and certain of its affiliates and the cash needed to fund the acquisition's working capital needs. With the proper execution of our operational and integration plan, we believe that our cash and cash equivalents as of September 30, 2008 and our internally generated cash flow will provide us with sufficient liquidity to meet our capital needs for the next twelve months. Failure to meet the operating and integration plan could require the need for additional sources of capital. In light of the current economic and credit conditions there can be no assurances that we will be able to find external sources of financing to fund our additional working capital needs, or if we procure financing the financing may not be at competitive terms.

### **Forward looking statements.**

From time to time, information provided by us, statements made by our employees or information provided in our Securities and Exchange Commission filings, including information contained in this Annual Report on Form 10-K, may contain forward looking information. Our actual future results may differ materially from those projections or statements made in such forward looking information as a result of various risks and uncertainties, including, but not limited to, rapid changes in technology, lack of funds for research and development, competition, proprietary patents and rights of others, loss of major customers, loss of sources of supply for our components, non-availability of management, government regulation, currency fluctuations and our inability to profitably sell our products. The market price of our Common Stock may be volatile at times in response to fluctuations in our quarterly operating results, changes in analysts' earnings estimates, market conditions in the computer hardware industry, seasonality of the business cycle, as well as general conditions and other external factors.

### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable

## **ITEM 2. PROPERTIES**

We occupy a facility located at 91 Cabot Court, Hauppauge, New York that we use for our executive offices and for the testing, storage and shipping of our products. Hauppauge Computer Works, Inc., (“HCW”) leases the premises (the “1990 Lease”), from Ladokk Realty Co., a real estate partnership which is principally owned by Kenneth Plotkin, our President, Chairman of the Board, Chief Executive Officer and Chief Operating Officer and the holder of approximately 8.34% of our shares of Common Stock as of September 30, 2008, Dorothy Plotkin, the wife of Kenneth Plotkin, holder of approximately 5.50% of our shares of Common Stock as September 30, 2008, and Laura Aupperle, believed by us to be the holder of approximately 7.64% of our shares of Common Stock, including shares of Common Stock attributed to the Estate of Kenneth R. Aupperle, as of September 30, 2008. We are obligated to pay real estate taxes and operating costs of maintaining the premises subject to the 1990 Lease.

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

HCW occupies a shared office facility at the Danville Business Center in Danville, California. We use the California office as our western region sales office. The lease expires on May 31, 2009 and requires us to pay an annual rent, which includes telecommunications services, of approximately \$9,800.

Our German subsidiary, Hauppauge Computer Works GmbH, occupies approximately 6,000 square feet in Mönchengladbach, Germany. It is used as our European sales office and customer support center. It also has a product demonstration room and a storage facility. Hauppauge Computer Works GmbH pays an annual rent of approximately \$55,000 for this facility pursuant to a rental agreement, which expires on October 31, 2009.

Our Singapore subsidiary, Hauppauge Digital Asia Pte. Ltd., occupies approximately 5,400 square feet in Singapore, which it uses as a sales and administration office and for the testing, storage and shipping of our products. The lease expires on November 30, 2009 and calls for an annual rent of approximately \$63,000. The rent includes an allocation for common area maintenance charges.

On May 1, 2001, Hauppauge Digital . commenced a lease of a 15,642 square foot building in Blanchardstown, Dublin, Ireland. The facility houses our European warehousing and distribution center. The lease, which is for the standard twenty-five year term in Ireland with the right to terminate on the fifth and tenth year of the lease, calls for an annual rent of approximately \$234,000. The rent includes an allocation for common area maintenance charges.

We are leasing space on a short term basis from Avid Technology Inc., in Braunschweig, Germany. In the near future we intend to enter into a lease agreement directly with the with landlord. This location is intended to house our PCTV engineering and product development personnel. On a short term basis we are paying Avid Technology, Inc. rent at an annualized rate of \$130,000.

## **ITEM 3. LEGAL PROCEEDINGS**

We are presently party to no pending material legal proceedings.

## **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

## **PART II**

### **Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

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

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

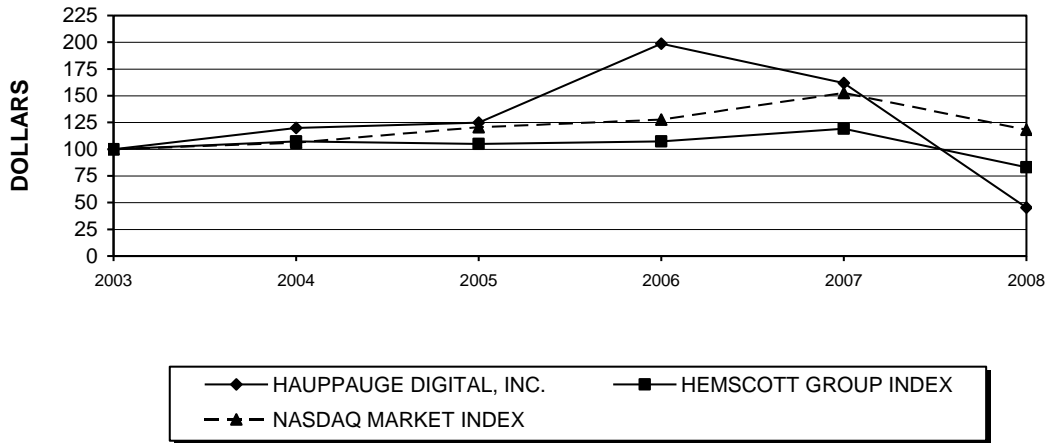
We have been advised by our transfer agent, Continental Stock Transfer & Trust Company that the approximate number of holders of record of our Common Stock as of September 30, 2008 was 156. We believe there are in excess of 4,000 beneficial holders of our Common Stock.

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

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

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

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



ASSUMES \$100 INVESTED ON OCT. 1, 2003  
ASSUMES DIVIDEND REINVESTED  
FISCAL YEAR ENDING SEPT. 30, 2008

## ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data with respect to our financial position and our results of operations for each of the five fiscal years in the period ended September 30, 2008 set forth below has been derived from our audited consolidated financial statements. The selected financial information presented below should be read in conjunction with the Consolidated Financial Statements and related notes thereto and “Item 7-Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in this Annual Report on Form 10-K.

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

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Results of operations

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

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

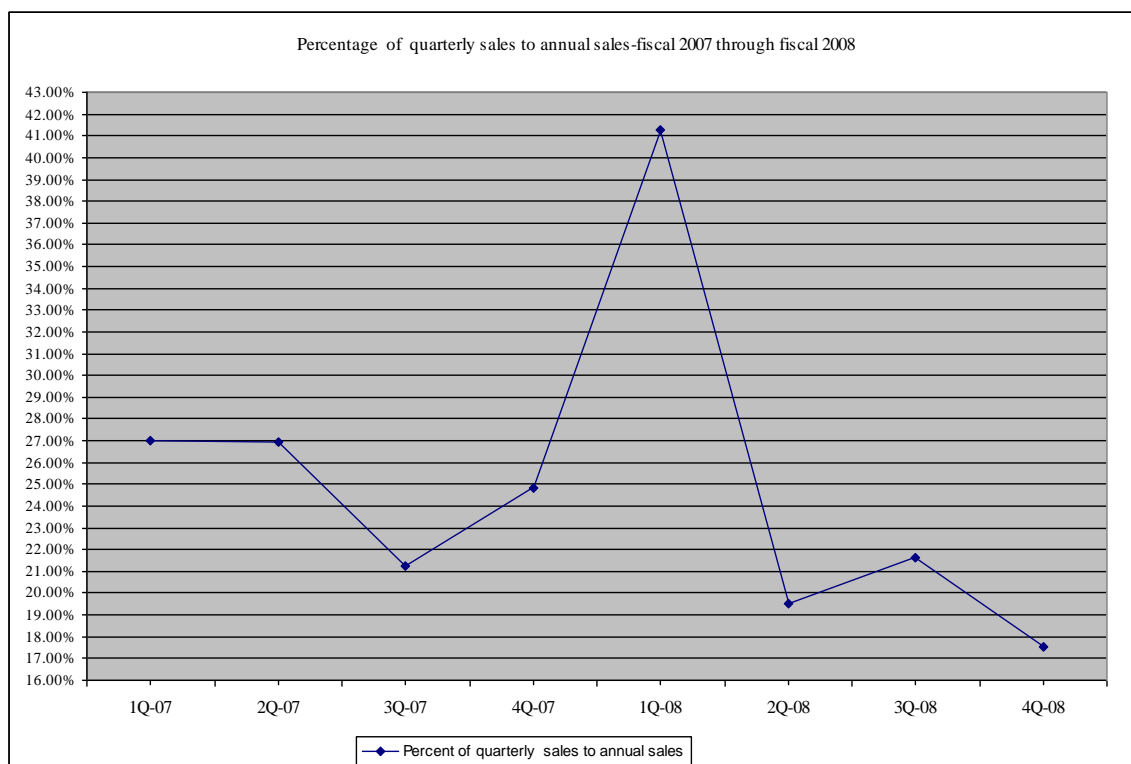
	Twelve	Twelve	Variance	Percentage of sales		
	Months	Months		2008	2007	Variance
	Ended	Ended	\$			
	<u>9/30/08</u>	<u>9/30/07</u>				
Net Sales	\$ 89,701,028	\$ 110,896,010	\$ (21,194,982)	100.00%	100.00%	-
Cost of sales	<u>72,019,046</u>	<u>88,651,881</u>	<u>(16,632,835)</u>	<u>80.29%</u>	<u>79.94%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

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

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

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

## Seasonal nature of sales



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

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

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

## Gross profit

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

The decrease in the gross profit is detailed below:

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

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

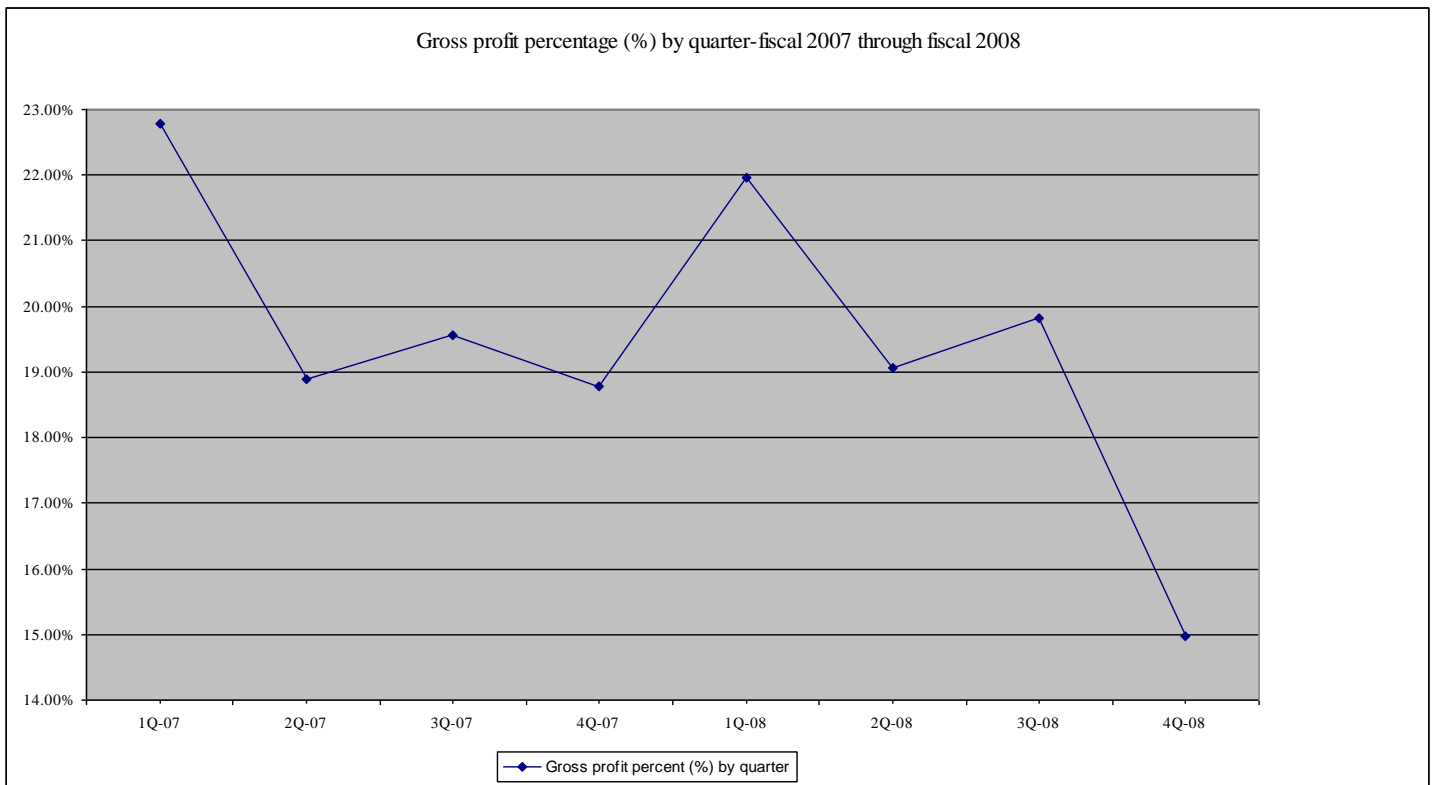
The increase in the gross profit percent is detailed below:

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

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

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

**Volatility of gross profit percentage:**



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

Factors affecting the volatility of our gross profit percentages are:

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

Managing product mix through market strategy and new products, moderating seasonal trends, efficiently managing shipments and achieving cost reductions are a company priority and are critical to our competitive

position in the market. Although our goal is to optimize gross profit and minimize gross profit fluctuations, in light of the dynamics of our market we anticipate the continuance of gross profit percentage fluctuations.

### Selling, general and administrative expenses

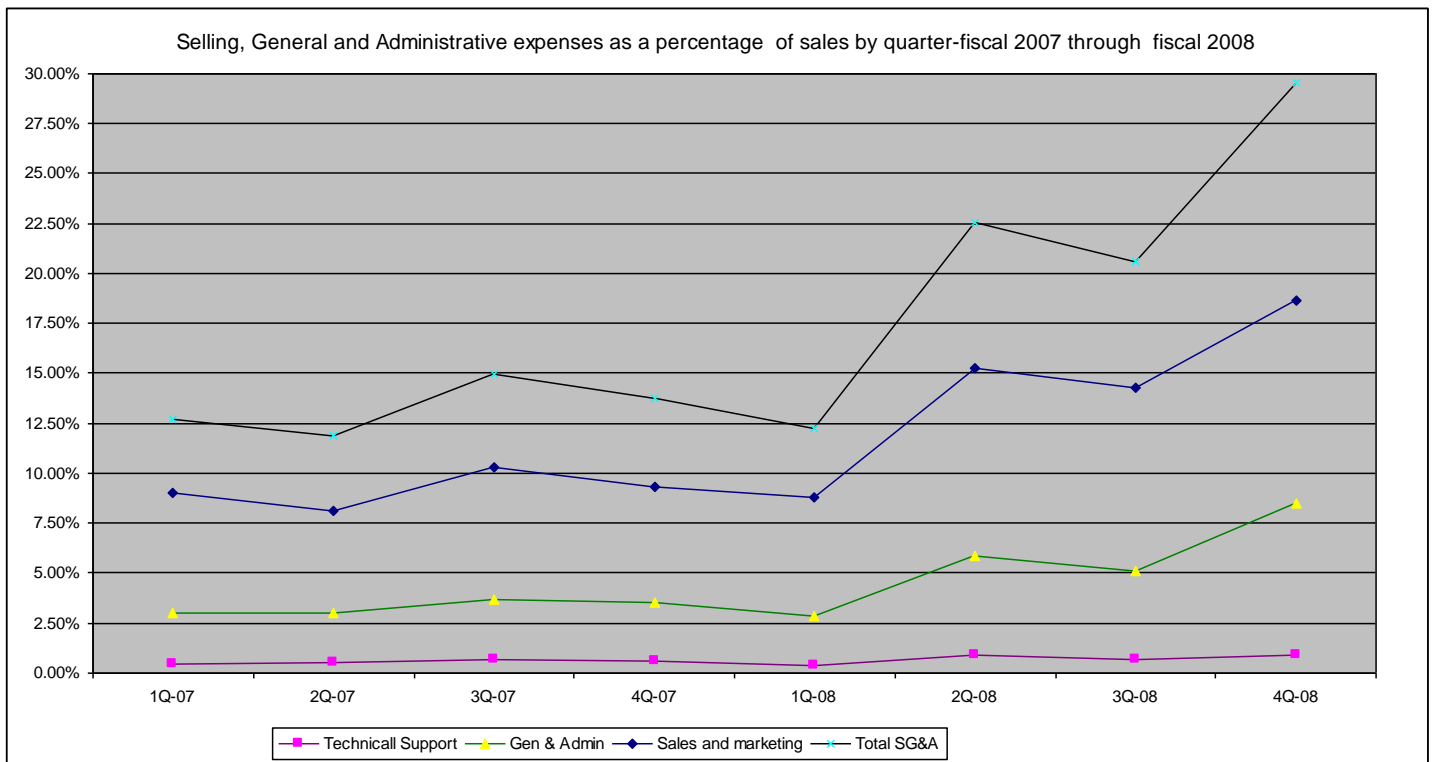
The chart below illustrates the components of Selling, general and administrative expenses.

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

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

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

### Selling general and administrative expenses as a percentage of sales



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

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

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

### Research and development expenses

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

## Other income

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

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

## Accumulated other comprehensive income (loss)

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

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

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

## Tax provision

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

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

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

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

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

As a result of all of the above items mentioned in the Management’s Discussion and Analysis of Financial Condition and Results of Operations, we had a net loss of \$3,088,189 for the twelve months ended September

30, 2008, which resulted in basic and diluted net loss per share of \$0.31 on weighted average basic and diluted shares of 9,969,939, compared to net income of \$5,305,384 for the twelve months ended September 30, 2007, which resulted in basic net income per share of \$0.54 and diluted net income per share of \$0.51 on weighted average basic and diluted shares of 9,862,655 and 10,367,775, respectively.

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

## Results of operations

### Twelve months ended September 30, 2007 compared to September 30, 2006.

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

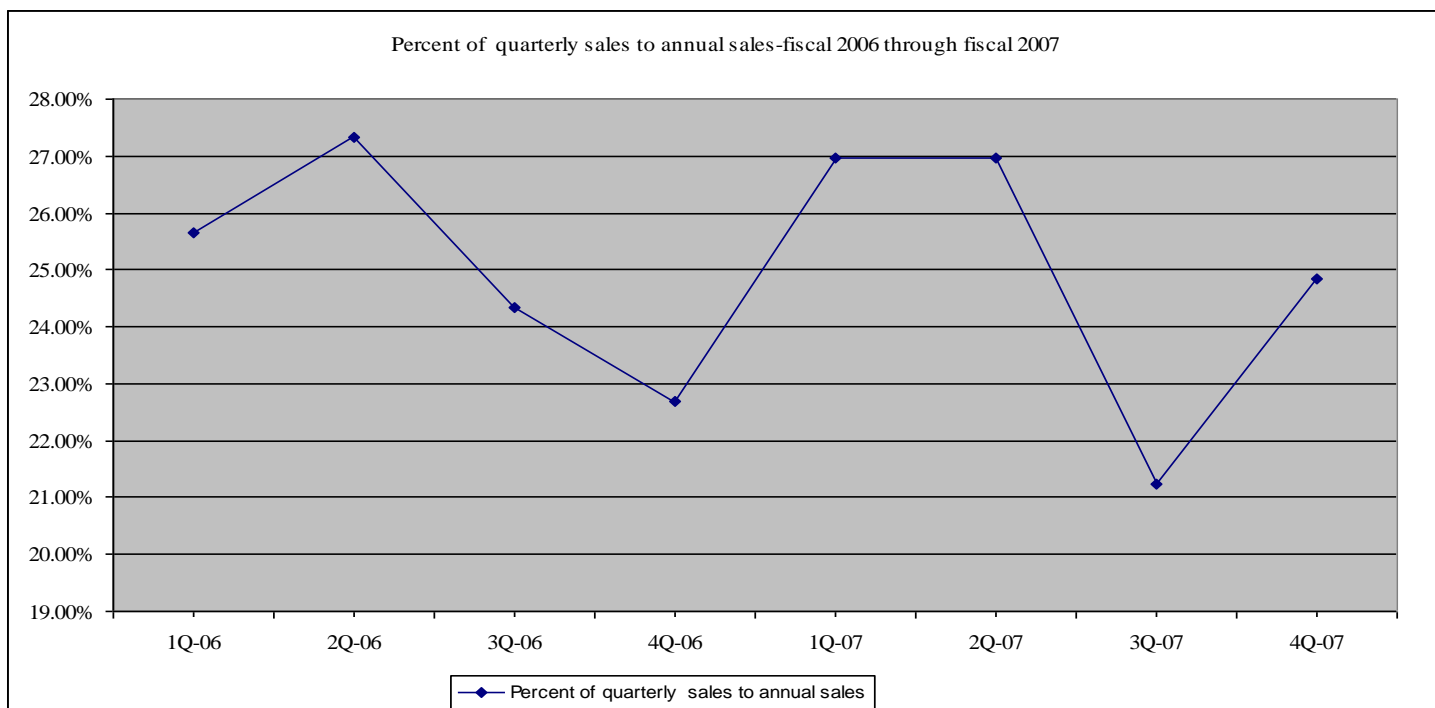
	Twelve	Twelve	Variance	Percentage of sales		
	Months	Months			2007	2006
	Ended	Ended	\$			
	9/30/07	9/30/06				
Net Sales	\$ 110,896,010	\$ 97,662,326	\$ 13,233,684	100.00%	100.00%	-
Cost of sales	<u>88,651,881</u>	<u>77,817,275</u>	<u>10,834,606</u>	<u>79.94%</u>	<u>79.68%</u>	<u>0.26%</u>
Gross Profit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

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

Location	Twelve Months Ended 9/30/07	Twelve Months Ended 9/30/06	Increase (decrease) Dollar Variance	Increase (decrease) Variance %	Percentage of sales by Geographic region	
					2008	2007
Domestic	62,649,883	45,231,986	17,417,897	39%	56%	46%
Europe	45,585,721	49,803,392	(4,217,671)	-8%	42%	51%
Asia	<u>2,660,406</u>	<u>2,626,948</u>	<u>33,458</u>	<u>1%</u>	<u>2%</u>	<u>3%</u>
Total	<u>\$ 110,896,010</u>	<u>\$ 97,662,326</u>	<u>\$ 13,233,684</u>	<u>14%</u>	<u>100%</u>	<u>100%</u>

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

### Seasonal nature of sales



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

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

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

### Gross profit

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

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

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

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

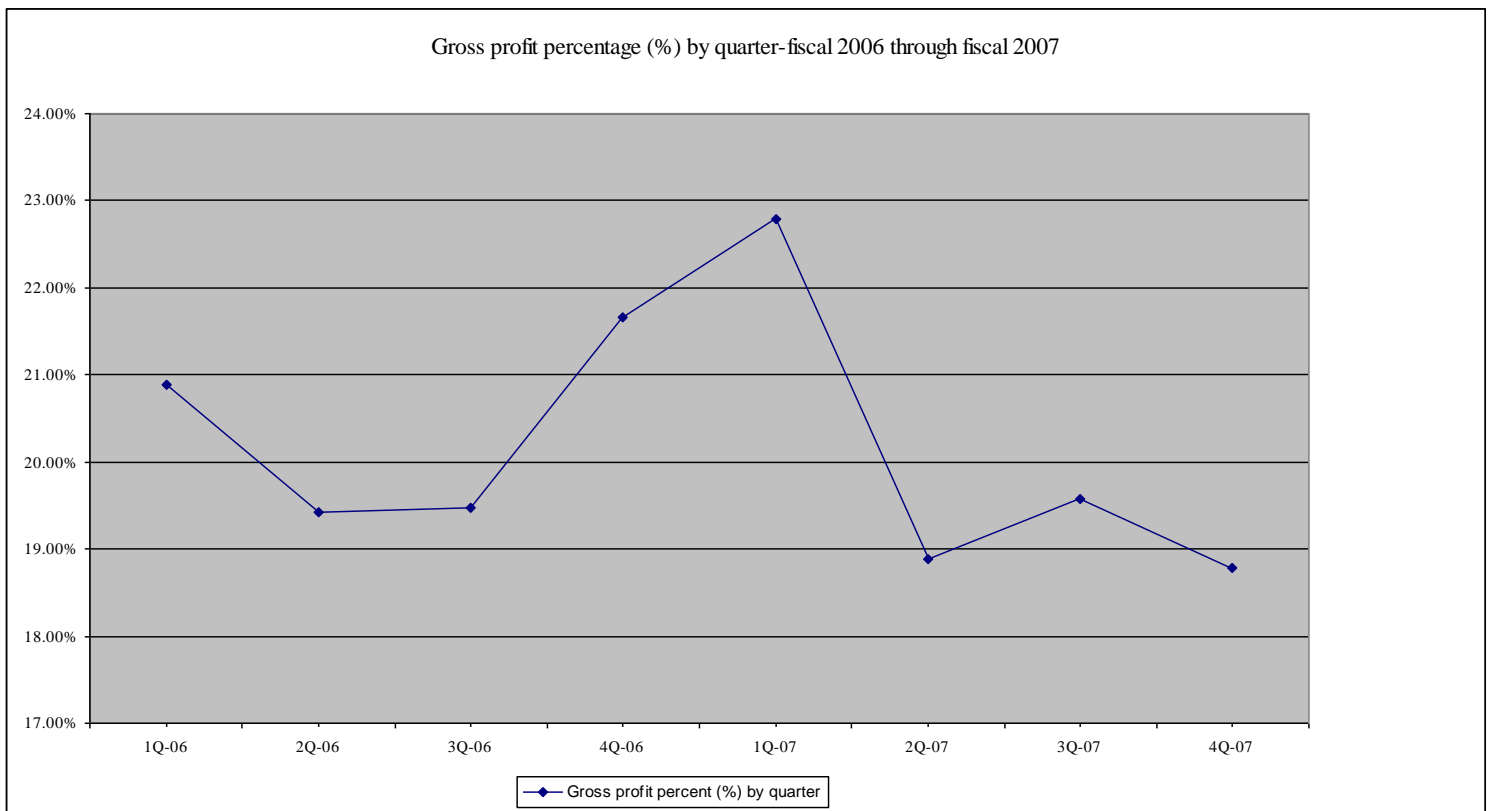
The increases and (decreases) in the gross profit percent are detailed below:

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

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

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

**Volatility of gross profit percentage:**



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

Factors affecting the volatility of our gross profit percentages are:

- Mix of product. Gross profit percentages vary within our retail family of products as well as for products sold to manufacturers. Varying sales mix of these different product lines affect the quarterly gross profit percentage

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

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

## Selling, general and administrative expenses

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

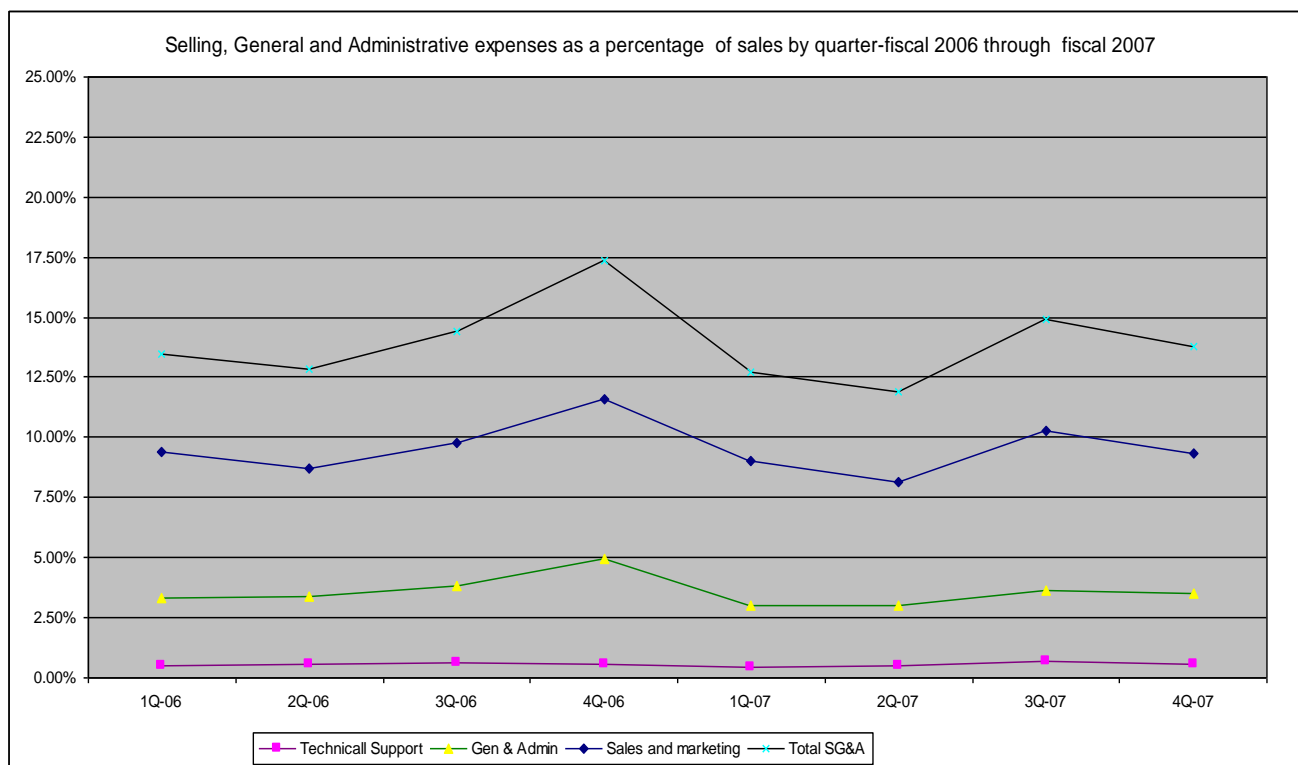
	Twelve months ended September 30,					
	Dollar Costs			Percentage of Sales		
	2007	2006	Increase (Decrease)	2007	2006	Increase (decrease)
Sales and marketing	\$10,132,587	\$ 9,565,730	\$ 566,857	9.14%	9.79%	-0.65%
Technical support	600,074	556,865	43,209	0.54%	0.57%	-0.03%
General and administrative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

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

Stock compensation expense related to SG&A personnel was \$52,929 higher than in fiscal 2006. During fiscal 2006, we had run out of options authorized in our stock option plan. Accordingly, we did not issue as many options as we would have in fiscal 2006 had there been additional shares authorized. At our October 2006 Annual Meeting of Stockholders, our stockholders approved the addition of 1 million shares of Common Stock

to our 2003 Performance and Equity Incentive Plan. As a result, we were able to grant more options in fiscal 2007 than fiscal 2006, thus increasing the stock compensation expense recorded in fiscal 2007.

### Selling general and administrative expenses as a percentage of sales



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

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

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

## Research and development expenses

Research and development expenses increased \$315,093. The increase was mainly due to the hiring of additional engineering personnel and increased program development expenses due to higher volume of new product and product enhancement programs. Stock compensation expense related to research and development personnel was \$92,653 higher than fiscal 2007.

## Other income

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

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

## Accumulated other comprehensive income (loss)

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

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

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

## Tax provision

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

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

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

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

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

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

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

## Liquidity and Capital Resources

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

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

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

The increase was due to:

### Sources of cash:

Decrease in accounts receivable	\$13,969,369
Decrease in inventory	355,698
Proceeds from employee stock purchases	291,463

### Less cash used for:

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

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

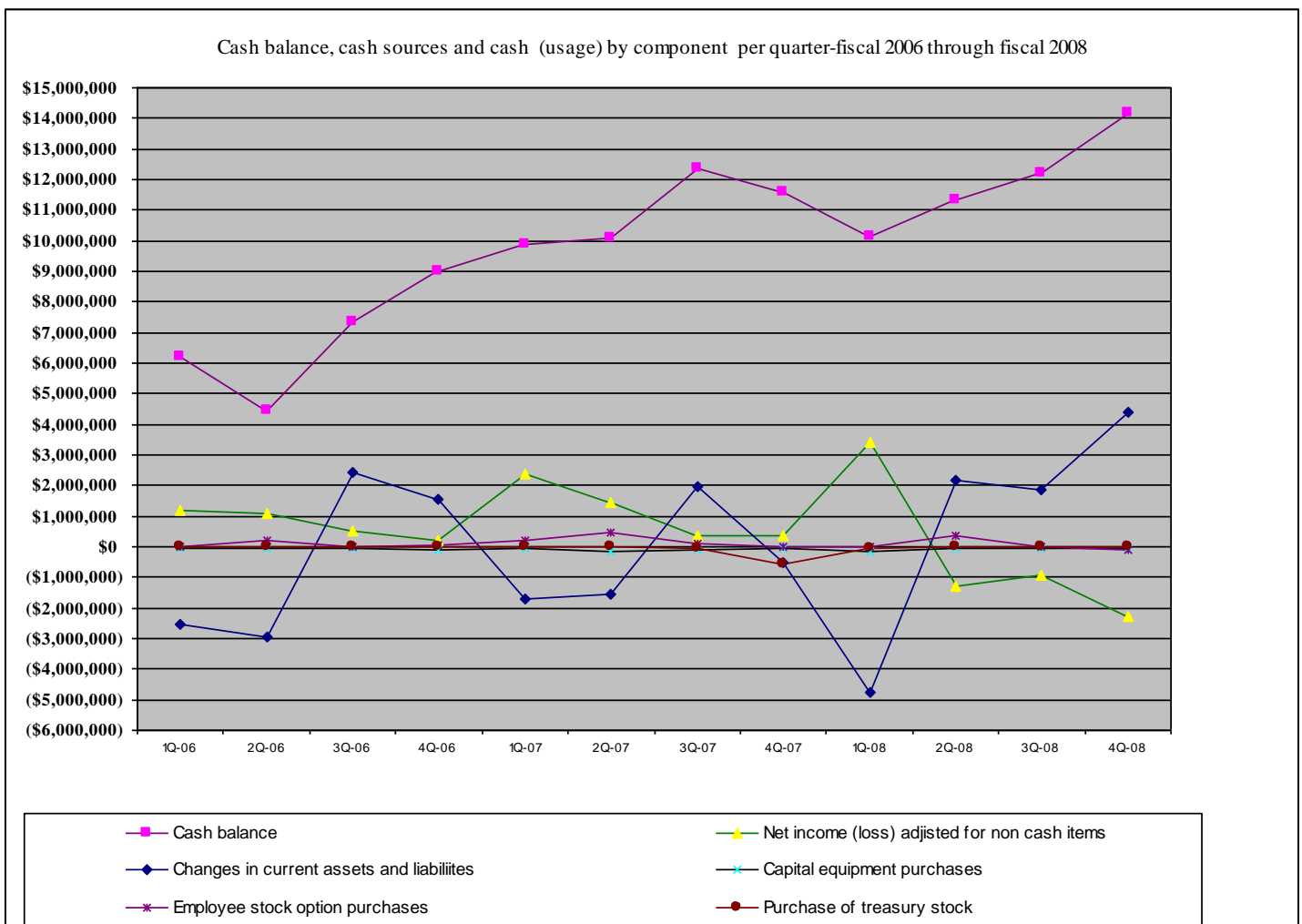
reduction in sales. Lower sales also resulted in less inventory purchased which was the driving force in the reduction of accounts payable and inventory.

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

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

### Sources and (usage) of cash components

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



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

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

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

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

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

### **Line of Credit**

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

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

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

There were no borrowings outstanding and \$680,000 letters of credit outstanding as of the filing date of this Annual Report on Form 10-K.

Our cash requirements during fiscal 2009 will include the cash required to finance the purchase the PCTV product line from Avid Technology, Inc. and the cash needed to fund the acquisition’s working capital needs. With the proper execution of our operational and integration plan, we believe that our cash and cash equivalents as of September 30, 2008 and our internally generated cash flow will provide us with sufficient liquidity to meet our capital needs for the next twelve months. Failure to meet the operating and integration plan could require the need for additional sources of capital. In light of the current economic and credit conditions there can be no assurances that we will be able to find external sources of financing to fund our additional working capital needs. See “Item 1. Business-Recent Developments”.

### Future Contractual Obligation

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

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

Effective December 24, 2008, pursuant to an Asset Purchase Agreement dated as of October 25, 2008, we acquired certain assets and properties of Avid Technology, Inc., Pinnacle Systems, Inc., Avid Technology GmbH, Avid Development GmbH, and Avid Technology International BV. The purchase price consisted of \$2,500,000 payable in cash and \$2,500,000 payable pursuant to Promissory Note made payable by the us to Avid. The principal amount due pursuant to the Note is payable in 12 equal monthly installments of \$208,333.33. The first payment is due and payable on January 24, 2009. Interest on the outstanding principal amount of the Note is payable at a rate equal to (i) from December 24, 2008 until the Maturity Date, five percent (5%), (ii) from and after the Maturity Date, or during the continuance of an Event of Default, at seven percent (7%). Pursuant to the terms of the Note, we and our affiliates are prohibited from (i) declaring or paying any cash dividend, or making a distribution on, repurchasing, or redeeming, any class of stock or other equity or ownership interest in the Buyer or its affiliates, (ii) selling, leasing, transferring or otherwise disposing of any assets or property of the Buyer or any of its affiliates, or attempting to or contracting to do so, other than (a) the sale of inventory in the ordinary course of business and consistent with past practice, (b) the granting of non-exclusive licenses of intellectual property in the ordinary course of business and consistent with past

practice and (c) the sale, lease, transfer or disposition of any assets or property (other than the Acquired Assets) with a value not to exceed \$500,000 in the aggregate, or (iii) dissolving or liquidating, or merging or consolidating with any other entity, or acquiring all or substantially all of the stock or assets of any other entity. See “Item 1. Business-Recent Developments”.

### **Critical Accounting Policies and Estimates**

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

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

### **Revenue Recognition**

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

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

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

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

### **Management’s Estimates**

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities and related disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts for revenues and expenses during the reporting period. On an ongoing basis, management evaluates estimates, including those

related to sales provisions, as described above, income taxes, bad debts, inventory allowances and contingencies. We base our estimates on historical data, when available, experience, and on various other assumptions that are believed to be reasonable under the circumstances, the combined results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

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

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

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

### **Inventory obsolescence and reserves**

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

### **Accounts receivable and related reserves**

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

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

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

### **Inflation**

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

will not have an overall effect on the computer equipment market that would have a material affect on us.

### **Recent Accounting Pronouncements**

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

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

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

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

### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

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

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

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

See “Item 1A--Risk Factors” and “Item 7--Management’s Discussion and Analysis of Financial Condition and Results of Operations” with reference to the impact of foreign currency exchange fluctuations.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements required by this Item 8 are included in this Annual Report on Form 10-K following Item 15 hereof.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A (T). CONTROLS AND PROCEDURES**

### ***Disclosure Controls and Procedures***

Our management with the participation of our Principal Executive Officer and Principal Financial Officer, evaluated the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e), as of September 30, 2008. Based on this evaluation, the Principal Executive Officer and Principal Financial Officer concluded, as of September 30, 2008, our disclosure controls and procedures were effective with respect to the recording, processing, summarizing and reporting on a timely basis the information that is required to be disclosed in the reports that we file or submit under the Exchange Act of 1934.

### ***Management’s Annual Report on Internal Control Over Financial Reporting***

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Exchange Act of 1934. Internal Control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes policies and procedures that (i) pertain to maintenance of records that in reasonable detail accurately and fairly reflect the transactions and disposition of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our

management and directors ; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

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 risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of internal control over financial reporting as of September 30, 2008. In making its assessment, management used as a guide the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission and the subsequent rules and guidelines issued by the Securities and Exchange Commission which are currently applicable for non accelerated filers. Based on our evaluation, management has concluded that, as of September 30, 2008, our internal control over financial reporting was effective.

***Exclusion of Registered Public Accounting Firm Attestation Report due to Temporary Rules of the Securities and Exchange Commission***

This Form 10-K does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this Form 10-K.

***Changes in internal control over financial reporting***

There has been no change in our internal control over financial reporting during our fourth fiscal quarter ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by Item 10 is incorporated by reference from our definitive Proxy Statement for our 2009 Annual Meeting of Stockholders (the "Proxy Statement") to be filed with the Securities Exchange Commission pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by Item 11 is incorporated by reference from our definitive Proxy Statement to be filed with the Securities Exchange Commission pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by Item 12 is incorporated by reference from our definitive Proxy Statement to be filed with the Securities Exchange Commission pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

**ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

The information required by Item 13 is incorporated by reference from our definitive Proxy Statement to be filed with the Securities Exchange Commission pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by Item 14 is incorporated by reference from our definitive Proxy Statement to be filed with the Securities Exchange Commission pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a)(1) Financial Statements

The following documents are included in Item 8 of this Annual Report on Form 10-K:

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(a)(2) Financial Statement Schedules

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(a)(3) Exhibits.

Exhibit  
Number

Description of Exhibit

- 2.1 Asset Purchase Agreement, dated October 25, 2008, by and among Avid Technology, Inc., Pinnacle Systems, Inc., Avid Technology GMBH, Avid Development GMBH, Avid Technology International BV, and PCTV Corp. (16)

- 2.1.1 Buyer Parent Guaranty, dated October 25, 2008, by Hauppauge Digital, Inc. to and for the benefit of Avid Technology, Inc., Pinnacle Systems, Inc., Avid Technology GMBH, Avid Development GMBH, and Avid Technology International BV (16)
- 2.1.2 Amendment No. 1 to Asset Purchase Agreement, dated December 24, 2008, by and among Avid Technology, Inc., Pinnacle Systems, Inc., Avid Technology GMBH, Avid Development GMBH, Avid Technology International BV, and PCTV Corp. (20)
- 2.1.3 Secured Promissory Note, dated December 24, 2008, made by PCTV Systems Sarl in favor of Avid Technology, Inc. (20)
- 2.1.4 Transition Services Agreement, dated December 24, 2008, by and among Hauppauge Digital Europe Sarl, PCTV Systems Sarl, Hauppauge Computer Works, Inc., Avid Technology, Inc., Pinnacle Systems, Inc., Avid Technology GMBH, Avid Development GMBH, and Avid Technology International BV. (20)
- 2.1.5 Inventory and Product Return Agreement, dated December 24, 2008, by and among Avid Technology, Inc., Avid Technology International BV, Hauppauge Computer Works, Inc. and Hauppauge Digital Europe Sarl (20)
- 2.1.6 Intellectual Property License Agreement, dated December 24, 2008, by and among Avid Technology, Inc., Pinnacle Systems, Inc. and PCTV Systems Sarl (20)
- 3.1 Certificate of Incorporation (1)
  - 3.1.1 Certificate of Amendment of the Certificate of Incorporation, dated July 14, 2000 (18)
- 3.2 By-laws, as amended to date (2)
- 4.1 Form of Common Stock Certificate (1)
- 4.2 1994 Incentive Stock Option Plan (1)
- 4.3 1996 Non-Qualified Stock Option Plan (7)
- 4.4 1998 Incentive Stock Option Plan (7)
- 4.5 2000 Hauppauge Digital, Inc. Performance and Equity Incentive Plan (3)
- 4.6 Hauppauge Digital, Inc. Employee Stock Purchase Plan (4)
- 4.7 Stockholder Rights Agreement (5)
- 4.8 2003 Hauppauge Digital, Inc. Performance and Equity Incentive Plan (6)
- 4.9 Amendment to 2003 Hauppauge Digital, Inc. Performance and Equity Incentive Plan (12)
- 4.10 Amendment to the Hauppauge Digital, Inc. Employee Stock Purchase Plan (13)
- 4.11 Second Amendment to the Hauppauge Digital, Inc. Employee Stock Purchase Plan (14)
- 4.12 Third Amendment to the Hauppauge Digital, Inc. Employee Stock Purchase Plan (12)
- 10.1 Employment Agreement, dated as of January 10, 1998, by and between Hauppauge Digital, Inc. and Kenneth Plotkin (7)
  - 10.1.1 Amendment to Employment Agreement with Kenneth Plotkin, dated April 10, 2008 (19)
- 10.2 Lease, dated February 7, 1990, between Ladokk Realty Company and Hauppauge Computer Works, Inc. (1)
  - 10.2.1 Modification made February 1, 1996 to lease dated 1990 between Ladokk Realty Company and Hauppauge Computer Works, Inc. (7)
  - 10.2.2 Lease, dated February 17, 2004, between Ladokk Realty Co., LLC and Hauppauge Computer Works, Inc. (8)
  - 10.2.3 Amendment dated October 17, 2006 to lease dated February 17, 2004, between Ladokk Realty Co., LLC and Hauppauge Computer Works, Inc. (9)
- 10.3 Fourth Amended and Restated Promissory Note, dated as of December 2, 2008, made payable by Hauppauge Computer Works, Inc. to the order of JP Morgan Chase Bank, N.A. in the original principal amount of Seven Hundred Thousand (\$700,000) Dollars. (17)
  - 10.3.1 Guaranty, dated as of December 1, 2005, by Hauppauge Digital, Inc. in favor of JPMorgan Chase Bank,

- N.A. (11)
- 10.3.2 Share Pledge Agreement, dated as of December 1, 2005, among Hauppauge Digital, Inc., JPMorgan Chase Bank, N.A. and Hauppauge Digital Europe Sarl (11)
- 10.3.3 Pledge Security Agreement, dated as of December 2, 2008, by Hauppauge Computer Works, Inc. and JP Morgan Chase Bank, N.A. (17)
- 14 Code of Ethics, as amended to date (10)
- 21 Subsidiaries
- 23 Consent of BDO Seidman, LLP
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- (1) Denotes document filed as an Exhibit to our Registration Statement on Form SB-2 (No. 33-85426), as amended, effective January 10, 1995 and incorporated herein by reference.
- (2) Denotes document filed as an Exhibit to our Form 8-K dated December 26, 2007 and incorporated herein by reference.
- (3) Denotes document filed as an Exhibit to our Registration Statement on Form S-8 (No. 333-46906), and incorporated herein by reference.
- (4) Denotes document filed as an Exhibit to our Registration Statement on Form S-8 (No. 333-46910), and as an annex to our Proxy Statement on Schedule 14A dated September 18, 2006 and are incorporated herein by reference.
- (5) Denotes document filed as an Exhibit to our Form 8-K dated July 20, 2001 (File Number 001-13550, Film Number 1685278) and as an Exhibit to the our Registration Statement on Form 8-A12G and incorporated herein by reference.
- (6) Denotes document filed as an Exhibit to our Registration Statement on Form S-8 (No. 333-109065), and as an annex to our Proxy Statement on Schedule 14A dated September 18, 2006 and incorporated herein by reference.
- (7) Denotes document filed as an Exhibit to our Form 10-K for the period ended September 30, 2003, and incorporated herein by reference.
- (8) Denotes document filed as an Exhibit to our Form 10-Q for the period ended March 31, 2004 and incorporated herein by reference.
- (9) Denotes document filed as an Exhibit to our Form 8-K dated October 17, 2006 and incorporated herein by reference.
- (10) Denotes document filed as an Exhibit to our Form 8-K dated August 23, 2004 and incorporated herein by reference.
- (11) Denotes document filed as an Exhibit to our Form 8-K dated December 6, 2005 and incorporated herein by reference.
- (12) Denotes document filed as an Exhibit to our Form 8-K dated October 17, 2006 and incorporated herein by reference.
- (13) Denotes document filed as an Exhibit to our Registration Statement on Form S-8 (No. 333-46910), and as an annex to our Proxy Statement on Schedule 14A dated September 18, 2006 and are incorporated herein by reference.
- (14) Denotes document filed as an Exhibit to our Registration Statement on Form S-8 (No. 333-46910), and as an annex to our Proxy Statement on Schedule 14A dated September 18, 2006 and are incorporated herein by reference.
- (15) Denotes document filed as an Exhibit to our Form 8-K dated December 26, 2007 and incorporated herein by reference.

- (16) Denotes document filed as an Exhibit to our Form 8-K dated October 25, 2008 and incorporated herein by reference.
- (17) Denotes document filed as an Exhibit to our Form 8-K dated December 12, 2008 and incorporated herein by reference.
- (18) Denotes document filed as an Exhibit to our Form 10-K for the period ended September 30, 2006, and incorporated herein by reference.
- (19) Denotes document filed as an Exhibit to our Form 8-K dated April 10, 2008, and incorporated herein by reference.
- (20) Denotes document filed as an Exhibit to our Form 8-K dated December 24, 2008, and incorporated herein by reference.

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## **Report of Independent Registered Public Accounting Firm**

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

We have audited the accompanying consolidated balance sheets of Hauppauge Digital, Inc. and Subsidiaries as of September 30, 2008 and 2007 and the related consolidated statements of operations, other comprehensive income, stockholders' equity and cash flows for each of the three years in the period ended September 30, 2008. These financial statements are the responsibility of the management of Hauppauge Digital, Inc. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Hauppauge Digital, Inc. and Subsidiaries as of September 30, 2008 and 2007 and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2008 in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO Seidman, LLP  
BDO Seidman, LLP

Melville, New York  
January 9, 2009

**HAUPPAUGE DIGITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

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

*See accompanying notes to consolidated financial statements*

**HAUPPAUGE DIGITAL, INC AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Years ended September 30,		
	2008	2007	2006
Net sales	\$89,701,028	\$110,896,010	\$97,662,326
Cost of sales	72,019,046	88,651,881	77,817,275
Gross profit	17,681,982	22,244,129	19,845,051
Selling, general and administrative expenses	17,152,848	14,667,766	14,115,989
Research and development expenses	3,883,747	3,480,017	3,164,924
Income (loss) from operations	(3,354,613)	4,096,346	2,564,138
Other Income (expense) :			
Interest income	43,989	43,135	28,422
Foreign currency	(15,138)	(31,676)	7,292
Total other income	28,851	11,459	35,714
Income (loss) before taxes (benefit) on income	(3,325,762)	4,107,805	2,599,852
Income tax provision (benefit)	(237,573)	(1,197,579)	190,240
Net income (loss)	(\$3,088,189)	\$5,305,384	\$2,409,612
Net income (loss) per share:			
Basic	(\$0.31)	\$0.54	\$0.25
Diluted	(\$0.31)	\$0.51	\$0.24

*See accompanying notes to consolidated financial statements*

**HAUPPAUGE DIGITAL, INC AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE INCOME (LOSS)**

<b>Other comprehensive income (loss) :</b>	<b>Years ended September 30,</b>		
	<b><u>2008</u></b>	<b><u>2007</u></b>	<b><u>2006</u></b>
Net income (loss)	(\$3,088,189)	\$5,305,384	\$ 2,409,612
Forward exchange contracts marked to market	51,509	(90,023)	(114,448)
Foreign currency translation loss	(2,088,408)	(726,629)	(1,077,641)
<b>Other comprehensive income (loss)</b>	<b>\$ (\$5,125,088)</b>	<b>\$ 4,488,732</b>	<b>\$ 1,217,523</b>

*See accompanying notes to consolidated financial statements*

**HAUPPAUGE DIGITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**FOR THE YEARS ENDED SEPTEMBER 30, 2008, 2007 AND 2006**

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

*See accompanying notes to consolidated financial statements*

**HAUPPAUGE DIGITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

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

*See accompanying notes to consolidated financial statements*

## **1. Summary of Significant Accounting Policies**

### ***Principles of Consolidation***

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

### ***Nature of Business***

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

The Company’s products fall under three product categories:

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

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

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

### ***Product Segment and Geographic Information***

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

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

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

Net sales to customers by geographic location consist of:

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

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

### ***Use of Estimates***

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company reviews all significant estimates affecting the financial statements on a recurring basis and records the effect of any adjustments when necessary.

### ***Cash and Cash Equivalents***

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

### ***Concentrations of Credit Risk***

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and accounts receivable. At times such cash in banks are in excess of the FDIC insurance limit. Concentration of credit risk with respect to accounts receivable exists because the Company operates in one industry (also see Note 7). Although the Company operates in one industry segment, it does not believe that

### ***Concentrations of Credit Risk (Continued)***

it has a material concentration of credit risk either from an individual counter party or a group of counter parties, due to the large and diverse user group for its products. The Company performs ongoing credit

evaluations of its customers and generally does not require collateral. The Company maintains allowances to cover potential or anticipated losses for uncollectible amounts.

### ***Shipping and Handling Costs***

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

### ***Revenue Recognition***

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

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

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

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

### ***Warranty Policy***

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

### ***Inventories***

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

### ***Property, Plant and Equipment***

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

Office Equipment and Machinery: 5 to 7 years

Leasehold improvements: Asset life or lease term, whichever is shorter

### ***Income taxes***

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

### ***Long-Lived Assets***

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

### ***Research and Development***

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

### ***Foreign Currency Translations and Transactions***

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

The financial position and results of operations of the Company's European subsidiaries are determined using Euros as the functional currency. Assets and liabilities of these subsidiaries are translated at the exchange rate in effect at each period end. Income statement accounts are translated at the average rate during the year. Translation adjustments arising from the translation to U.S. Dollars at differing exchange rates are included in the accumulated other comprehensive income (loss) account in stockholders' equity. Gains and losses resulting from transactions that are denominated in currencies other than Euros are included in earnings as a component of other income. The Company had a translation loss of \$1,257,918 recorded on the balance sheet as of September 30, 2007. For the twelve months ended September 30, 2008 the Company recorded on the balance sheet deferred translation losses of \$2,088,408 resulting in a translation loss of \$3,346,326 recorded as a component of accumulated other comprehensive income as of September 30, 2008.

### ***Derivatives and Hedging Activities***

For each of the three fiscal years ended September 30, 2008, 2007 and 2006, at least 40 % of the Company's sales were generated by its European subsidiary and were invoiced and collected in local currency, which was primarily the Euro. On the supply side, since the Company predominantly deals with North American and Asian suppliers and contract manufacturers, approximately 90% of the Company's inventory required to

support its European sales are purchased and paid in U.S. Dollars. The combination of sales billed in Euros supported by inventory purchased in U.S. dollars results in an absence of a natural local currency hedge. Consequently, the Company's financial results are subject to market risks resulting from the fluctuations in the Euro to U.S. Dollar exchange rates.

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

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

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

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

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

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

### ***Fair Value of Financial Instruments***

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

### ***Net income (loss) per share***

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

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

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

### ***Stock Based Compensation***

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

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

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

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

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

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

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

### ***Accrued expenses- licensing fees***

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

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

### ***Recent Accounting Pronouncements***

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

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

In September 2006, the FASB issued Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurement," which defines fair value, establishes a framework for measuring fair value and expands disclosures regarding assets and liabilities measured at fair value. In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" (FSP 157-1) and FSP 157-2, "Effective Date of FASB Statement No. 157"

(FSP 157-2). FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the Company's first quarter of fiscal 2010. The measurement and disclosure requirements related to financial assets and financial liabilities are effective for the Company's first quarter of fiscal 2009. The Company does not expect that the adoption of SFAS 157 will have a material impact on its consolidated financial position, results of operations or cash flows.

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

### ***Reclassifications***

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

## **2. Accounts receivable**

Receivables consist of:

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

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

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

### 3. Inventories

Inventories consist of the following:

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

### 4. Property, Plant and Equipment

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

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

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

### 5. Accrued Expenses – Licensing Fees

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

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

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

## 6. Income Taxes

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

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

Components of deferred taxes are as follows:

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

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

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

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

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

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

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

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

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

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

## 7. Stockholders' Equity

### *a. Treasury Stock*

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

### *b. Stock Compensation Plans*

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

On December 14, 1995, the Board of Directors authorized the adoption of the 1996 Non-Qualified Stock Option Plan (the "1996 Non-Qualified Plan") which was approved by the Company's stockholders on March 5, 1996. The 1996 Non-Qualified Plan authorizes the grant of 500,000 shares of Common Stock, subject to adjustment as provided in the plan. The plan terminated on March 5, 2006. This plan does not qualify for treatment as an incentive stock option plan under the Internal Revenue Code. There are various tax benefits which could accrue

to the Company upon exercise of non-qualified stock options that may not be available to the Company upon exercise of qualified incentive stock options. The purpose of the plan is to provide the Company greater flexibility in rewarding key employees, consultants, and other entities without burdening the Company's cash resources. As of September 30, 2008, 2007 and 2006, 186,975, 248,975 and 285,975 options ranging in prices from \$1.08 to \$4.13 were outstanding under the 1996 Non-Qualified Plan.

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

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

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

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

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

The 2003 Plan as adopted reserves up to 500,000 shares of Common Stock to be issued pursuant to stock options grants or other awards, subject to adjustment for any merger, reorganization, consolidation,

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

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

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

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

Stock Appreciation Rights may be granted in conjunction with all or part of any stock option granted under the 2003 Plan or independent of a stock option grant. Stock Appreciation Rights shall be subject to such terms and conditions as shall be determined by the Board or the Committee. Upon the exercise of a Stock Appreciation

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

Upon a Change in Control as defined in the 2003 Plan, but only to the extent determined by the Board or the Committee, stock options, stock appreciation rights and long term performance awards (the "Award") will vest, provided that no award granted to an employee of the Company shall vest or be exercisable unless the employee's employment is terminated within 24 months from the date of the Change in Control, (as defined in the 2003 Plan) unless the employee is terminated for Cause, as defined in the 2003 Plan or if the employee resigns his employment without Good Reason, as defined in the 2003 Plan. Otherwise, the Award shall not vest and be exercisable upon a Change in Control, unless otherwise determined. The employee shall have 30 days from after his employment is terminated due to a Change in Control to exercise all unexercised Awards. However, in the event of the death or disability of the employee, all unexercised Awards must be exercised within twelve (12) months after the death or disability of the employee.

The Company's Board of Directors on May 9, 2000 adopted the Employee Stock Purchase Plan. This plan was approved by the Company's stockholders' at the Company's July 18, 2000 annual stockholders' meeting. This plan is intended to provide the Company's full-time employees an opportunity to purchase an ownership interest in the Company through the purchase of Common Stock. The Company had reserved 100,000 shares of Common Stock for issuance under the plan. This plan is to be administered by the Board of Directors. Employees who have completed six months of employment and who work more than 20 hours per week for more than five months in the year are eligible to participate in the plan. The employee may elect to payroll deductions up to 10% per pay period. The purchase price shall either be the lower of 85% of the closing price on the offering commencement date or the offering termination date. No employee will be granted an option to purchase shares of Common Stock if such employee would own shares or holds options to purchase shares which would cause the employee to own more than 5% of the combined voting power of all classes of stock. Non-employees are not eligible to participate. The plan's initial termination date was December 31, 2003. The maximum number of shares that may be issued in any quarterly offering is 10,000, plus un-issued shares from prior offerings whether offered or not. At the Company's September 6, 2002 stockholders' meeting, the Company's stockholders' approved an increase in shares reserved under this plan to 180,000, and extended the plan termination date to December 31, 2004. At the Company's September 27, 2004 stockholders' meeting the Company's stockholders' approved an increase in shares reserved under this plan to 260,000, and extended the plan termination date to December 31, 2006. On May 25, 2006 the Company's Board of Directors approved a third amendment to the plan increasing the number of shares available to 420,000 and extending the expiration date of the plan to December 31, 2010. The amendment was approved by the Company's stockholders' at the Company's October 17, 2006 annual stockholders' meeting. As of September 30, 2008, 2007 and 2006, 175,324, 155,409 and 142,736 shares of Common Stock were purchased under this plan.

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

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

The aggregate intrinsic value of options exercised during the years ended September 30, 2008 and 2007 was approximately \$309,000 and \$1,002,000.

The following table summarizes information about stock options outstanding at September 30, 2008:

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

### c. Stockholders' Rights Agreements

On July 19, 2001, the Company's Board of Directors adopted a stockholder rights plan, as set forth in the Rights Agreement, dated as of July 20, 2001 (the "Rights Agreement") between the Company and North American

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

## **8. Significant Customer Information**

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

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

## **9. Related Party Transactions**

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

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

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

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

**Years Ended September 30,**

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

**10. Litigation**

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

**11. Quarterly Information (Unaudited)**

The following presents certain unaudited quarterly financial data:

(In thousands, except per share data)

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

(In thousands, except per share data)

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

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

(1) During the first quarter of the fiscal year ended September 30, 2008 the Company increased its inventory reserve by approximately \$930,000 which was due to the expected loss of a customer program and the

continued decreases in the analog product market. The Company also decreased its accrued licensing fees in this quarter by approximately \$1,100,000 due to an \$827,000 change in estimate and a \$273,000 correction of an error.

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

## **12. Subsequent events**

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

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

In connection with the transactions contemplated by the Asset Purchase Agreement, the Buyer, Hauppauge Digital Europe Sarl ("HDES"), and Hauppauge Computer Works, Inc. ("HCW"), each a wholly-owned

subsidiary of ours (collectively, the “Subsidiaries”) and the Sellers entered into a Transition Services Agreement, dated December 24, 2008 (the “TSA”), pursuant to which, among other things, the parties agreed to provide each other with certain services relating to infrastructure and systems, order processing and related matters and systems transition and related matters (the “Services”), as set forth in detail in the TSA. The fees for such Services are set forth in the TSA. The term of the TSA shall be until the earlier to occur of (i) 18 months following the Closing or (ii) termination of the last of the Services to be provided pursuant to the TSA. The TSA may be terminated by the Subsidiaries at any time upon thirty (30) days prior written notice to the Sellers and may be terminated with respect to any particular Service to be provided pursuant to the TSA upon ten (10) days prior written notice to Seller.

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

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

### **13. Line of credit**

On December 12, 2008, Hauppauge Computer Works, Inc. (“HCW”), a wholly-owned subsidiary of ours, executed a Fourth Amended and Restated Promissory Note (the “Fourth Amendment”) to the order of JPMorgan Chase Bank, N.A. (the “Bank”). The Fourth Amendment modified the terms and conditions of that certain Promissory Note dated December 1, 2005, executed by HCW and made payable to the order of the Bank (the “Note”), as amended by an Amended and Restated Promissory Note dated March 31, 2006, as further amended by a Second Amended and Restated Promissory Note dated February 28, 2007 and as further amended by a Third Amended and Restated Promissory Note dated March 31, 2008. The Fourth Amendment, among other things, reduces the amount HCW is authorized to borrow from the Bank from a principal amount of up to Five Million Dollars (\$5,000,000) to a principal amount of up to Seven Hundred Thousand Dollars (\$700,000), based upon borrowings made under the Fourth Amendment which may be made from time to time by HCW (each, a “Loan”). The Fourth Amendment matures on March 31, 2009 (the “Maturity Date”) and principal payments are due on the Maturity Date, and thereafter on demand. Until the Maturity Date, Loans made under the Amendment bear interest annually at HCW’s option of (i) the Eurodollar Rate (as defined in the Fourth Amendment) (each, a “Eurodollar Loan”) or (ii) the Prime Rate (as defined in the Fourth Amendment) minus one percent (1.0%) (each, a “Prime Loan”). Interest is payable with respect to each Eurodollar Loan at the end

of one month after the date of such Loan (the "Interest Period"), provided that, upon the expiration of the first Interest Period and each Interest Period thereafter, each Eurodollar Loan will be automatically continued with an Interest Period of the same duration, unless HCW notifies the Bank that it intends to convert a Eurodollar Loan to a Prime Loan or if the Bank is prohibited from making Eurodollar Loans, and with respect to each Prime Loan the last day of each calendar month during the term of the Fourth Amendment and on the date on which a Prime Loan is converted to a Eurodollar Loan, until such Loan(s) shall be due and payable. Interest due after the Maturity Date shall be payable at a rate of three percent (3%) per annum over the Prime Rate.

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

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

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

## Report of Independent Registered Public Accounting Firm

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

The audits referred to in our report dated January 9, 2009, relating to the consolidated financial statements of Hauppauge Digital, Inc. and Subsidiaries also included the audits of the financial statement schedules for each of the three years in the period ended September 30, 2008. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits.

In our opinion such financial statement schedules when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ BDO Seidman, LLP

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BDO Seidman, LLP

Melville, New York  
January 9, 2009

## SCHEDULE II-VALUATION AND QUALIFYING ACCOUNTS

<u>Allowance for Doubtful Accounts</u>	Balance at of	Charged to Costs	Charged to		Bad Debt	Balance at
<u>Description</u>	<u>Beginning Year</u>	<u>and Expenses</u>	<u>Other</u>	<u>Deductions</u>	<u>Recoveries</u>	<u>End of Year</u>
YEAR ENDED SEPTEMBER 30, 2008						
Reserve and allowances deducted from asset accounts :						
Allowance for doubtful accounts	\$ 440,000	\$ 450,000	\$ -	\$ -	\$ -	\$ 890,000
YEAR ENDED SEPTEMBER 30, 2007						
Reserve and allowances deducted from asset accounts:						
Allowance for doubtful accounts	\$ 420,000	\$ 20,000	\$ -	\$ -	\$ -	\$ 440,000
YEAR ENDED SEPTEMBER 30, 2006						
Reserve and allowances deducted from asset accounts:						
Allowance for doubtful accounts	\$ 300,000	\$ 120,000	\$ -	\$ -	\$ -	\$ 420,000

## SCHEDULE II-VALUATION AND QUALIFYING ACCOUNTS

### Reserve for Obsolete and Slow Moving Inventory

<u>Description</u>	<u>Balance at Beginning of Year</u>	<u>Charged to Costs And Expenses</u>	<u>Charged to Other Accounts</u>	<u>Disposals (1)</u>	<u>Balance at End of Year</u>
YEAR ENDED SEPTEMBER 30, 2008					
Reserve and allowances deducted from asset accounts:					
Reserve for obsolete and slow moving inventory	\$1,750,000	\$930,000	\$ -	\$ -	\$2,680,000
YEAR ENDED SEPTEMBER 30, 2007					
Reserve and allowances deducted from asset accounts:					
Reserve for obsolete and slow moving inventory	\$1,300,000	\$450,000	\$ -	\$ -	\$1,750,000
YEAR ENDED SEPTEMBER 30, 2006					
Reserve and allowances deducted from asset accounts:					
Reserve for obsolete and slow moving inventory	\$1,407,712	\$265,947	\$ -	\$ (373,659)	\$1,300,000

(1) Obsolete inventory disposed of

## SCHEDULE II-VALUATION AND QUALIFYING ACCOUNTS

### Reserve for sales returns

<u>Description</u>	<u>Balance at Beginning of Year</u>	<u>Charged to Costs And Expenses</u>	<u>Charged to Other Accounts</u>	<u>Adjustments (1)</u>	<u>Balance at End of Year</u>
YEAR ENDED SEPTEMBER 30, 2008					
Sales reserve deducted from sales and receivables account	\$3,845,814	\$3,845,814	\$ -	\$(3,845,814)	\$3,845,814
Reserve for sales returns					
YEAR ENDED SEPTEMBER 30, 2007					
Sales reserve deducted from sales and receivables account	\$2,957,000	\$ 3,845,814	\$ -	\$(2,957,000)	\$3,845,814
Reserve for sales returns					
YEAR ENDED SEPTEMBER 30, 2006					
Sales reserve deducted from sales and receivables account	\$2,957,000	\$ 2,957,000	\$ -	\$(2,957,000)	\$2,957,000
Reserve for sales returns					

(1) Sales reserve adjusted per historical evaluation

## 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.

HAUPPAUGE DIGITAL INC.

By: /s/ Kenneth Plotkin Date: January 13, 2009  
KENNETH PLOTKIN  
President, Chairman of the Board, Chief Executive Officer and Chief  
Operating Officer (Principal Executive Officer)

By: /s/ Gerald Tucciarone Date: January 13, 2009  
GERALD TUCCIARONE  
Treasurer, Chief Financial Officer and Secretary (Principal Financial  
And Accounting Officer)

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.

By: /s/ Kenneth Plotkin Date: January 13, 2009  
KENNETH PLOTKIN  
  
President, Chairman of the Board, Chief Executive Officer and Chief  
Operating Officer (Principal Executive Officer) and Director

By: /s/ Gerald Tucciarone Date: January 13, 2009  
GERALD TUCCIARONE  
Treasurer, Chief Financial Officer and Secretary (Principal Financial  
And Accounting Officer)

By: /s/ Seymour G. Siegel Date: January 13, 2009  
SEYMOUR G. SIEGEL  
Director

By: /s/ Bernard Herman Date: January 13, 2009  
BERNARD HERMAN  
Director

By: /s/ Robert S Nadel Date: January 13, 2009  
ROBERT S. NADEL  
Director

By: /s/ Neal Page Date: January 13, 2009  
NEAL PAGE  
Director

By: /s/ Christopher G/ Payan Date: January 13, 2009  
CHRISTOPHER G. PAYAN  
Director

SUBSIDIARIES OF REGISTRANT

<u>Name of Corporation</u>	<u>State/Jurisdiction of incorporation</u>
Hauppauge Digital Europe Sarl	Luxembourg
Hauppauge Computer Works Inc.	New York, USA
Hauppauge Computer Works Gmbh	Germany
Hauppauge Digital Asia Pte Ltd.	Singapore
Hauppauge Computer Works Limited	UK
Hauppauge Computer Works .	France
HCW Distributing Corp.	New York, USA
Hauppauge Computer Works, Ltd.	British Virgin Islands
Hauppauge Digital Taiwan	Taiwan, ROC
PCTV Systems Sarl	Luxembourg
PCTV Corp.	Delaware, USA

**Exhibit 23**

Consent of Independent Registered Public Accounting Firm

Hauppauge Digital, Inc.  
Hauppauge, New York

We hereby consent to the incorporation by reference in the Prospectus constituting a part of the Registration Statements on Forms S-8, filed with the Securities and Exchange Commission on April 28, 1997, October 4, 1999, September 29, 2000, December 2, 2002, September 24, 2003, May 11, 2004, December 17, 2004, December 14, 2006 and on Form S-3 filed with the Securities and Exchange Commission on December 14, 2006, respectively, of Hauppauge Digital, Inc. and Subsidiaries (the "Company"), of our report dated January 9, 2009 on the consolidated financial statements of Hauppauge Digital, Inc. appearing in the Company's Annual Report on Form 10-K for the year ended September 30, 2008. We also consent to the incorporation by reference to our report dated January 9, 2009 relating to the financial statement schedules, which appear in this Form 10-K.

/s/ BDO Seidman, LLP  
Melville, New York

January 9, 2009

**CERTIFICATION**

I, Kenneth Plotkin, certify that:

1. I have reviewed this Form 10-K of Hauppauge Digital, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15-(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: January 13 , 2009

/s/ Kenneth Plotkin  
Kenneth Plotkin,  
Chief Executive Officer

**CERTIFICATION**

I, Gerald Tucciarone, certify that:

1. I have reviewed this Form 10-K of Hauppauge Digital, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15-(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: January 13 , 2009

/s/ Gerald Tucciarone  
Gerald Tucciarone,  
Treasurer, Chief Financial Officer,

and Secretary

**Exhibit 32**

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER  
PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The undersigned hereby certifies, pursuant to, and as required by, 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Annual Report of Hauppauge Digital, Inc. (the “*Company*”) on Form 10-K for the period ended September 30, 2008 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and that information contained in such Annual Report on Form 10-K fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: January 13, 2009

/s/ *Kenneth Plotkin*

Kenneth Plotkin  
Chief Executive Officer

/s/ *Gerald Tucciarone*

Gerald Tucciarone  
Treasurer, Chief Financial Officer, and Secretary