



**Hauppauge!**<sup>®</sup>

**2009** ANNUAL REPORT

**Results of operations**

**Twelve months ended September 30, 2009 compared to September 30, 2008.**

Results of operations for the twelve months ended September 30, 2009 compared to September 30, 2008 are as follows:

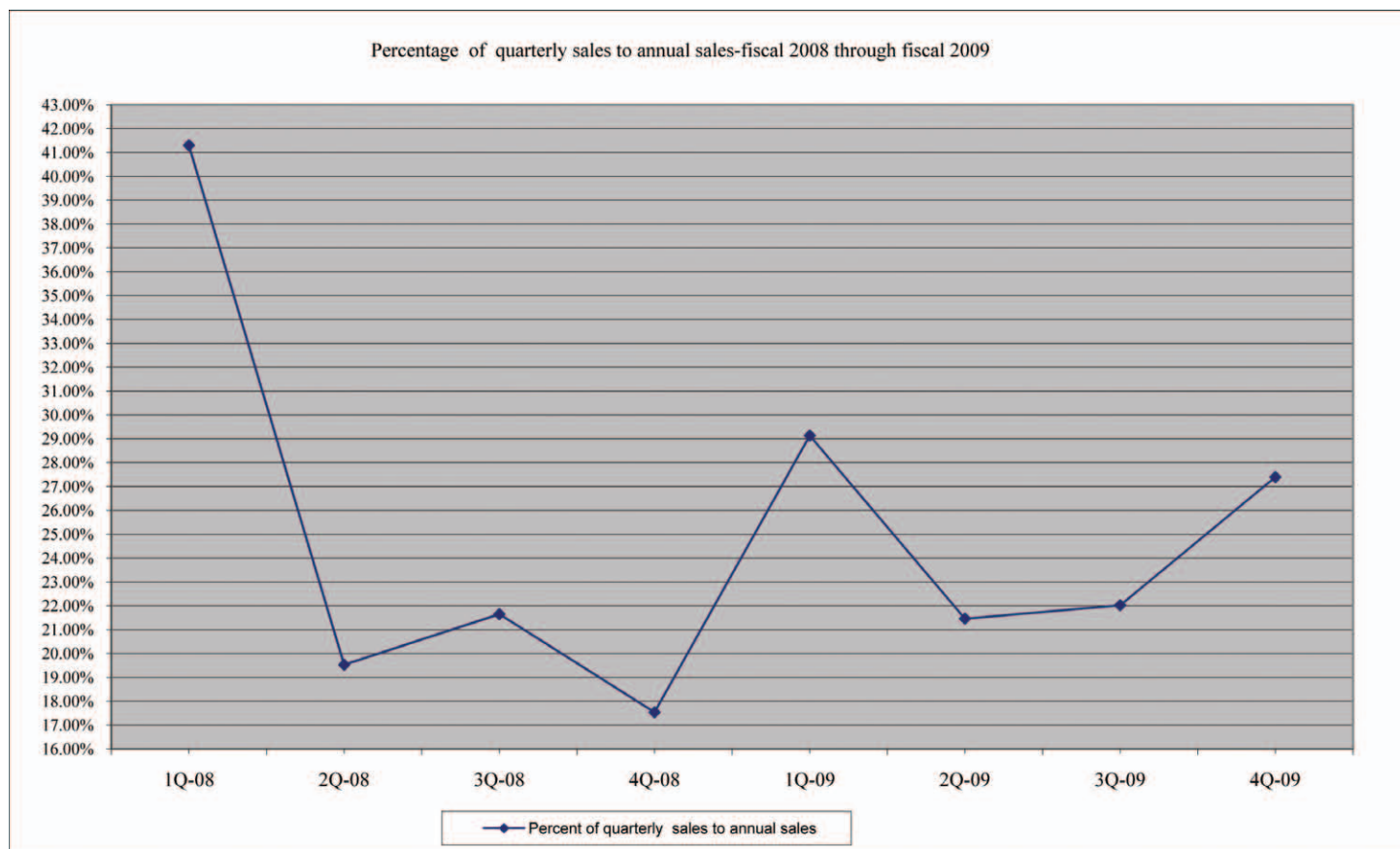
	Twelve Months Ended 9/30/09	Twelve Months Ended 9/30/08	Variance \$	Percentage of sales		
				2009	2008	Variance
Net Sales . . . . .	\$59,344,538	\$89,701,028	(\$30,356,490)	100.00%	100.00%	-
Cost of sales . . . . .	46,557,904	72,019,046	(25,461,142)	78.45%	80.29%	-1.84%
Gross Profit . . . . .	12,786,634	17,681,982	(4,895,348)	21.55%	19.71%	1.84%
Gross Profit % . . . . .	21.55%	19.71%	1.84%			
Expenses:						
Sales & marketing . . . . .	10,634,647	11,630,853	(996,206)	17.92%	12.97%	4.95%
Sales & marketing-PCTV . . . . .	320,732	0	320,732	0.54%	0.00%	0.54%
Technical support . . . . .	549,046	578,815	(29,769)	0.93%	0.65%	0.28%
General & administrative . . . . .	3,433,719	4,421,012	(987,293)	5.79%	4.93%	0.86%
General & administrative-PCTV . . . . .	266,250	0	266,250	0.45%	0.00%	0.45%
Amortization of intangible assets . . . . .	566,127	0	566,127	0.95%	0.00%	0.95%
Selling, general and administrative stock compensation expense . . . . .	347,069	522,168	(175,099)	0.58%	0.58%	0.00%
Total selling, general and administrative expense . . . . .	16,117,590	17,152,848	(1,035,258)	27.16%	19.13%	8.03%
Research and development . . . . .	2,819,542	3,610,003	(790,461)	4.75%	4.02%	0.73%
Research and development-PCTV . . . . .	1,410,777	0	1,410,777	2.38%	0.00%	2.38%
Research and development stock compensation expense . . . . .	191,616	273,744	(82,128)	0.32%	0.31%	0.01%
Total expenses . . . . .	20,539,525	21,036,595	(\$497,070)	34.61%	23.46%	11.15%
Net operating loss . . . . .	(7,752,891)	(3,354,613)	(4,398,278)	-13.06%	-3.75%	-9.31%
Other income :						
Interest income . . . . .	14,217	43,989	(29,772)	0.02%	0.05%	-0.03%
Interest (expense) . . . . .	(62,557)	0	(62,557)	-0.11%	0.00%	-0.11%
Foreign currency . . . . .	670,760	(15,138)	685,898	1.13%	-0.02%	1.15%
Total other income . . . . .	622,420	28,851	593,569	1.04%	0.03%	1.01%
Loss before tax provision (benefit) . . . . .	(7,130,471)	(3,325,762)	(3,804,709)	-12.02%	-3.72%	-8.30%
Income tax provision (benefit) . . . . .	12,550	(237,573)	250,123	0.02%	-0.26%	0.28%
Net loss . . . . .	<u>(\$7,143,021)</u>	<u>(\$3,088,189)</u>	<u>(\$4,054,832)</u>	<u>-12.04%</u>	<u>-3.46%</u>	<u>-8.58%</u>

Net sales for the twelve months ended September 30, 2009 decreased \$30,356,490 compared to the twelve months ended September 30, 2008 as shown in the table below.

Location	Twelve Months Ended 9/30/09	Twelve Months Ended 9/30/08	Increase (decrease) Dollar Variance	Increase (decrease) Variance %	Percentage of sales by Geographic region	
					2009	2008
Domestic . . . . .	\$28,480,464	\$42,964,592	\$(14,484,128)	-34%	48%	48%
Europe . . . . .	28,932,928	43,810,431	(14,877,503)	-34%	49%	49%
Asia . . . . .	1,931,146	2,926,005	(994,859)	-34%	3%	3%
Total . . . . .	<u>\$59,344,538</u>	<u>\$89,701,028</u>	<u>(\$30,356,490)</u>	<u>-34%</u>	<u>100%</u>	<u>100%</u>

We experienced a decrease in unit sales of about 35.83%, while changes in sales mix, the addition of approximately \$8.5 million of PCTV product line sales and price increases increased the average sales price by about 3.10%. Sales were impacted negatively by the closing of Circuit City, the lack of consumer demand due to the weak global economic conditions and a weaker Euro exchange rate.

**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 holiday spending, our sales during our first fiscal quarter, which encompasses the holiday season, have historically been the highest of our fiscal year.
- For each of the fiscal years ended September 30, 2009 and 2008 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 2008 and fiscal 2009 accounted for 61% and 51% of sales, respectively, and our sales for the last six months of fiscal 2008 and 2009 accounted for 39% and 49% 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 \$4,895,348 for the twelve months ended September 30, 2009 compared to the twelve months ended September 30, 2008.

The decrease in the gross profit is detailed below:

	<b>Increase (decrease)</b>
Decrease in sales . . . . .	(\$8,808,350)
Reduction in gross profit due lower Euro exchange rate . . . . .	(2,746,142)
Higher gross profit on sales mix . . . . .	4,731,228
Lower production and production related costs . . . . .	1,927,916
Total decrease in gross profit . . . . .	<u>(\$4,895,348)</u>

Gross profit percentage for the twelve months ended September 30, 2009 was 21.55% compared to 19.71% for the twelve months ended September 30, 2008, an increase of 1.84%.

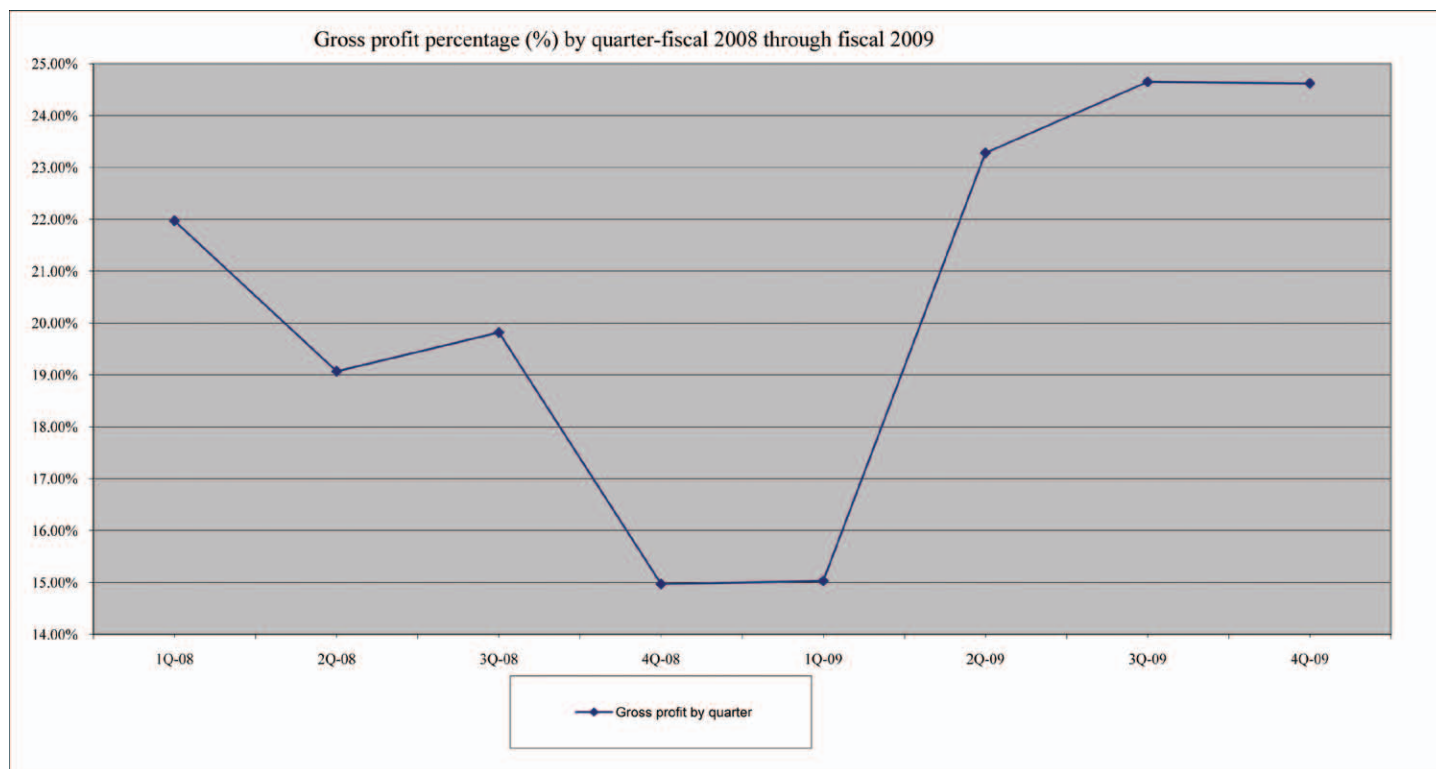
The increase in the gross profit percentage is detailed below:

	<b>Increase (decrease)</b>
Higher gross profit on sales mix . . . . .	7.77%
Reduction in gross profit due lower Euro exchange rate . . . . .	-4.42%
Higher production and production related costs as a percentage of sales . . . . .	-1.51%
Net increase in gross profit percentage . . . . .	<u>1.84%</u>

The increase in the gross profit percentage for the twelve months ended September 30, 2009 compared to the twelve months ended September 30, 2008 was primarily due to:

- Favorable changes in the product sales mix, price increases and the addition of the PCTV product line resulted in an increase in the gross profit percentage over fiscal 2008 of 7.77%.
- 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, causing a decrease in gross profit percentage of 1.51% compared to fiscal 2008.
- A decrease in the average Euro to USD rate from \$1.5031 for fiscal 2008 to \$1.3532 for fiscal 2009 caused a decrease in the gross profit percentage of 4.42% compared to fiscal 2008.

**Volatility of gross profit percentage:**



The chart above indicates the quarterly fluctuations in gross profit percentage. Over the eight quarters ended with the fourth quarter of fiscal 2009, the gross profit percentage has ranged from a low of 14.97% to a high of 24.65%.

Factors affecting the volatility of our gross profit percentages are:

- Mix of gross profit percentages: gross profit percentages vary within our retail family of products as well as for products sold to manufacturers. Varying sales mix of these product lines affects 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. When unit and dollar sales decline due to seasonal sales trends, these fixed costs get spread over lower unit and dollar sales, which increases the product unit costs, increases the fixed costs as a percentage of sales and lowers the gross profit percentage.

- 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 to meet our competitors' prices which tends to reduce gross profit percentage.
- 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 impacts our 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, rising fuel prices increase our freight costs and negatively impact our gross profit.
- Volatility of Euro to U.S. dollar exchange rate. With over 40% of our sales denominated in Euros, changes in the Euro to U.S. dollar exchange rate impact gross profit. An increase in the Euro tends to increase our gross profit percentage, while a decrease in the Euro tends to decrease our gross profit percentage.

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

### Selling, general and administrative expenses

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

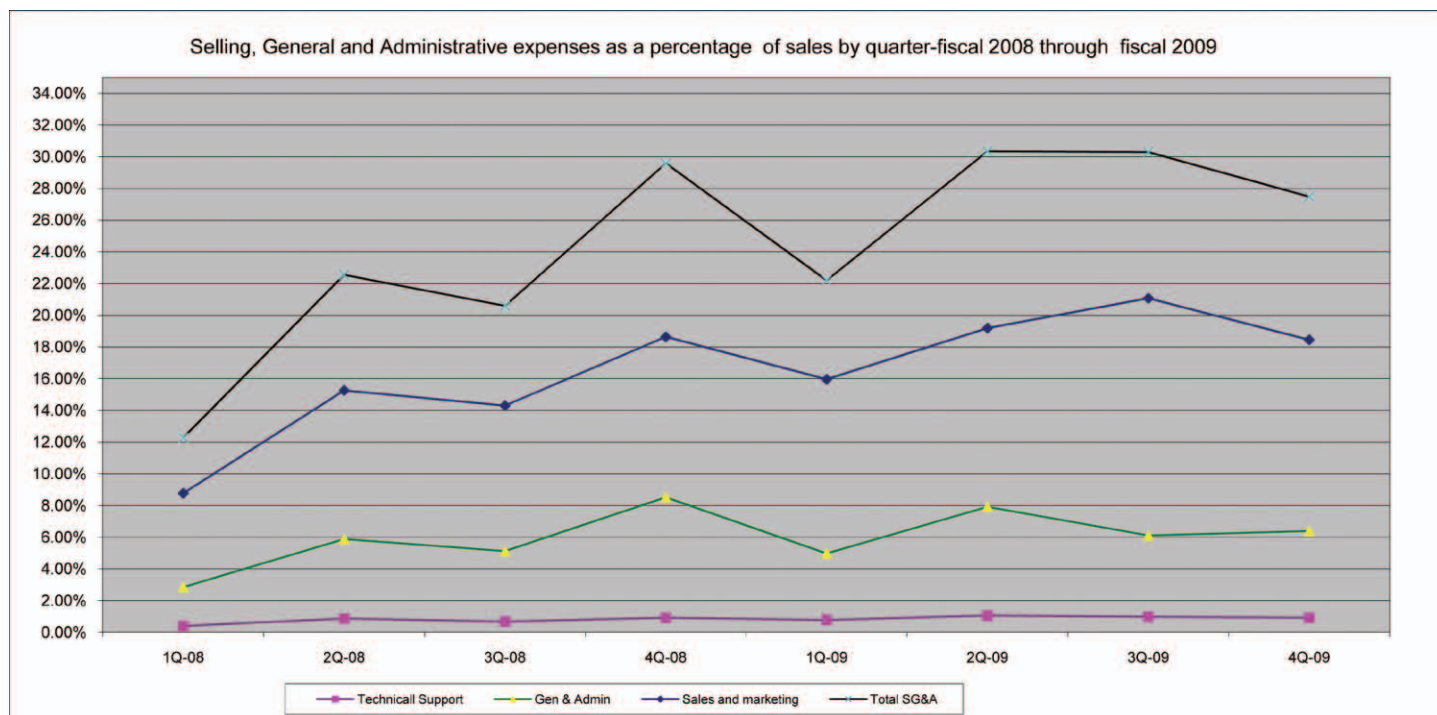
	Twelve months ended September 30,			Percentage of Sales		
	Dollar Costs		Increase (Decrease)	2008		Increase (Decrease)
	2009	2008		2009	2008	
Sales & marketing-HCW . . . . .	\$10,634,647	\$11,630,853	\$(996,206)	17.92%	12.97%	4.95%
Sales & marketing-PCTV . . . . .	320,732	0	320,732	0.54%	0.00%	0.54%
Technical support . . . . .	549,046	578,815	(29,769)	0.93%	0.65%	0.28%
General & administrative-HCW . . . . .	3,433,719	4,421,012	(987,293)	5.79%	4.93%	0.86%
General & administrative-PCTV . . . . .	266,250	0	266,250	0.45%	0.00%	0.45%
Amortization of intangible assets . . . . .	566,127	0	566,127	0.95%	0.00%	0.95%
Selling, general and administrative stock compensation expense	347,069	522,168	(175,099)	0.58%	0.58%	0.00%
Total selling, general and administrative expense . . .	<u>\$16,117,590</u>	<u>\$17,152,848</u>	<u>\$(1,035,258)</u>	<u>27.16%</u>	<u>19.13%</u>	<u>8.03%</u>

Selling, general and administrative expense decreased \$1,035,258 from the prior fiscal year as follows.

Excluding the PCTV expenses and amortization of intangible assets acquired in the PCTV acquisition, selling, general and administrative expense decreased \$2,188,367 from the prior fiscal year. Sales and marketing expense for HCW decreased \$966,206, primarily driven by the decrease in the Euro exchange rate compared to the U.S. dollar, which resulted in an expense reduction of \$771,666, lower compensation expenses of \$104,792 due to personnel reductions and lower commissions and marketing development fund expense of \$100,705 due to lower sales.

The decrease in general and administrative expense for HCW of \$987,293 was primarily due to lower professional fees, primarily for legal and consulting fees, of \$252,665, a decrease in bad debt expense of \$415,000 related to the February 2008 liquidation of CompUSA and the November 2008 bankruptcy of Circuit City, a decrease in compensation expense of \$118,026 due to staff reductions and a 10% salary reduction, a reduction of \$132,501 in insurance expense due to lower negotiated premiums, lower communication expense of \$23,543 and lower travel expense of \$14,341 due to travel budget reduction. Offsetting the expense decreases were increases of \$320,732 in sales and marketing expense and \$266,250 in general and administrative expense related to personnel and overhead expense of the PCTV business acquired at the end of December 2008 from Avid Technology, Inc. Amortization of intangible assets was related to intangible assets acquired in the purchase of the PCTV business from Avid Technology, Inc.

**Selling, general and administrative expense 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 expense. Due to fixed costs which fluctuate minimally with changes in sales coupled with the seasonal nature of our business, selling general and administrative expense as a percentage of sales are sensitive to seasonal sales fluctuations. Over the eight quarters ending with the fourth quarter of fiscal 2009, selling general and administrative expense as a percentage of sales has resulted in the following trends:

- Due to our first quarter yielding the highest quarterly sales levels of our fiscal year, our total selling, general and administrative expense as a percentage of sales have typically been the lowest during our first quarter. As reflected in the chart, selling, general and administrative expense as a percentage of sales were the lowest in the first quarter of fiscal 2008 and 2009.
- Reflecting the seasonal trend in sales, our selling, general and administrative expense for our third or fourth quarter 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 fourth quarter of fiscal 2008 and third quarter of fiscal 2009.
- Reflecting the decline in sales, total selling, general and administrative expenses as a percent of sales were higher for fiscal 2009 compared to fiscal 2008.

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

**Research and development expense**

Research and development expense increased \$538,188 from the prior fiscal year as follows:

	Fiscal 2009 increases (decreases) from fiscal 2008		
	HCW	PCTV	Total
Research and development expense-HCW . . . . .	(\$790,461)	\$0	(\$790,461)
Research and development expense-PCTV. . . . .	-	1,410,777	1,410,777
Stock compensation expense. . . . .	(82,128)	-	(82,128)
Total research and development expense . . . . .	<u>(\$872,589)</u>	<u>\$1,410,777</u>	<u>\$538,188</u>

Excluding the expense of the PCTV division, research and development expense decreased \$872,589 from the prior fiscal year. The decrease was primarily due to personnel and personnel related reductions and the timing of development programs in process.

Offsetting the expense decreases were \$1,410,777 in expense related to personnel and development programs of the PCTV business acquired at the end of December 2008.

### Other income

Other income for the twelve months ended September 30, 2009 was \$622,420 compared to other income of \$28,851 for the twelve months ended September 30, 2008 as detailed below:

	<b>Twelve months ended September 30, 2009</b>	<b>Twelve months ended September 30, 2008</b>
Interest income .....	\$ 14,217	\$ 43,989
Interest (expense) .....	(62,557)	-
Foreign currency transaction gains (losses) .....	670,760	(15,138)
Total other income (expense) .....	<u>\$ 622,420</u>	<u>\$ 28,851</u>

Lower interest income was due to lower interest rate yields coupled with less cash invested. Interest expense was due to payment on a note payable to Avid Technology, Inc. Foreign currency transactions gains were due to favorable Euro rates on forward exchange contracts.

### Tax provision

Our net tax provision for the year ended September 30, 2009 and 2008 is as follows:

	<b>Twelve months ended September 30, 2009</b>	<b>Twelve months ended September 30, 2008</b>
Income tax benefit due to change in deferred taxes .....	\$(164,500)	\$(529,995)
Tax expense European operations .....	137,050	267,422
State taxes .....	40,000	25,000
Net tax (benefit) provision .....	<u>\$ 12,550</u>	<u>\$ (237,573)</u>

Deferred tax assets and the offsetting tax valuation allowance is primarily attributable to our Hauppauge Computer Works Inc. domestic operations. In evaluating the future realization of our deferred tax asset and the corresponding valuation allowance as of September 30, 2009, we took into consideration:

- our domestic operations had taxable income for three out of the last four fiscal years
- including royalties paid to our domestic operations by our European subsidiary, we anticipate taxable income for our domestic operations for fiscal 2010
- our history of utilization of prior domestic net operating losses

After evaluating the circumstances listed above, it was our opinion that our net deferred tax asset of \$2,185,185 is realizable as of September 30, 2009.

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 \$7,143,021 for the twelve months ended September 30, 2009, which resulted in basic and diluted net loss per share of \$0.71 on weighted average basic and diluted shares of 10,045,449, compared to 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.

Options to purchase 1,522,394 and 1,767,744 shares of Common Stock at prices ranging \$1.05 to \$8.75 and \$1.08 to \$8.75, respectively, were outstanding as of September 30, 2009 and 2008, 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:

	<u>As of September 30, 2009</u>	<u>As of September 30, 2008</u>
Cash .....	\$ 8,368,342	\$ 14,191,721
Working Capital .....	5,885,577	17,229,410
Stockholders' Equity .....	<u>12,334,866</u>	<u>18,988,536</u>

We had cash and cash equivalents as of September 30, 2009 of \$8,368,342 a decrease of \$5,823,379 from September 30, 2008.

The decrease in cash was due to:

	<u>Operating Activities</u>	<u>Investing Activities</u>	<u>Financing Activities</u>	<u>Total</u>
Sources of cash:				
Decrease in inventory .....	\$3,669,643	\$0	\$0	\$3,669,643
Increase in accounts payable and accrued expenses . . .	5,556,205	-	-	5,556,205
Proceeds from employee stock purchases .....	-	-	29,058	29,058
Decrease in prepaid expenses and other current assets . .	164,726	-	-	164,726
Total sources of cash.....	<u>9,390,574</u>	<u>-</u>	<u>29,058</u>	<u>9,419,632</u>
Less cash used for:				
Net loss adjusted for non cash items .....	(5,397,382)	-	-	(5,397,382)
PCTV acquisition-net of note payable .....	-	(4,506,225)	-	(4,506,225)
Increase in accounts receivable .....	(5,219,333)	-	-	(5,219,333)
Effect of exchange rates on cash .....	(78,392)	-	-	(78,392)
Capital equipment purchases .....	-	(41,679)	-	(41,679)
Total usage of cash .....	<u>(10,695,107)</u>	<u>(4,547,904)</u>	<u>-</u>	<u>(15,243,011)</u>
Net cash decrease .....	<u>(\$1,304,533)</u>	<u>(\$4,547,904)</u>	<u>\$29,058</u>	<u>(\$5,823,379)</u>

Net cash used in operating activities was due to an increase in accounts receivable of \$5,219,333 and cash used of \$5,397,562 to fund the net loss adjusted for non cash items. Offsetting these cash decreases in operating activities was a decrease in inventories of \$3,669,643, a decrease in prepaid expenses and other current assets of \$164,726 and an increase in accounts payable and accrued expenses of \$ 5,556,205. The increase in accounts receivable was due to 43% of the sales for the fourth quarter of fiscal 2009 being shipped in September 2009 coupled with a \$530,161 sales increase for the fourth quarter of fiscal 2009 over the fourth quarter of fiscal 2008. Lower fiscal 2009 sales resulted in lower inventory levels required to support sales and was the driving force in the decrease in inventory between fiscal 2009 and fiscal 2008.

Cash of \$4,547,904 was used in investing activities. Of this amount, \$4,506,225 was used for the acquisition of the PCTV business and \$41,679 was used to purchase fixed assets. The \$4,506,225 used for the PCTV acquisition consisted of \$2,238,000 paid against the \$5,000,000 purchase price, \$1,874,997 in payments made pursuant to a \$2,500,000 note payable to Avid Technology, Inc. and \$393,228 in payments for direct expenses of the acquisition. As of September 30, 2009, \$625,045 was left to pay on the note payable and \$93,308 was left to pay for direct acquisition costs. Cash of \$29,058 from financing activities came from purchases of stock under our employee stock purchase plan.

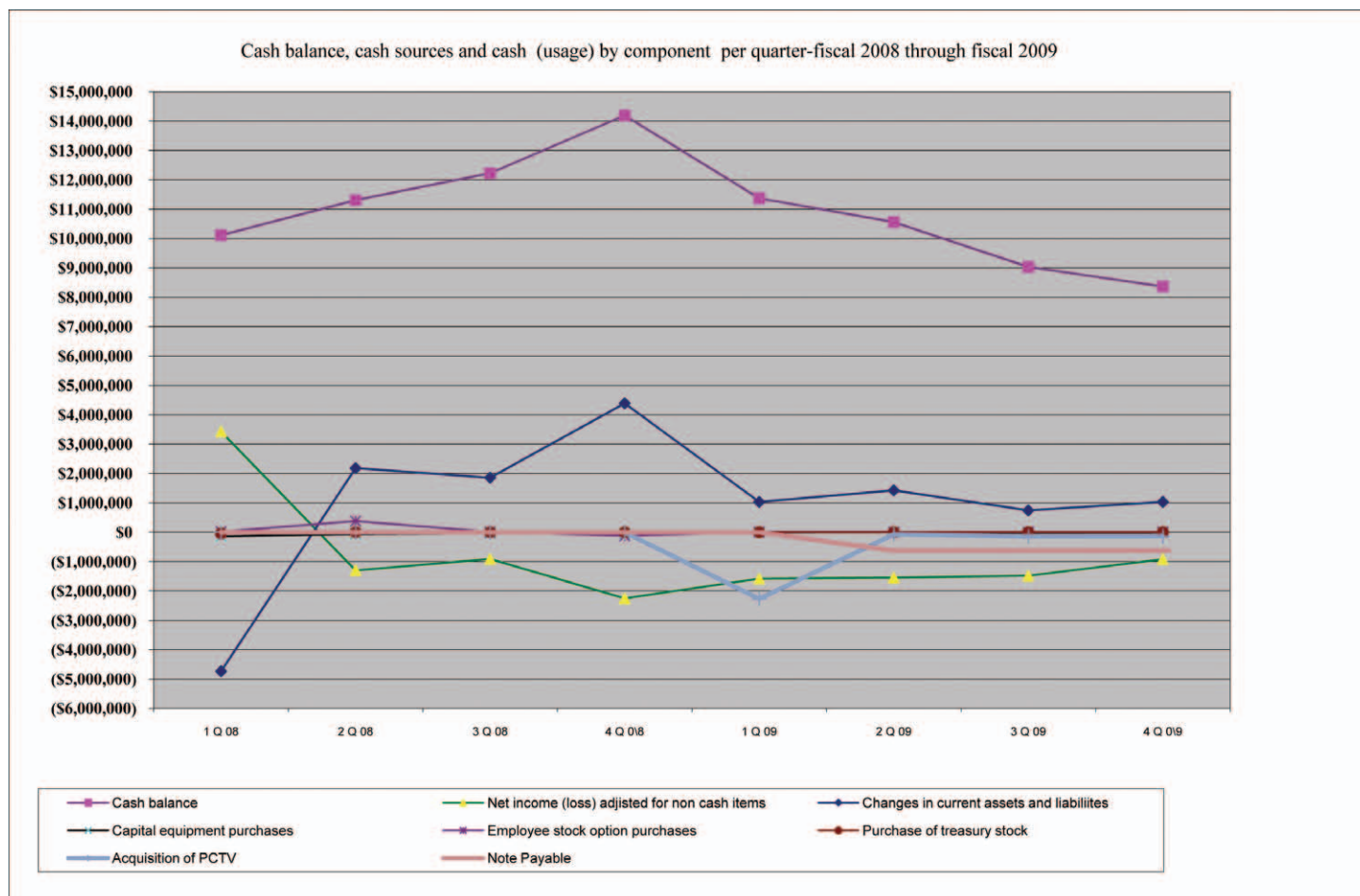
Our cash requirements for the next twelve months will include, among other things, the cash required to pay off the note to Avid Technology, Inc. related to the purchase the PCTV business and the cash needed to fund our working capital needs. With the proper execution of our business and operational integration plan, we believe that our cash and cash equivalents as of September 30, 2009 and our internally generated cash 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.

On March 31, 2009 our line of credit with the JP Morgan Chase Bank expired and was not renewed.

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, 2009, 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 by quarter for fiscal 2008 through fiscal 2009.



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

- Net income (loss) 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. 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.

During fiscal 2009, \$4,506,225, or about 77% of the \$5,823,379 cash decrease, was used to fund the PCTV acquisition, the acquisition related direct costs and the acquisition related note payable to Avid Technology, Inc.

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 March 31, 2009 our line of credit with the JP Morgan Chase Bank expired and was not renewed.

In addition to our operating cash requirements, our cash requirements during fiscal 2010 will include \$625,000 required to pay the final three installments on the note payable to Avid Technology, Inc. With the proper execution of our operational plan we believe that our cash and cash equivalents as of September 30, 2009 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 plan could require the need for additional sources of capital. In light

of the current economic and credit conditions there can be no assurances that we will be able to find external sources of financing to fund our additional working capital needs.

### Future Contractual Obligation

The following table shows our contractual obligations related to lease and note payable obligations as of September 30, 2009:

	Payments due by period			
	Total	Less than 1 year	1-3 years	3 to 5 years
Note payable to Avid Technology Inc. (1)	\$625,045	\$625,045	-	-
Operating lease obligations	\$1,812,303	\$742,023	\$775,590	\$294,690
Total	\$2,437,348	\$1,367,068	\$775,590	\$294,690

(1) See Note 13 to our consolidated financial statements for further details on the note payable to Avid Technology, Inc.

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 \$2,238,000 payable in cash, \$2,500,000 payable pursuant to a Promissory Note made payable by us to Avid and the assumption of certain liabilities. The principal amount due pursuant to the Note is payable in 12 equal monthly installments of \$208,333. The first payment was 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%), and (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. As of September 30, 2009 there was approximately \$625,000 open on the note payable.

### 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
- Intangible assets

### 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 FASB ASC 605-15 (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 FASB ASC 605-50 (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.

### **Intangible assets**

Long-lived assets include indefinite and definite-lived intangible assets. Definite-lived intangible assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable through the estimated undiscounted future cash flows derived from such assets. Definite-lived intangible assets primarily consist of covenant not to compete, customer relationships and technology. Indefinite-lived intangible assets primarily consist of trademarks. When an impairment exists, the related assets are written down to fair value. Although we believe our judgments, estimates and/or assumptions used in estimating cash flows and determining fair value are reasonable, making material changes to such judgments, estimates and/or assumptions could materially affect such impairment analyses and our financial results.

**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 effect on us.

**Recent Accounting Pronouncements**

We adopted FASB ASC 820-01 (SFAS No. 157, "Fair Value Measurements") ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a methodology for measuring fair value, and expands the required disclosure for fair value measurements. On February 12, 2008, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. SFAS 157-2, "Effective Date of FASB Statement No. 157," which amends SFAS No. 157 by delaying its effective date by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The adoption of SFAS No. 157 for our financial assets and financial liabilities did not have a material impact on our consolidated financial statements. At September 30, 2009, we did not have any forward exchange contracts outstanding. If we would have had forward exchange contracts outstanding their fair value at quarter end would have been determined via inputs that included quoted prices for similar foreign exchange contracts in active markets and were thus considered to be Level 2 inputs under the SFAS 157 hierarchy (see Note 1-Derivative and Hedging Activities). Effective October 1, 2009, SFAS No. 157 will also apply to all other fair value measurements for us. We are evaluating the effect the implementation of SFAS No. 157 will have on our non-financial assets and non-financial liabilities on our consolidated financial statements.

The carrying amount of cash, accounts receivable and accounts payable and other short-term financial instruments approximate their fair value due to their short-term nature. We believe that borrowings outstanding under our note payable approximate fair value due to the short-term duration of the loan.

In December 2007, the FASB issued new guidance for business combinations that will significantly change the accounting for business combinations in a number of areas including the treatment of contingent consideration, contingencies, acquisition costs, IPR&D and restructuring costs. The changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. This guidance is effective for fiscal years beginning after December 15, 2008. We have not yet evaluated the impact, if any, of adopting this pronouncement.

In December 2007, the FASB issued new guidance for Noncontrolling Interests in Consolidated Financial Statements. This will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests (NCI) and classified as a component of equity. This new consolidation method will significantly change the accounting for transactions with minority interest holders. This guidance is effective for fiscal years beginning after December 15, 2008. We have not yet evaluated the impact, if any, of adopting this pronouncement.

**Certain information required to be included in this Annual Report is contained in our consolidated financial statements included in this Annual Report.**

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, 2009 were as follows:

<b>Year ended September 30, 2009</b>	<b>High</b>	<b>Low</b>
First Quarter	1.16	0.82
Second Quarter	1.86	1.01
Third Quarter	1.40	1.03
Fourth Quarter	1.31	0.95
<b>Year ended September 30, 2008</b>	<b>High</b>	<b>Low</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

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 December 21, 2009 was 250.

No cash dividends have been paid during the two fiscal years ended September 30, 2009. 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. Pursuant to the terms of the Note, we and our affiliates are prohibited from declaring or paying any cash dividend.

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. There were no repurchases under the plan during fiscal 2009.

On October 6, 2009, NASDAQ notified us that we were subject to delisting based on our failure to timely hold our annual meeting. In accordance with NASDAQ's Listing Rules, we requested a hearing before a NASDAQ Hearings Panel. On November 12, 2009, we appeared before the Panel and presented our plan to regain compliance. On December 9, 2009, we held our annual meeting and on December 10, 2009, the Panel rendered its determination to continue our listing. The decision of the Panel is subject to review by the NASDAQ Listing and Review Council within 45 days following the issuance of the Panel's written decision.

On November 18, 2009, we received a letter from NASDAQ indicating that we are not in compliance with NASDAQ's minimum bid price rule. The letter noted that, for the thirty consecutive trading days prior to November 18, 2009, our minimum closing bid price per share had been below the \$1.00 minimum bid price requirement set forth in NASDAQ Rule 5450(a)(1). In accordance with NASDAQ Rule 5810(c)(3)(A), we have 180 days, or until May 17, 2010, to regain compliance. In its notice, NASDAQ indicated that, if at any time during this period the minimum closing bid price is \$1.00 or more per share for at least ten consecutive trading days, NASDAQ will provide confirmation that we have regained compliance.

Should we fail to regain compliance by May 17, 2010, NASDAQ has advised it will then provide a notice to us that our common stock will be delisted. However, we may be eligible for an additional grace period if we satisfy all the requirements, other than the minimum bid price requirement, for initial listing on the NASDAQ Capital Market, set forth in NASDAQ Listing Rule 5505. In order to take advantage of this alternative we will need to submit an application to transfer our securities to the NASDAQ Capital Market.

No assurances can be provided that we will be able to achieve or maintain compliance with the requirements under the NASDAQ continued listing rules or standards (including the minimum bid price rule) or that we will maintain our NASDAQ listing.

### Securities Authorized for Issuance Under Equity Compensation Plans

Set forth in the table below is certain information regarding the number of shares of our common stock that may be issued under options, warrants and rights pursuant to all of our existing equity compensation plans as of September 30, 2009.

	<b>Number of securities to be issued upon exercise of outstanding options, warrants and rights</b>	<b>Weighted average exercise price of outstanding options, warrants and rights</b>	<b>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column)</b>
Equity compensation plans approved by stockholders . . . . .	1,522,394	\$3.78	499,325
Equity compensation plans not approved by stockholders . . . . .	-	\$-	-
Total . . . . .	1,522,394	\$3.78	499,325



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, 2009 and 2008 and the related consolidated statements of operations, other comprehensive loss, stockholders' equity and cash flows for the years then ended. 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 at September 30, 2009 and 2008 and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*BDO Seidman, LLP*

/s/ BDO Seidman, LLP

BDO Seidman, LLP

Melville, New York

December 29, 2009

consolidated balance sheets

<b>ASSETS</b>	<u>September 30, 2009</u>	<u>September 30, 2008</u>
Current Assets:		
Cash and cash equivalents . . . . .	\$8,368,342	\$14,191,721
Accounts receivable, net of various allowances . . . . .	9,770,584	6,932,400
Other non trade receivables . . . . .	4,116,392	2,316,057
Inventories . . . . .	8,616,800	12,236,166
Deferred tax asset-current . . . . .	1,297,574	1,133,073
Prepaid expenses and other current assets . . . . .	928,680	1,093,406
Total current assets . . . . .	<u>33,098,372</u>	<u>37,902,823</u>
Intangible assets, net . . . . .	4,696,102	-
Property, plant and equipment, net . . . . .	757,488	769,288
Security deposits and other non current assets . . . . .	108,088	102,227
Deferred tax asset-non current . . . . .	887,611	887,611
Total assets . . . . .	<u>\$39,547,661</u>	<u>\$ 39,661,949</u>
<b>Liabilities And Stockholders' Equity:</b>		
Current Liabilities:		
Accounts payable . . . . .	\$12,478,625	\$10,406,836
Accrued expenses – fees . . . . .	5,753,546	5,604,485
Accrued expenses . . . . .	8,131,263	4,603,858
Note payable . . . . .	625,045	0
Income taxes payable . . . . .	224,316	58,234
Total current liabilities . . . . .	<u>27,212,795</u>	<u>20,673,413</u>
Commitments and contingencies		
<b>Stockholders' Equity</b>		
Common stock \$.01 par value; 25,000,000 shares authorized, 10,814,042 and 10,784,717 issued, respectively . . . . .	108,140	107,847
Additional paid-in capital . . . . .	17,276,651	16,709,201
Retained earnings . . . . .	795,674	7,938,695
Accumulated other comprehensive loss . . . . .	(3,441,262)	(3,362,870)
Treasury Stock at cost, 759,579 shares . . . . .	(2,404,337)	(2,404,337)
Total stockholders' equity . . . . .	<u>12,334,866</u>	<u>18,988,536</u>
Total liabilities and stockholders' equity . . . . .	<u>\$39,547,661</u>	<u>\$39,661,949</u>

See accompanying notes to consolidated financial statements

## consolidated statements of operations

	<b>Years ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Net sales .....	\$59,344,538	\$89,701,028
Cost of sales .....	46,557,904	72,019,046
Gross profit .....	12,786,634	17,681,982
Selling, general and administrative expenses .....	16,117,590	17,152,848
Research and development expenses .....	4,421,935	3,883,747
Loss from operations .....	(7,752,891)	(3,354,613)
Other Income:		
Interest income .....	14,217	43,989
Interest expense .....	(62,557)	-
Foreign currency .....	670,760	(15,138)
Total other income .....	622,420	28,851
Loss before tax provision (benefit) .....	(7,130,471)	(3,325,762)
Income tax provision (benefit) .....	12,550	(237,573)
Net loss .....	<u>(\$7,143,021)</u>	<u>(\$3,088,189)</u>
Net loss per share:		
Basic and Diluted .....	<u>(\$0.71)</u>	<u>(\$0.31)</u>

See accompanying notes to consolidated financial statements

## consolidated statements of other comprehensive income (loss)

	<b>Years ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Other comprehensive income (loss):		
Net loss	(\$7,143,021)	(\$3,088,189)
Forward exchange contracts marked to market	16,545	51,509
Foreign currency translation loss	(94,937)	(2,088,408)
Other comprehensive loss	<u>(\$7,221,413)</u>	<u>(\$5,125,088)</u>

See accompanying notes to consolidated financial statement

consolidated statements of stockholders' equity

For the years ended September 30, 2009 and 2008

<b>Common Stock</b>							
	<b>Number Of Shares</b>	<b>Amount</b>	<b>Additional Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (loss)</b>	<b>Treasury Stock</b>	<b>Total</b>
BALANCE AT SEPTEMBER 30, 2007 .....	10,597,002	\$105,970	\$15,497,703	\$11,026,884	\$(1,325,971)	\$(2,363,505)	\$22,941,081
Net loss for the year ended September 30, 2008 .....	-	-	-	(3,088,189)	-	-	(3,088,189)
Stock compensation .....	-	-	795,912	-	-	-	795,912
Stock compensation-stock issued to directors .....	35,000	350	125,650	-	-	-	126,000
Purchase of treasury stock ...	-	-	-	-	-	(40,832)	(40,832)
Exercise of Stock Options ....	132,800	1,327	235,471	-	-	-	236,798
Foreign currency translation loss .....	-	-	-	-	(2,088,408)	-	(2,088,408)
Change in fair value of forward contracts .....	-	-	-	-	51,509	-	51,509
Stock issued through Employee Stock Purchase plan .....	<u>19,915</u>	<u>200</u>	<u>54,465</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>54,665</u>
BALANCE AT SEPTEMBER 30, 2008 .....	10,784,717	\$107,847	\$16,709,201	\$7,938,695	\$(3,362,870)	\$(2,404,337)	\$ 18,988,536
Net loss for the year ended September 30, 2009 .....	-	-	-	(7,143,021)	-	-	(7,143,021)
Stock compensation .....	-	-	538,685	-	-	-	538,685
Foreign currency translation loss .....	-	-	-	-	(94,937)	-	(94,937)
Change in fair value of forward contracts .....	-	-	-	-	16,545	-	16,545
Stock issued through Employee Stock Purchase plan .....	<u>29,325</u>	<u>293</u>	<u>28,765</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>29,058</u>
BALANCE AT SEPTEMBER 30, 2009 .....	<u>10,814,042</u>	<u>\$108,140</u>	<u>\$17,276,651</u>	<u>\$795,674</u>	<u>(\$3,441,262)</u>	<u>(\$2,404,337)</u>	<u>\$12,334,866</u>

## consolidated statements of cash flows

See accompanying notes to consolidated financial statements

	<b>Years ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Cash Flows From Operating Activities:</b>		
Net loss	(\$7,143,021)	(\$3,088,189)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	280,610	266,858
Amortization of intangible assets	566,127	-
Inventory reserve	360,000	930,000
Bad debt expense	35,000	450,000
Sales reserve-net	135,537	-
Stock compensation expense-employees	538,685	921,912
Deferred tax benefit	(164,500)	(529,995)
Other non cash items	(5,820)	7,938
<b>Changes in current assets and liabilities:</b>		
Accounts receivable and other non trade receivables	(5,219,333)	13,969,369
Inventories	3,669,643	355,698
Prepaid expenses and other current assets	164,726	(290,831)
Accounts payable	1,978,439	(10,228,301)
Accrued expenses and income taxes	3,577,766	1,922,898
Total adjustments	<u>5,916,880</u>	<u>7,775,546</u>
Net cash (used in) provided by operating activities	<u>(1,226,141)</u>	<u>4,687,357</u>
<b>Cash Flows From Investing Activities:</b>		
Purchase of PCTV assets	(4,506,225)	-
Purchases of property, plant and equipment	(41,679)	(291,025)
Net cash used in investing activities	<u>(4,547,904)</u>	<u>(291,025)</u>
<b>Cash Flows From Financing Activities:</b>		
Proceeds from employee stock purchases	29,058	291,463
Purchase of treasury stock	-	(40,832)
Net cash provided by financing activities	<u>29,058</u>	<u>250,631</u>
Effect of exchange rates on cash	<u>(78,392)</u>	<u>(2,036,899)</u>
Net (decrease) increase in cash and cash equivalents	<u>(5,823,379)</u>	<u>2,610,064</u>
Cash and cash equivalents, beginning of year	<u>14,191,721</u>	<u>11,581,657</u>
Cash and cash equivalents, end of year	<u>\$8,368,342</u>	<u>\$14,191,721</u>
<b>Supplemental disclosures:</b>		
Interest paid	\$ 62,557	-
Income taxes paid	\$ 60,880	\$375,437
Note payable to Avid Technology, Inc.	\$ 2,500,000	-

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., Hauppauge Digital Inc. Taiwan, PCTV Systems Sarl, its branch PCTV Systems GmbH, Hauppauge Digital Europe Sarl, its branch Hauppauge Digital Europe Sarl 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 Sarl. 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., Hauppauge Digital Europe Sarl and PCTV 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 PCs 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. The Company has administrative offices in Luxembourg, Ireland and Singapore and sales offices in Germany, London, Paris, The Netherlands, Sweden, Italy, Spain, Singapore, Taiwan and California and research and development centers in Hauppauge, New York, Braunschweig, Germany and Taiwan.

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:

	<b>Twelve months ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Product line sales:		
Analog sales . . . . .	\$1,829,752	\$10,561,536
Digital sales . . . . .	55,770,304	74,371,847
Other non TV tuners products . . . . .	1,744,482	4,767,645
Total sales . . . . .	<u>\$59,344,538</u>	<u>\$89,701,028</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% and 52% and 48% of total sales for the years ended September 30, 2009 and 2008, respectively.

Net sales to customers by geographic location consist of:

	<b>Years ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Sales to:		
The Americas . . . . .	48%	48%
Northern Europe . . . . .	7%	9%
Southern Europe . . . . .	17%	14%

## notes to consolidated financial statements

Central and Eastern Europe . . . . .	25%	26%
Asia . . . . .	<u>3%</u>	<u>3%</u>
Total . . . . .	<u>100%</u>	<u>100%</u>

Net long lived assets located in the United States, Europe and Asia locations were approximately 55%, 38% and 7% of total net long lived assets, respectively, at September 30, 2009, and 74%, 16% and 10%, respectively, at September 30, 2008.

### **Subsequent Events**

Management has evaluated subsequent events after the balance sheet date through the issuance of the financial statements for appropriate accounting and disclosure through the December 29, 2009 filing date of our Form 10-K.

### **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 10). Although the Company operates in one industry segment, it does not believe that the Company 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 is comprised 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 FASB ASC 605-15 (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 FASB ASC 605-50 ( 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. The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the Company's financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount currently estimated to be realized. The Company adopted ASC 740-10 (Financial Accounting Standards Board ("FASB") Interpretation No. 48), "Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109" ("FIN 48") effective October 1, 2007. Under ASC 740-10 (FIN 48), tax benefits are recognized only for tax positions that are more likely than not to be sustained upon examination by tax authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50% likely to be realized upon ultimate settlement. Unrecognized tax benefits are tax benefits claimed in tax returns that do not meet these recognition and measurement standards. At September 30 2009, the Company did not have any uncertain tax positions, and the Company does not expect ASC 740-10 (FIN 48) to have a significant impact on its results of operations or financial position during the next 12 months. As permitted by ASC-740-10(FIN 48), the Company also adopted an accounting policy to prospectively classify accrued interest and penalties related to any unrecognized tax benefits in its income tax provision. Previously, the Company's policy was to classify interest and penalties as an interest expense in arriving at pre-tax income.

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

Long-lived assets, such as property and equipment and intangible assets, 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. In accordance with ASC 360-10-35 (SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets" ASC 360-10-35 ("SFAS No. 144"), amortization of intangible assets is provided using the straight-line method over the estimated useful lives of the assets. Impairment indicators include, among other conditions: cash flow deficits, a historic or anticipated decline in net sales or operating profit, adverse legal or regulatory developments, accumulation of costs significantly in excess of amounts originally expected to acquire the asset, and a material decrease in the fair market value of some or all of the assets. Assets are grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows generated by other asset groups.

#### **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 \$3,346,325 recorded on the balance sheet as of September 30, 2008. For the twelve months ended September 30, 2009 the Company recorded on the balance sheet translation losses of \$94,937, resulting in an accumulated translation loss of \$3,441,262 recorded as a component of accumulated other comprehensive income as of September 30, 2009.

**Derivatives and Hedging Activities**

For each of the fiscal years ended September 30, 2009 and 2008, 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 95% 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.

Due to the rapid upward spike of the Euro compared to the U.S. dollar, the Company chose not to invest in any forward exchange contracts during the Company's fourth fiscal quarter. As of September 30, 2009 the Company had no open contracts outstanding. 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 expired 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 \$0 and \$16,545 as of September 30, 2009 and 2008, 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, 2009 and 2008 because of the relatively short term maturity of these instruments. The Company believes that borrowings outstanding under its note payable approximate fair value due to the short-term duration of the loan.

**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:

	<u>Years ended September 30,</u>	
	<u>2009</u>	<u>2008</u>
Weighted average Common Stock outstanding-basic . . . . .	10,045,449	9,969,939
Common Stock equivalents-stock options . . . . .	-	-
Weighted average shares outstanding-diluted . . . . .	<u>10,045,449</u>	<u>9,969,939</u>

Options to purchase 1,522,394 and 1,767,744 shares of Common Stock at prices ranging \$1.05 to \$8.75 and \$1.08 to \$8.75, respectively, were outstanding as of September 30, 2009 and 2008, 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 FASB ASC-718 (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, 2009 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 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

<b>Stock option grant assumptions:</b>	<b>2009</b>	<b>2008</b>
Weighted average fair value of grants . . . . .	\$0.70	\$1.02
Risk free interest rate . . . . .	4.25%	4.25%
Dividend yield . . . . .	-	-
Expected volatility . . . . .	50%	50%
Expected life in years . . . . .	7	7

As of September 30, 2009, there was \$830,226 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, 2009 and 2008 was \$538,685 and \$795,912. For September 30, 2009 and 2008, stock compensation expense of \$347,069 and \$522,168 have been recorded to SG&A expense and \$191,616 and \$273,744 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, 2009 and changes during the twelve months ended September 30, 2009 is presented below:

	<b>Shares</b>	<b>Weighted Grant date fair value</b>
Non-vested as of October 1, 2008 . . . . .	621,143	\$2.76
Granted . . . . .	95,000	0.70
Vested . . . . .	(153,000)	2.75
Forfeited . . . . .	(98,143)	1.05
Non-vested as of September 30, 2009 . . . . .	<u>465,000</u>	<u>\$2.70</u>

**Accrued expenses- 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 incurs 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. The licensing fees are accounted for as a component of product cost and are charged to cost of sales.

**Recent Accounting Pronouncements**

The Company adopted FASB ASC 820-10 (SFAS No. 157, "Fair Value Measurements") ("SFAS No. 157") on October 1, 2008. SFAS No. 157 defines fair value, establishes a methodology for measuring fair value, and expands the required disclosure for fair value measurements. On February 12, 2008, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. SFAS 157-2, "Effective Date of FASB Statement No. 157," which amends SFAS No. 157 by delaying its effective date by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The adoption of SFAS No. 157 for the Company's financial assets and financial liabilities did not have a material impact on its consolidated financial statements. At September 30, 2009 the Company did not have any forward contracts outstanding. If the Company would have had forward exchange contracts outstanding their fair value at quarter end would have been determined via inputs that included quoted prices for similar foreign exchange contracts in active markets and were thus considered to be Level 2 inputs under the SFAS 157 hierarchy (see Note 1-Derivatives and Hedging Activities). Effective October 1, 2009, SFAS No. 157 will also apply to all other fair value measurements for the Company. The Company is evaluating the effect the implementation of SFAS No. 157 will have on its non-financial assets and non-financial liabilities on its consolidated financial statements.

In December 2007, the FASB issued new guidance for business combinations that will significantly change the accounting for business combinations in a number of areas including the treatment of contingent consideration, contingencies, acquisition costs, IPR&D and restructuring costs. The changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. This guidance is effective for fiscal years beginning after December 15, 2008. The adoption of this accounting pronouncement will affect future acquisitions, if any.

In December 2007, the FASB issued new guidance for Noncontrolling Interests in Consolidated Financial Statements. This will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests (NCI) and classified as a component of equity. This new consolidation method will significantly change the accounting for transactions with minority interest holders. This guidance is effective for fiscal years beginning after December 15, 2008. The Company has not yet evaluated the impact, if any, of adopting this pronouncement.

### 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

The following is a listing by category of the Company's accounts receivable as of September 30, 2009 and 2008.

	<b>As of September 30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Receivable detail:</b>		
Trade receivables	\$13,893,804	\$ 11,668,214
Allowances and reserves	(4,123,220)	(4,735,814)
Net trade receivables	<u>9,770,584</u>	<u>6,932,400</u>
Receivable from contract manufacturers	2,933,918	1,795,225
GST and VAT taxes receivables	1,134,331	484,086
Other	<u>48,143</u>	<u>36,746</u>
Total other non trade receivables	<u>\$4,116,392</u>	<u>\$ 2,316,057</u>

## 3. Inventories

Inventories consist of the following:

	<b>As of September 30,</b>	
	<b>2009</b>	<b>2008</b>
Component Parts . . . . .	\$ 2,799,723	\$ 4,561,140
Finished Goods . . . . .	<u>5,817,077</u>	<u>7,675,026</u>
	<u>\$ 8,616,800</u>	<u>\$12,236,166</u>

## 4. Property, Plant and Equipment

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

	<b>As of September 30,</b>	
	<b>2009</b>	<b>2008</b>
Office Equipment and Machinery . . . . .	\$ 3,780,398	\$ 3,492,520
Leasehold Improvements . . . . .	115,870	115,870
	3,896,268	3,608,390
Less: Accumulated depreciation and amortization . . . . .	(3,138,780)	(2,839,102)
	<u>\$ 757,488</u>	<u>\$ 769,288</u>

Depreciation and amortization expense totaled \$ 280,610 and \$ 266,858 for the years ended September 30, 2009 and 2008, respectively.

## 5. Intangible Assets

The following is a summary of intangible assets as of September 30, 2009

	<u>Purchase cost</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>	<u>Weighted average remaining life (in years)</u>
Asset description:				
Customer relationships . . . . .	\$1,644,353	(\$102,772)	\$1,541,581	11.25
Value of technology . . . . .	1,849,897	(198,203)	1,651,694	6.25
Covenant not to compete . . . . .	1,767,979	(265,152)	1,502,827	4.25
Total intangible assets . . . . .	<u>\$5,262,229</u>	<u>(\$566,127)</u>	<u>\$4,696,102</u>	<u>8.45</u>

Amortization expense totaled \$566,127 for the year ended September 30, 2009. The Company had no intangible assets for the year ended September 30, 2008. Amortization expense is expected to be approximately \$755,000 for each of the fiscal years ended September 30, 2010, 2011, 2012 and 2013, respectively, and \$490,000 for the year ended September 30, 2014.

## 6. Accrued Expenses – 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. For fiscal 2009 \$2,694,648 in fees were charged to cost of sales and \$2,545,587 in fees were paid to various third parties. For fiscal 2008 \$3,169,649 in fees were charged to cost of sales and \$2,274,559 in fees were paid to various third parties.

During fiscal year 2008, the Company identified \$1,462,661 of license accrual amounts that were no longer 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 - 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 – fees by approximately \$1,190,000 due to a change in the Company’s estimate during fiscal 2008. The Company did not record any such change in estimates during fiscal 2009.

## 7. Accrued Expenses

Accrued expenses are for costs incurred for goods and services which are based on estimates, charged as incurred to operations as period costs and for which no invoice has been rendered. Included in accrued expenses are accruals for product costs of \$4,995,109 and \$2,347,759 as of September 30, 2009 and 2008, respectively; accruals for sales costs relating to a sales rebate program of \$1,104,992 at September 30, 2009 and 2008, respectively; accruals for freight and duty expenses of \$1,020,432 and \$348,164 at September 30, 2009 and 2008, respectively; accruals for compensation costs of \$343,925 and \$269,916 at September 30, 2009 and 2008, respectively; accruals for warranty repair costs of \$283,507 and \$24,101 at September 30, 2009 and 2008, respectively and accruals for advertising and marketing costs of \$294,942 and \$300,253, at September 30, 2009 and 2008, respectively.

## 8. Income Taxes

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

notes to consolidated financial statements

	<b>Years ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Current tax expense:		
State income taxes . . . . .	\$ 40,000	\$ 25,000
Foreign income taxes . . . . .	137,050	267,422
Total current tax expense . . . . .	<u>177,050</u>	<u>292,422</u>
Deferred tax (benefit)		
Federal	(147,184)	(474,206)
State	<u>(17,316)</u>	<u>(55,789)</u>
Total tax provision (benefit) . . . . .	<u>\$ 12,550</u>	<u>\$(237,573)</u>

Components of deferred taxes are as follows:

	<b>Years ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Net operating loss domestic . . . . .	\$388,989	\$ -
Net operating loss foreign . . . . .	475,693	475,693
Sales reserve . . . . .	328,119	380,764
Inventory obsolescence . . . . .	705,932	874,000
Allowance for bad debts . . . . .	312,824	338,200
Vacation accrual . . . . .	24,588	24,588
Warranty reserve . . . . .	9,158	9,158
263 A inventory capitalization . . . . .	115,650	83,517
Depreciation . . . . .	14,822	4,834
Goodwill . . . . .	114,856	135,376
AMT credit . . . . .	170,247	170,247
R&D credit . . . . .	407,971	407,971
Subtotal . . . . .	<u>3,068,849</u>	<u>2,904,348</u>
Valuation allowance . . . . .	<u>(883,664)</u>	<u>(883,664)</u>
Net deferred tax assets . . . . .	<u>\$2,185,185</u>	<u>\$ 2,020,684</u>

Deferred tax assets and the offsetting tax valuation allowance is primarily attributable to the Company's Hauppauge Computer Works Inc. domestic operations. In evaluating the future realization of the Company's deferred tax asset and the corresponding valuation allowance as of September 30, 2009, the Company took into consideration:

- the Company's domestic operations had taxable income for three out of the last four fiscal years
- including royalties paid to the Company's domestic operations by the Company's European subsidiary, the Company anticipates taxable income for its domestic operations for fiscal 2010
- the Company's history of utilization of prior domestic net operating losses

After evaluating the circumstances listed above, it was the Company's opinion that its net deferred tax asset net of \$2,185,185 is realizable as of September 30, 2009.

As of September 30, 2008, the Company had utilized all of the Company's unrestricted domestic net operating losses. As of September 30, 2009, the Company has \$1,023,655 in unrestricted domestic net operating losses. As of September 30, 2009 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 \$2,672,177 at September 30, 2009 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:

	<b>Years ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Income tax expense at federal statutory rate . . . . .	\$ (2,424,360)	(1,130,759)
Change in estimate of prior year income taxes . . . . .	(178,025)	79,438
Permanent differences-life insurance . . . . .	1,700	1,360
Permanent differences-compensation expense . . . . .	183,153	270,610
Permanent differences-other . . . . .	1,190	1,700
State income taxes, net of federal benefit . . . . .	9,084	(39,289)
Foreign earnings taxed at rates other than the federal statutory rate . . .	2,430,294	544,782
Other . . . . .	(10,486)	34,585
Taxes (benefit) on income . . . . .	<u>\$ 12,550</u>	<u>\$(237,573)</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 pretax income of \$406,646 for the year ended September 30, 2009 and a pretax loss of \$2,509,998 for the year ended September 30, 2008. The Company's international operations had pretax net income (loss) net of royalty fees of \$(7,537,116) and \$(815,764) for the years ended September 30, 2009 and 2008.

## **9. 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, 2009, 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. The plan has expired and no further options can be granted under this plan. As of September 30, 2009 and 2008, 32,267 and 33,867 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 expired on March 5, 2006 and no more options can be issued under this plan. This plan does not qualify for treatment as an incentive stock option plan under the Internal Revenue Code. As of September 30, 2009 and 2008, 181,400 and 186,975 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 and no further options can be issued under this plan. As of September 30, 2009 and 2008, 168,360 and 270,610 options were outstanding with exercise prices from \$1.08 to \$ 8.75.

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

The 2000 Plan as adopted reserves 500,000 shares of Common Stock to be issued pursuant to stock options grants or other awards, subject to adjustment for any merger, reorganization, consolidation, recapitalization, stock dividend, stock split or any other changes in corporate structure affecting the Common Stock. This plan is to be administered by the Board of Directors. Grants of awards to non-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, 2009 and 2008, 188,867 and 202,667 options were outstanding from this plan ranging in prices from \$1.05 to \$ 5.78.

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

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

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

This plan allows the granting of options as either incentive stock options or non-qualified options. Non-employee directors and non-employee consultants may only be granted Non-Qualified Stock Options. Incentive stock options are priced at the market value at the time of grant and shall be exercisable no more than ten years after the date of the grant. Incentive stock options granted to employees who own 10% or more of the Company's combined voting power cannot be granted at less than 110% of the market value at the time of grant. Non-qualified options shall be granted at a price determined by the Board of Directors and shall be exercisable no more than 10 years and one month after the grant. The aggregate fair market value of shares subject to an incentive stock option granted to an optionee in any calendar year shall not exceed \$100,000. Any fair value at the time of grant that exceeds \$100,000 in any calendar year will not be deemed as incentive stock options. As of September 30, 2009 and 2008, 951,500 and 1,073,625 were outstanding from this plan ranging in prices from \$1.24 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 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, 2009 and 2008, 204,289 and 175,324 shares of Common Stock were purchased under this plan.

A summary of the of the Company's fixed options plans as of September 30, 2009 and 2008 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, 2007. . . . .	1,475,619	\$ 4.16	308,975	\$ 3.24		
Granted . . . . .	144,500	1.79	-	-		
Forfeited . . . . .	-	-	(28,550)	2.36		
Exercised . . . . .	(39,350)	2.29	(93,450)	2.36		
Balance at September 30, 2008. . . . .	1,580,769	\$ 3.99	186,975	\$ 3.53		
Granted . . . . .	95,000	1.24	-	-		
Forfeited . . . . .	(334,775)	3.85	(5,575)	1.08		
Balance at September 30, 2009	1,340,994	\$ 3.77	181,400	\$ 3.64	4.15	-
Options exercisable at September 30, 2009	875,994	\$3.68	181,400	\$ 3.64	3.76	-

There were no options exercised during fiscal 2009. The aggregate intrinsic value of options exercised during the year ended September 30, 2008 was approximately \$309,000.

### 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 of 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 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.

### 10. Significant Customer Information

For fiscal 2009, the Company had one customer, D&H Distributing, that accounted for approximately 12% of our net sales. For fiscal 2008, the Company had one customer, Hon Hai Precision Industry Co. LTD, that accounted for approximately 16% of our sales.

### 11. Related Party Transactions

The Company occupies a facility located at 91 Cabot Court, Hauppauge, New York for its executive offices and for the testing, storage and shipping of its products. Hauppauge Computer Works, Inc., ("HCW") leases the premises (the "1990 Lease"), from Ladokk Realty Co.,

a real estate partnership which is principally owned by Kenneth Plotkin, the Company's President, Chairman of the Board, Chief Executive Officer and Chief Operating Officer and a stockholder of the Company, Dorothy Plotkin, the wife of Kenneth Plotkin and a stockholder of the Company and Laura Aupperle, the widow of Kenneth Aupperle, a founder and former President of the Company. The Company is obligated to pay real estate taxes and operating costs of maintaining the premises subject to the 1990 Lease.

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

The Company had no amount payable to this related party for unpaid rent as of September 30, 2009 and \$48,667 in unpaid rent as of September 30, 2008. Rent expense to related parties and non related third parties totaled approximately \$730,000 and \$687,000 for the years ended September 30, 2009 and 2008 respectively. The Company pays the real estate taxes and it is responsible for normal building maintenance.

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

<u>Years Ended September 30,</u>	
2010 .....	\$ 742,023
2011 .....	666,151
2012 .....	227,315
2013 .....	117,876
2014 .....	<u>58,938</u>
Total .....	<u>\$1,812,303</u>

## 12. 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.

## 13. Acquisition of PCTV Assets from Avid Technology, Inc.

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 the Company's wholly-owned subsidiary, 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 Acquired Assets were 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 potential increase in the Company's customer base, the potential absorption of the PCTV operations into the existing Hauppauge infrastructure with minimal incremental costs plus the acquisition of the seller's technology, reference designs and product line were among the attributes that were considered in the Company's decision to complete the acquisition.

The purchase price consisted of \$2,238,000 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. The principal amount due pursuant to the Note is payable in 12 equal monthly installments of \$208,333. The first such payment was due and paid 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.

The \$4,112,997 paid to the seller, Avid Technology, Inc., consisted of \$2,238,000 paid at the closing and \$1,874,997 paid pursuant to a note payable. As of September 30, 2009, the note payable to Avid Technologies Inc. was \$625,045. The interest paid on the note was \$62,557 for twelve months ended September 30, 2009. The Company believes that borrowings outstanding under its note payable approximate fair value due to the short-term duration of the loan.

The purchase price paid and the allocation of the purchase price is presented below.

Purchase Price Paid	
Cash paid to seller . . . . .	\$4,112,997
Balance of note payable assumed. . . . .	625,045
Warranty liability assumed . . . . .	262,000
Direct acquisition costs paid. . . . .	393,228
Direct acquisition costs accrual . . . . .	93,308
Total purchase price . . . . .	<u>\$5,486,578</u>
Allocation of Purchase Price	
Identifiable intangible assets . . . . .	\$ 5,262,229
Fixed assets . . . . .	224,349
Total allocation of purchase price . . . . .	<u>\$ 5,486,578</u>

The values allocated to identifiable intangible assets in the acquisition are expected to be deductible for income tax purposes.

Because the acquisition was completed on December 24, 2008, results from the operations of the PCTV business effectively started on January 1, 2009.

The following unaudited pro forma results assume the acquisition occurred on October 1, 2007. The pro forma results do not purport to represent what the Company's results of operations actually would have been if the transactions set forth above had occurred on the date indicated or what the Company's results of operations will be in future periods. The financial results for the periods prior to the acquisition were based on internal financial statements as provided by the Sellers.

Pro forma statements:	<u>Twelve months ended Sept 30,</u>	
	<u>2009</u>	<u>2008</u>
Revenue	\$70,367,528	\$133,793,028
Net loss	(\$7,841,031)	(\$10,560,189)
Net loss per share:		
Basic and Diluted net loss per share	(\$0.78)	(\$1.06)

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 the Company (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.

The Transition Services Agreement was terminated as of April 30, 2009.

Further, Avid and 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.

#### 14. Line of credit

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

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

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

There were no borrowings outstanding and no letters of credit outstanding as of the filing date of our Annual Report on Form 10-K.

On March 31, 2009 our line of credit with the JP Morgan Chase Bank expired and was not renewed.

## corporate information

### Executive Offices

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

### Subsidiaries

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

### Transfer Agent

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

### General Counsel

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

### Auditors

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

### Common Stock

NASDAQ Global Market; symbol: HAUP

### Officers and Directors

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

Gerald Tucciarone  
Chief Financial Officer and Treasurer

John Casey  
Vice-President of Technology

Bernard Herman  
Director - Retired President of Okidata America

Seymour G. Siegel  
Director - Partner, Rothstein, Kass & Company  
An accounting and audit service firm

Christopher G. Payan  
Director - Business Consultant

### Annual Report on form 10-K available

A copy of the Company's Annual Report, including the financial statements and the financial statement schedules on Form 10-K, as filed with the Securities and Exchange Commission for the year ended September 30, 2009, can be obtained from the Company without charge by writing to:

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



Hauppauge Digital Inc.  
91 Cabot Court  
Hauppauge, NY 11788 USA  
tel: 631.434.1600  
fax: 631.434.3198  
[www.hauppauge.com](http://www.hauppauge.com)