2003 annual report

Hauppauge!®

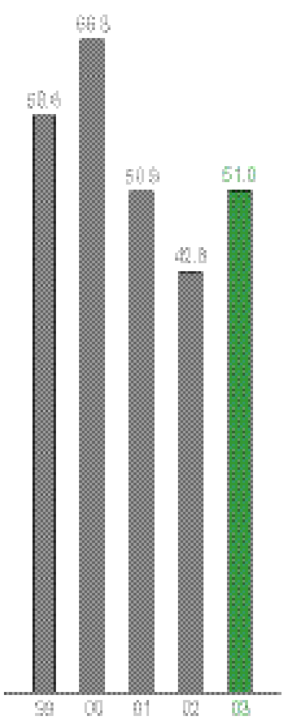
selected financial data

Years ended September 30,	**2003**	**2002**	**2001**	**2000**	**1999***
		(in thousands except for per share amounts)			
Net sales	$ 50,956	$ 42,797	$ 50,910	$ 66,292	$ 58,602
Income (loss) before taxes on income	$ (507)	$ 417	$ (1,851)	$ (2,183)	$ 4,593
Net income (loss)	$ (814)	$ 348	$ (2,282)	$ (999)	$ 3,118
Diluted net income (loss) per share	$ (0.09)	$ 0.04	$ (0.26)	$ (0.11)	$ 0.33
Shares outstanding (diluted) in millions	8,867	9,002	8,910	8,837	9,480
Balance Sheet Data (at period end)					
Working capital	$ 10,860	$ 11,266	$ 10,258	$ 11,767	$ 12,533
Total assets	$ 21,650	$ 19,846	$ 18,784	$ 26,316	$ 27,728
Stockholders' equity	$ 11,468	$ 11,967	$ 11,186	$ 13,654	$ 13,322

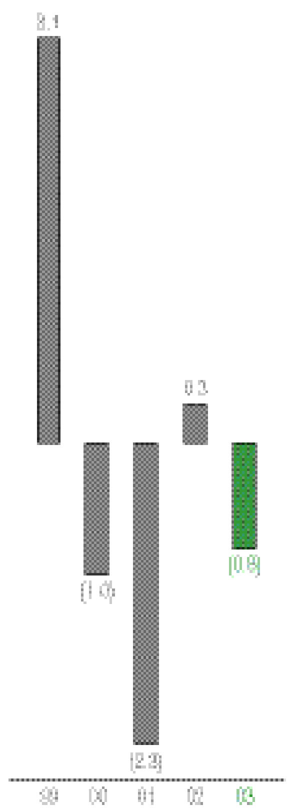
*Period restated to reflect 2 for 1 stock split

financial highlights

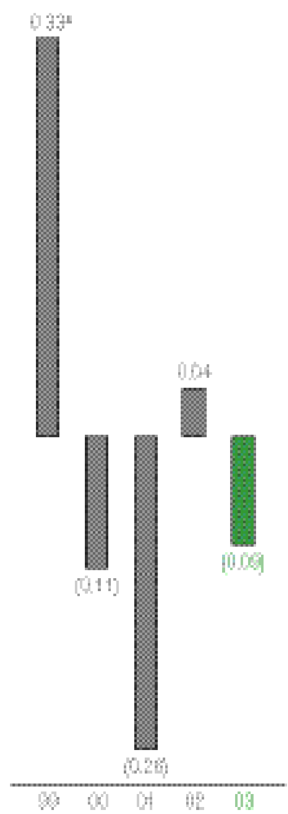
Net Sales
(in millions)



Net income (loss)
(in millions)



Net income (loss)
(per share)



*Period restated to reflect 2 for 1 stock split

Dear Stockholder,

Fiscal 2003 at Hauppauge Digital presented ups and downs for both management and our employees. We started 2003 on a solidly upward note, with first half sales growing 29% compared with the same period in the prior fiscal year. Revenues were growing nicely for our key strategic products in the U.S. and Europe; we were experiencing above-average growth for our European digital TV receiver business, as well as an increased acceptance of our WinTV-PVR products in both the U.S. and European markets. The feeling that the slow 2002 market was behind us, and the growing acceptance of strategic products, gave management optimism as we moved into the second half of the fiscal year.

But by the beginning of the second half of the year, as the Iraq war started, the Company saw a drop in sales through our retail customers. Not only did sales decline dramatically when the war in Iraq began, but the official end of the war also failed to stem a fall in sales to levels we had not seen since early fiscal 2002. We held on tight, and the downturn was over by the end of the second half of the fiscal year when we began seeing steady growth again.

Despite the ups and downs in sales and profits, the Company continued on track in the development of its strategic products: analog and digital TV receiver products for PCs and media player products for the home entertainment market. In our PC market, leadership is determined by the degree of innovation a company exhibits in its new products compared to its competition. By this measure, we did well in 2003.

Highlights of the Year

In fiscal 2003, consumers began moving away from our low-priced analog TV receivers and instead were buying our more fully-featured WinTV-PVRs, which can digitally record TV shows to a PC's disk drive and display the show in a window on the PC screen. This shift has resulted in our WinTV-PVR product line, introduced in 1999, achieving a larger percentage of the Company's overall sales at the retail level.

In late Q4 we also took the next step in our plan to deliver a complete solution for home media distribution by introducing our MediaMVP. MediaMVP is the companion to WinTV-PVR; while WinTV-PVR allows a user to watch and record television on their PC, MediaMVP plays the digitally recorded program on a television set in another room in the home.

Fiscal 2003 also marked the first year our sales of digital TV receiver products in Europe exceeded those of our older analog TV receivers, a trend we have predicted for some time. Unfortunately the same cannot be said for our U.S. digital TV receiver business, where the market for ATSC high definition TV continues to grow very slowly. Our research and development team is working on new U.S. digital TV receivers in anticipation of a 2004/2005 launch.

In the OEM arena, our WinTV-PVRs and European digital TV receiver products received new design-ins among personal computer manufacturers. The PC OEM industry is highly competitive and offers low profit margins, but we continue to develop products for this market in consultation with our OEM partners because we believe there is value in making television reception an essential part of the PC experience.

Products introduced during Fiscal 2003

- The 'Amity1' board, a PC OEM product designed for use with Microsoft's Windows XP Media Center Edition. This product has excellent video quality, and was used by Microsoft in its editorial evaluation systems supporting the rollout of Media Center Edition 'Harmony' version in September, 2003. The 'Amity1' is currently being sold through our retailers as the WinTV-PVR-250.
- The WinTV-PVR-USB2, a personal video recorder supporting both laptop computers and desktop PCs. This product is a small external box which has a built-in hardware MPEG video encoder, the same high quality MPEG encoder used in the 'Amity1', and connects to PC's and laptop computers through a USB cable.
- The low cost 'Roslyn' board. This product was offered to PC OEMs as an inexpensive alternative to the 'Amity1' board for use with Windows XP Media Center Edition.
- MediaMVP, first in our line of digital media receivers for home TV sets. The MediaMVP receives digital music, digital pictures and digital videos from a PC over a home network, then displays or plays the media on a TV set or through a home theater sound system.

Results for the 2003 Fiscal Year

Despite the ups and downs in fiscal 2003, Hauppauge was able to achieve sales growth of 19% year-over-year, resulting in total revenues of $51 million. As previously mentioned, the first half of the year showed a robust 29% sales increase over the same period in 2002, while the last half of the year saw sales decline dramatically from the first half. The Company still finished above the $50 million point, a level we had not reached since the burst of the dot-com bubble in 2001.

Our net loss for the year was $814,000 compared with a profit in the previous year of $347,000. Once again, the Company generated approximately $1 million profit in the first half of the year, only to see the profit turn into a loss as sales dropped in the third and fourth fiscal quarters.

To remain competitive in the market, it is important that we continually drive down our manufacturing costs. This is especially important as a greater percentage of our sales are made to personal computer OEMs. In 2003, our gross profit margins were 23.4% versus 27.5% for the previous year. Much of the decrease was due to our expanding sales in the OEM market, where gross profit margins are typically low.

Conclusion

Though we are encouraged by the sales growth for 2003, we realize that, in order to grow the market for our TV receivers and digital media receivers for the PC market, Hauppauge needs to do a better job of executing our strategic marketing plan. Our new product, the MediaMVP, is intended to position the Company in the new media decoder area of the PC market. And, along with Microsoft's Windows XP Media Center Edition, the transition from analog to digital TV should continue to help the market for PC based TV receivers. But, as I have said, there is more work to be done by Hauppauge before the use of TV receivers and media decoder boxes becomes a standard feature of consumer PCs.

On behalf of all of us at Hauppauge Digital, I'd like to thank all of our shareholders for their continued support. In particular I'd like to thank our employees for pushing ahead in 2003.

Yours sincerely,

Kenneth Plotkin

Chairman and Chief Executive Officer

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, S.A.R.L.
Hauppauge Computer Works, S.A.R.L. (France)
Hauppauge Digital Asia Pte, Ltd. (Singapore)
Hauppauge Computer Works, Ltd. (Virgin Islands)
Hauppauge Computer Works, GmbH (Germany)
Hauppauge Computer Works, Ltd. (U.K.)

Transfer Agent

North American Transfer Co.
147 West Merrick Road
Freeport, New York 11520

General Counsel

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

Auditors

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

Common Stock

NASDAQ National Market; symbol: HAUP

Officers and Directors

Kenneth Plotkin
Chairman of the Board and Chief Executive Officer

Dean Cirelli
President and Chief Operating Officer

Gerald Tucciarone
Chief Financial Officer and Treasurer

John Casey
Vice-President of Technology

Benjamin Tan
Corporate Counsel, Secretary

Bernard Herman
Director - Retired President of Okidata America

Steven Kuperschmid
Director - Partner, Certilman Balin Adler & Hyman, LLP

Seymour Siegel
Director - Partner, Rothstein, Kass & Company

Neal Page
Director - President, Inlet Group

Christopher G. Payan
Director - Chief Executive Officer, Emerging Vision, Inc.

Robert S. Nadel
Director - President, Human Resources Spectrum, Inc.

Annual Report on form 10-K available

A copy of the Company's Annual Report on Form 10-K as filed with the Securities and Exchange Commission for September 30, 2003 can be obtained from the Company without charge by writing to:

Hauppauge Digital, Inc.
91 Cabot Court
Hauppauge, New York 11788
Attention: Benjamin Tan, Secretary

Results of operations
September 30, 2003 and 2002

Results of operations for the twelve months ended September 30, 2003 compared to September 30, 2002 are as follows:

	12 Months Ended 9/30/03	12 Months Ended 9/30/02	Variance $	Percentage of sales 2003	Percentage of sales 2002	Variance
Net sales	$ 50,956,034	$ 42,796,726	$ 8,159,308	100.0%	100.0%	-
Cost of sales	38,715,103	31,661,073	7,054,030	75.98%	73.98%	2.00%
Gross profit	12,240,931	11,135,653	1,105,278	24.02%	26.02%	-2.00%
Gross profit %	24.02%	26.02%	-2.00%			
Costs:						
Sales & marketing	7,145,730	5,741,510	1,404,220	14.02%	13.42%	0.60%
Technical support	420,566	379,592	40,974	0.83%	0.89%	-0.06%
General & administrative	3,329,815	2,947,943	381,872	6.53%	6.89%	-0.36%
Total selling, general and administrative costs	10,896,111	9,069,045	1,827,066	21.38%	21.20%	0.18%
Research & development	1,901,843	1,591,551	310,292	3.73%	3.72%	0.01%
Total costs	12,797,954	10,660,596	2,137,358	25.11%	24.92%	0.19%
Net operating income (loss)	(557,023)	475,057	(1,032,080)	-1.09%	1.10%	-2.19%
Other income (expense):						
Interest income	15,858	34,781	(18,923)	0.03%	0.08%	-0.05%
Foreign currency	(17,913)	4,750	(22,663)	-0.04%	0.01%	-0.05%
Non operational USD to Euro re-measurement	51,936	(98,066)	150,002	0.10%	-0.23%	0.33%
Total other income (expense)	49,881	(58,535)	108,416	0.09%	-0.14%	0.23%
Income before taxes (loss)	(507,142)	416,522	(923,664)	-1.00%	0.96%	-1.96%
Income tax provision	306,890	69,000	237,890	0.60%	0.16%	0.44%
Net (loss) income	$ (814,032)	$ 347,522	$ (1,161,554)	-1.60%	0.80%	-2.40%

Results of operations continued
September 30, 2003 and 2002

Net sales for the twelve months ended September 30, 2003 increased $8,159,308 compared to the prior year. Domestic and European sales increased by $4,655,424 and $3,716,401, respectively, while Asian sales decreased $212,517 as follows:

Location:	12 Months Ended 9/30/03	12 Months Ended 9/30/02	Increase (Decrease) Dollar Variance	Increase (Decrease) Variance %	Percentage of sales by Geographic region 2003	2002
Domestic	$ 16,163,782	$ 11,508,358	$ 4,655,424	40%	32%	27%
Europe	34,082,082	30,365,681	3,716,401	12%	67%	71%
Asia	710,170	922,687	(212,517)	-23%	1%	2%
Total	$ 50,956,034	$ 42,796,726	$ 8,159,308	19%	100%	100%

The primary forces contributing to the net sales increase were:
- Digital and digital satellite productsof $4,466,127 due to expanding market
- Analog and personal video recorder sales of $3,693,181 due to new product introductions

Net sales to domestic customers were 32% of net sales for the year ended September 30, 2003 compared to 27% for the year ended September 30, 2002. Net sales to European customers were 67% of net sales compared to 71% for same period of the prior year. Net sales to Asian customers were 1% for the year ended September 30, 2003 as compared to 2% for the year ended September 30, 2002.

Gross profit increased $1,105,278 for the year ended September 30, 2003. Gross profit percentage for the year ended September 30, 2003 was 24.02% compared to 26.02% for the prior year.

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

	Increase (Decrease)
Due to increased sales	$ 2,740,103
Higher margins due to product mix	161,443
Third quarter fiscal 2002 inventory obsolescence adjustment	(151,119)
Effect of increased sales of lower margin OEM products	(1,105,746)
Due to increases in labor related and other costs	(539,404)
Total increase in gross profit	$ 1,105,278

The decrease in gross profit percentage of 2.00% for the twelve months ended September 30, 2003 compared to the twelve months ended September 30, 2002 is as follows:

	Increase (Decrease)
Higher margins due to product mix	0.31%
Third quarter fiscal 2002 inventory reserve adjustment	(0.36%)
Effect of increased sales of lower margin OEM products	(2.17%)
Labor related and other costs	0.22%
Net decrease gross profit %	(2.00%)

The 0.31% improved gross profit percentage on assembled boards due to product mix was primarily caused by unit price reductions from our suppliers and subcontractors on our analog product lines and digital video satellite products, offset somewhat by sales of lower average margin set top box products.

OEM sales of media center boards for the twelve months ended September 30, 2003 were $4,828,040, which accounted for 9.47% of the net sales for fiscal 2003. Although OEM sales require less sales and marketing support, their gross profit percentages are substantially less than those of our retail products. Our OEM sales had an average gross profit percentage of 11.02% for the twelve months ended September 30, 2003. There were no significant OEM sales in the previous year. The increased product mix of OEM sales during fiscal 2003 contributed to the 2.00% reduction in our fiscal 2003 gross profit percentage when compared to the previous year.

Results of operations continued
September 30, 2003 and 2002

During the latter part of fiscal 2001, the factors below affected the realization of the Company's inventory:
- The loss during the fourth quarter of 2001 of a long-time direct corporate customer impacted the existing value of assembled boards and component inventory relating to this customer
- A change with a major contract manufacturer from consigning component parts to the contract manufacturer to purchasing the assembled boards on a turnkey basis impacted the value of component inventory
- The second consecutive year of declining sales resulted in slower sales of older models
- Engineering changes made to our USB and Macintosh products which rendered certain inventory associated with this product obsolete
- The better use of new software that assisted the Company in identifying slow moving inventory

With respect to the factors above, we deemed it necessary to increase our reserve for obsolete and slow moving inventory. An additional reserve of $1,862,766 was recorded during the fourth quarter of fiscal 2001 and charged to cost of sales.

During fiscal 2002, there were certain assembled boards and component material inventory that we were able to sell through the use of a liquidation firm. In recognition of this, we reduced our inventory reserve to reflect the decrease in the obsolete inventory value due to the liquidation of such products. There was no similar obsolete inventory liquidation during fiscal 2003, which resulted in a comparative reduction in our gross profit percentage 0.36% between fiscal 2003 and fiscal 2002.

For the twelve months ended September 30, 2003, the increase in the gross profit margin percentage of 0.22% relating to labor related and other costs was due to the percentage increase in sales of 19.07% for the twelve months ended September 30, 2003 over September 30, 2002 being in excess of the percentage increase in labor related and other costs of 15.92% for the twelve months ended September 30, 2003 over September 30,2002.

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

	12 Months Ended 9/30/03	12 Months Ended 9/30/02	Increase (Decrease)	Percentage of sales 2003	Percentage of sales 2002	Increase (Decrease)
Sales and Marketing	$ 7,145,730	$ 5,741,510	$ 1,404,220	14.02%	13.42%	0.61%
Technical Support	420,566	379,592	40,974	0.83%	0.89%	-0.06%
General and Administrative	3,329,815	2,947,943	381,872	6.53%	6.89%	-0.35%
Total	$ 10,896,111	$ 9,069,045	$ 1,827,066	21.38%	21.20%	0.19%

Selling, general and administrative expenses increased $1,827,066 from the prior year. As a percentage of sales, selling, general and administrative expenses increased by 0.19% when compared to the twelve months ended September 30, 2002.

The increase in sales and marketing expense of $1,404,220 which accounted for about 77% of the total increase in selling, general and administrative expenses, was mainly due to:
- Higher advertising costs of $872,896 due to higher sales based co-operative advertising, higher customer rebate realization and increased special promotions
- Higher advertising costs of $188,765 due to higher translated Euro to U.S dollar amounts due to the strengthening of the Euro against the USD
- Higher commissions expense of $86,779 due to increased sales
- Increased sales commission expense of $53,232 due to higher translated Euro to U.S dollar amounts due to the strengthening of the Euro against the USD
- Increased European sales office costs of $123,675
- Increased European sales office costs of $302,216 due to higher translated Euro to U.S dollar amounts due to the strengthening of the Euro against the USD
- Lower trade show costs of $236,061 due to smaller show presence and frequency

The increase in general and administrative expenses of $381,872 was primarily due to:
- Addition of senior executive officer $109,976
- Higher legal costs of $78,785
- Increased travel costs of $11,961
- Increased Directors fees of $46,581
- Increased banking fees of $65,047
- Increased consulting fees for investment advice and public relations $47,849

Research and development expenses increased $310,292 or approximately 19%. The increase was mainly due to higher compensation costs attributable to additional staff and increased material and contract services cost for product enhancements and new projects under development.

Other income (expense)

Net other income for the twelve months ended September 30 , 2003 was $49,881 compared to net other expense of ($58,535) for the twelve months ended September 30, 2002 as detailed below:

	12 Months Ended 9/30/03	12 Months Ended 9/30/02
Interest income	$ 15,858	$ 34,781
Foreign currency transaction gains (losses)	(17,913)	4,750
Non operational USD to Euro currency re-measurement	51,936	(98,066)
Total other income (expense)	$ 49,881	$ (58,535)

The decrease in total other expense was due to current year gains on non-operational USD-to-Euro currency re-measurements due to increases in the Euro offset by lower interest income due to lower investment yields.

Non Operational USD to Euro currency re-measurement

We follow the rules prescribed in paragraph 15 of SFAS 52 "Foreign Currency Translation", which states that accounts denominated in a currency other than an entity's functional currency need to be re-measured into the entity's functional currency, and any gain or loss from this re-measurement are included in the determination of net income. Re-measurement gains and losses on inter company accounts that are of a long term investment nature and for which settlement is not planned or anticipated in the foreseeable future are excluded in determining net income and are reported in the same manner as are translation gains and losses.

Since the functional currency of Hauppauge Digital Europe Sarl ("HDE Sarl") is the Euro, any asset, liability or equity accounts which are invested in or purchased using U.S. Dollars or Great British Pound by HDE Sarl are revalued into Euros at the end of each period. The gains or losses on HDE Sarl's books resulting from the revaluation of U.S. Dollar and Great British Pound accounts into Euros are booked on the Company's statement of operations in the other income (loss) section under the description " Non operational USD to Euro currency re-measurement." Re-measurement gains and losses on inter company accounts that are of a long term investment nature and for which settlement is not planned or anticipated in the foreseeable future are booked as a component of translation gains and losses on the balance sheet under the stockholders' equity section.

Primarily due to a decrease in U.S Dollar denominated inventory on HDE Sarl's books, HDE Sarl experienced a net asset decrease for the year ended September 30, 2003. The increase in the value of the Euro versus the U.S. Dollar coupled with the decrease in net assets resulted in a re-measurement gain of $51,936 for the year ended September 30, 2003.

Accumulated other comprehensive income (loss)

The Euro is the functional currency of the Company's European subsidiary, HDE Sarl. Assets and liabilities of this subsidiary are translated to U.S. Dollars at the exchange rate in effect at the end of each reporting period, while equity accounts are translated to U.S. Dollars at the historical rate in effect at the date of the contribution. Operating results are translated to U.S. Dollars at the average prevailing exchange rate for the period, with the exception of sales which are translated to U.S. Dollars at the average monthly forward exchange contract rate. The use of differing exchange rates results in foreign currency translation gains or losses. Since the Euro accounts on HDE Sarl's books result in a net asset position (total Euro assets are in excess of Euro liabilities), an increase in the Euro value results in a deferred gain for the translation of Euro accounts to U.S. Dollars. The Company had a translation loss of $3,845 recorded on the balance sheet as of September 30, 2002. For the year ended September 30, 2003, the Company recorded in other comprehensive income deferred translation gains $708,028, resulting in a translation gain of $704,183 recorded as a component of accumulated other comprehensive income as of September 30, 2003.

The Company uses forward exchange contracts to reduce our exposure to fluctuations in foreign currencies. Mark-to-market gains and losses on these open contracts result from the difference between the USD value of our open foreign currency forward contracts at the average contract rate as opposed to the same contracts translated at the month-end forward rate. The Company qualifies for cash flow hedge accounting as prescribed under FAS 133, which allows the Company to record the mark-to-market gains and losses in the equity section of our balance sheet under accumulated other comprehensive income. The Company had mark-to-market gains of $190,919 recorded on the balance sheet as of September 30, 2002. For the year ended September 30, 2003, the Company recorded, as a component of other comprehensive income, a mark-to-market loss of $425,510, resulting in a mark-to-market loss of $234,591 for contracts open as of September 30, 2003.

Results of operations continued
September 30, 2003 and 2002

As stated above, accumulated other comprehensive income (loss) consists of two components:
- Translation gains and losses
- FAS 133 mark-to-market gains and losses on our open foreign exchange contracts

The table below details the gains and losses recorded for the components that make up accumulated other comprehensive income (loss):

	Balance as of 9/31/02	10/02-12/02 Gains (Losses)	Balance as of 12/31/02	1/03-3/03 Gains (Losses)	Balance as of 3/31/03	4/03-6/03 Gains (Losses)	Balance as of 6/30/03	6/03-9/03 Gains (Losses)	Balance as of 9/30/03
Translation adjustments	$ (3,845)	$ 150,728	$ 146,883	$ 13,318	$ 160,201	$ 197,917	$ 358,118	$ 346,065	$ 704,183
FAS 133 mark to market adjustments	190,919	(518,974)	(328,055)	163,879	(164,176)	18,169	(146,007)	(88,584)	(234,591)
	$ 187,074	$ (368,246)	$ (181,172)	$ 177,197	$ (3,975)	$ 216,086	$ 212,111	$ 257,481	$ 469,592

Tax provision

Our net tax provision for the years ended September 30, 2003 and 2002 is as follows:

	12 Months Ended 9/30/03	12 Months Ended 9/30/02
Tax (benefit) attributable to U.S operations	$ (972,000)	$ (980,000)
Tax expense European operations	108,465	69,000
Adjustment of prior year estimated income taxes	198,425	-
Deferred tax asset valuation allowance	972,000	980,000
Net tax provision	$ 306,890	$ 69,000

Our Luxembourg operation had a profit net of licensing fees for fiscal 2003 and fiscal 2002, which resulted in an income tax liability inclusive of commission agents of $108,465 and $69,000, respectively.

For the last four fiscal years, our domestic operation has incurred losses. We analyzed the future realization of our deferred tax assets as of September 30, 2003 and 2002 and we concluded that under the present circumstances, it would be appropriate for us to record a valuation allowance against the increase in the deferred tax asset attributable to the loss incurred in fiscal 2003 from domestic operations.

During the fiscal year ended September 30,2003, the Company adjusted the prior year provision for estimated income tax receivable and income tax payable, based in part upon the completion of a tax examination. The net result was a charge of $198,425.

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 incurred a net loss of $814,032 for the year ended September 30, 2003, which resulted in basic and diluted net loss per share of $0.09 on weighted average basic and diluted shares of 8,867,309, compared to a net income of $347,522 for the year ended September 30, 2002, which resulted in basic and diluted net income per share of $0.04 on weighted average basic and diluted shares of 8,887,107 and 9,002,150, respectively.
Options to purchase 1,896,101 and 825,322 shares of Common Stock at prices ranging $1.05 to $ 10.06 and $2.07 and $10.06, respectively, were outstanding for the years ending September 30, 2003 and 2002, but were not included in the computation of diluted earnings per share because they were anti-dilutive.

Results of operations continued
September 30, 2002 and 2001

Results for the fiscal years ended September 30, 2002 and 2001 are detailed below:

	12 Months Ended 9/30/02	12 Months Ended 9/30/01	Variance $	Percentage of sales 2002	Percentage of sales 2001	Variance
Net sales	$ 42,796,726	$ 50,910,463	$ (8,113,737)	100.00%	100.00%	0.00%
Cost of sales	31,661,073	42,056,859	(10,395,786)	73.98%	82.61%	-8.63%
Gross margin	11,135,653	8,853,604	2,282,049	26.02%	17.39%	8.63%
Gross margin %	26.02%	17.39%	8.63%			
Costs:						
Sales & marketing	5,741,510	6,479,351	(737,841)	13.42%	12.73%	0.69%
Technical support	379,592	380,488	(896)	0.89%	0.75%	0.14%
General & administrative	2,947,943	3,422,635	(474,692)	6.89%	6.72%	0.17%
Total selling general and administrative costs	9,069,045	10,282,474	(1,213,429)	21.20%	20.20%	1.00%
Litigation settlement	-	212,500	(212,500)	0.00%	0.42%	-0.42%
Write of off goodwill	-	701,919	(701,919)	0.00%	1.37%	-1.37%
R&D	1,591,551	1,510,092	81,459	3.72%	2.97%	0.75%
Total costs	10,660,596	12,706,985	(2,046,389)	24.92%	24.96%	-0.04%
Net operating income (loss)	475,057	(3,853,381)	4,328,438	1.10%	-7.57%	8.67%
Other income (expense):						
Interest income	34,781	42,137	(7,356)	0.08%	0.08%	0.00%
Interest expense	-	(30,833)	30,833	0.00%	-0.06%	0.06%
Foreign currency	4,750	6,740	(1,990)	0.01%	0.01%	0.00%
Non operational USD to Euro re-measurement (loss)	(98,066)	(15,863)	(82,203)	-0.23%	-0.03%	-0.20%
Insurance proceeds	-	2,000,000	(2,000,000)	0.00%	3.93%	-3.93%
Total other income (expense)	(58,535)	2,002,181	(2,060,716)	-0.14%	3.93%	-4.07%
Income (loss) before taxes	416,522	(1,851,200)	2,267,722	0.96%	-3.64%	4.60%
Taxes on income	69,000	749,497	(680,497)	0.16%	1.47%	-1.31%
Income (loss) before cumulative effect of a change in accounting principle	347,522	(2,600,697)	2,948,219	0.80%	-5.11%	5.91%
Cumulative effect of change in accounting principle	-	319,000	(319,000)	0.00%	0.63%	-0.63%
Net income (loss)	$ 347,522	$ (2,281,697)	$ 2,629,219	0.80%	-4.48%	5.28%

Results of operations continued
September 30, 2002 and 2001

Net sales for the years ended September 30, 2002 decreased $8,113,737 when compared to the prior year. Sales declined in all geographic locations as follows:

Location:	12 Months Ended 9/30/02	12 Months Ended 9/30/01	Increase (Decrease) Dollar Variance	Increase (Decrease) Variance %	Percentage of sales by Geographic region 2002	2001
Domestic	$ 11,508,358	$ 11,888,839	$ (380,481)	(3%)	27%	23%
Europe	30,365,681	35,624,555	(5,258,874)	(15%)	71%	70%
Asia	922,687	3,397,069	(2,474,382)	(73%)	2%	7%
Total	$ 42,796,726	$ 50,910,463	$ (8,113,737)	(16%)	100%	100%

The primary forces causing the net sales decrease were:
- Sluggish economic conditions
- Reduction in analog board sales
- Lower OEM sales activity
- Lower Asian sales

Net sales to domestic customers were 27% of net sales for the year ended September 30, 2002 compared to 23% for the year ended September 30, 2001. Net sales to European customers were 71% of net sales compared to 70% for the same period of the prior year. Net sales to Asian customers were 2% compared to 7% for the same period the prior year.

Gross profit increased $2,282,049 for the year ended September 30, 2002. Gross profit percentage for the year ended September 30, 2002 was 26.02% compared to 17.39% for the same period in the prior year.

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

	Increase (decrease)
Due to lower sales	$ (2,352,411)
Due to higher margins on assembled boards	2,116,392
Due to decreases in labor related and other costs	655,302
Due to inventory obsolescence reserve booked during the fourth quarter of fiscal 2001	1,862,766
Total increase in margins	$ 2,282,049

The increase in gross profit percentage of 8.63% for the twelve months ended September 30, 2002 compared to the prior year is as follows:

	Increase (decrease)
Increase in margin on assembled boards	4.95%
Labor related and other costs as a larger percent of sales	0.03%
Due to inventory obsolescence reserve booked during the fourth quarter of fiscal 2001	3.65%
Net increase	8.63%

The improved gross profit percentage on assembled boards was primarily a result of unit price reductions from our suppliers and subcontractors coupled with a larger sales mix of higher gross margin product. The increase in the gross profit percentage of 0.03% due to labor related and other costs was due to the decrease in labor related and other costs of 16.20% being in excess of the sales decrease of 15.94%.

During the fourth quarter of fiscal 2001, in recognition of the sales decline from fiscal 2000, slower sales of older product lines and engineering changes to products, we reviewed the net realizable value of our inventory as of September 30, 2001. We deemed it necessary to increase our reserve for obsolete and slow moving inventory. An additional reserve of $1,862,766 was recorded during the fourth quarter of fiscal 2001 and charged to cost of sales. A similar provision was not required in fiscal 2002, thus there was an improvement in gross profit percentage of 3.65% for fiscal 2002.

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

	12 Months Ended 9/30/02	12 Months Ended 9/30/01	Increase (Decrease) Dollar Variance	Increase (Decrease) Variance %	Percentage of sales by Geographic region 2002	2001
Sales and Promotional	$ 5,741,510	$ 6,479,351	$ (737,841)	0.69%	13.42%	12.73%
Customer Support	379,592	380,488	(896)	0.14%	0.89%	0.75%
General and Administrative	2,947,943	3,422,635	(474,692)	0.17%	6.89%	6.72%
Total	$ 9,069,045	$ 10,282,474	$ (1,213,429)	1.00%	21.20%	20.20%

Selling, general and administrative expenses decreased $1,213,429 from the prior fiscal year. As a percentage of sales, selling, general and administrative expenses for the year ended September 30, 2002 increased by 1.00% when compared to the year ended September 30, 2001.

The decrease in sales and promotional expense of $737,841 was mainly due to:
- Lower advertising costs of $502,057 due to lower co-operative advertising and reduced special promotions
- Lower trade show costs of $146,052 due to smaller size and frequency of trade show attendance
- Lower commission payments of $31,355 due to lower sales
- Decreased compensation costs of $70,295 due to personnel reductions for sales and marketing personnel

The decrease in general and administrative expenses of $474,692 was primarily due to:
- A decrease in compensation costs of $188,572 due to personnel reductions for administrative personnel
- Lower legal costs of $80,553 due to less litigation activity during fiscal 2002
- Decreased amortization costs of $81,637 mainly due to the write off of goodwill during the fourth quarter of fiscal 2001
- Lower rent costs of $48,301 and lower communication costs of $32,211 due to the consolidation of the Eskape™ Labs office in California into our California office

Research and development expenses increased $81,459, or approximately 3.7%. The increase was mainly due to higher compensation and increased material and contract services cost.

Litigation settlement

During the third quarter of fiscal 2001, we paid $212,500 to settle a claim pursuant to a copyright infringement dispute.

Write off of goodwill

During fiscal 2000, we acquired certain assets of Eskape™ Labs, Inc. This acquisition was accounted for using the purchase method. The fair value of the consideration paid exceeded the fair value of the assets acquired and goodwill of approximately $810,000 was recorded.

Due to changing conditions during fiscal 2001, the following events and circumstances indicated to us that our goodwill asset had been impaired and was not likely to be recovered:
- Eskape™ Labs was not profitable during fiscal 2001 and did not contribute, nor is expected to contribute, any positive cash flow stream
- Eskape™ Labs did not fulfill its internal sales forecast for fiscal 2001
- The asset value was greater than the estimated future cash flows
- At the time of the acquisition, we hired approximately 10 of the Eskape™ Labs employees, including three from senior management. Only four employees remain
- Certain Eskape™ Labs products have been deemed by management as slow moving products

In recognition of the above events, we recognized an impairment loss during the fourth quarter of fiscal 2001 for the entire remaining goodwill balance of $701,919. The loss was recorded as a component of other income (loss) from operations.

Results of operations continued
September 30, 2002 and 2001

Other income (expense)

Net other expense for the year ended September 30, 2002 was $58,535 compared to net other income of $2,002,181 for the year ended September 30, 2001 as detailed below:

	12 Months Ended 9/30/02	12 Months Ended 9/30/01
Interest income	$ 34,781	$ 42,137
Interest expense	-	(30,833)
Foreign currency transaction gains (losses)	4,750	6,740
Non operational USD to Euro currency re-measurement	(98,066)	(15,863)
Life insurance proceeds	-	2,000,000
Total other income (expense)	$ (58,535)	$ 2,002,181

The decrease in total other income (expense) was due to the receipt of insurance proceeds during fiscal 2001 pursuant to a key man life insurance on the Company's deceased former President and losses in fiscal 2002 resulting from the "Non-operational USD to Euro currency re-measurements" offset by lower interest expense during fiscal 2002.

"Non-operational USD to Euro currency re-measurement" results from the revaluing from U.S. dollars to Euros any U.S. dollar denominated assets and liabilities on the books of our Luxembourg based subsidiary, Hauppauge Digital Europe S.à.r.l.. Since the functional currency of Hauppauge Digital Europe S.à.r.l. is the Euro, any asset, liability or equity accounts which are invested in or purchased using U.S. dollars by Hauppauge Digital Europe S.à.r.l. need to be revalued into Euros at the end of each reporting period. This revaluation of U.S. dollar denominated accounts into Euros results in a non-transactional re-measurement gain or loss, which we have classified as " Non-operational USD to Euro currency re-measurement."

Tax provision (benefit)

Our net tax provision for the year ended September 30, 2002 and 2001 is as follows:

	12 Months Ended 9/30/02	12 Months Ended 9/30/01
Tax (benefit) attributable to U.S operations	$ (980,000)	$ (501,000)
Tax expense Asian operations	-	44,200
Tax expense European operations	69,000	123,500
Deferred tax asset valuation allowance	980,000	1,082,797
Net tax provision	$ 69,000	$ 749,497

Effective October 1, 1999, we restructured our foreign operations. The result of the restructuring eliminated the foreign sales corporation and established a new Luxembourg corporation, which functions as the entity which services our European customers. The new structure created separate domestic and foreign tax entities, with the Luxembourg entity paying a license fee to our domestic operation for use of the Hauppauge name. For the last three fiscal years, our domestic operation has incurred losses. We analyzed the future realization of our deferred tax assets as of September 30, 2002 and we concluded that, under the present circumstances, it would be appropriate for us to record a valuation allowance against the increase in the deferred tax asset attributable to the loss incurred in 2002 from domestic operations.

Accumulated other comprehensive income (loss)

As of September 30, 2002, appearing in the equity section under " Accumulated other comprehensive income (loss)" was a deferred gain of $187,074. Translation gains and losses, which are the result of translating Euros to USD at the month end exchange rate for current assets and liabilities, at historical rates for fixed assets and paid in capital, and at average exchange rates for revenue and expense items, resulted in a deferred loss of $3,845 as of September 30, 2002.

Mark-to-market gains and losses result from the difference between the USD value of our open foreign currency forward contracts at the average contract rate as opposed to the same contracts translated at the month-end spot rate. Prior to July 1, 2002, the Company did not qualify for cash flow hedge accounting under FAS 133, therefore material gains or losses were recorded through operations. As a result of our qualification for cash flow hedge accounting, effective July 1, 2002, gains aggregating to $190,919 on these contracts are shown in the equity section under "Accumulated other comprehensive income."

The components of other comprehensive income (loss) as of September 30, 2002 are shown below:

	As of 9/30/01	Fiscal 2002 Other comprehensive income (loss)	As of 9/30/02
Translation gains (loss) on HDE S.à.r.l Euro accounts translated to USD	$ (218,987)	$ 215,142	$ (3,845)
Mark to market gains (loss) per FAS 133 on open foreign currency contracts	(48,217)	239,136	190,919
Other comprehensive income	$ (267,204)	$ 454,278	$ 187,074

The adoption of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities", on October 1, 2000 resulted in a $319,000 net gain, due to the cumulative effect of a change in accounting principle.

As a result of all of the above mentioned MD&A items, we recorded net income of $347,522 for the year ended September 30, 2002, which resulted in basic and diluted net income per share of $0.04 on weighted average basic and diluted shares of 8,887,107 and 9,002,150, respectively, compared to a net loss of $2,281,697 for year ended September 30, 2001, which resulted in basic and diluted net loss per share of $0.26 on weighted average basic and diluted shares of 8,910,117. Options to purchase 825,322 and 1,827,326 shares of Common Stock at prices ranging from $2.07 to $ 10.06 and from $1.05 to $10.06, were outstanding for the twelve month period ending September 30, 2002 and 2001, respectively, but were not included in the computation of diluted net income or net loss per share because they were anti-dilutive.

Seasonality

As our sales are primarily to the consumer market, we have experienced certain seasonal revenue trends. Our peak sales quarter, due to holiday season sales of computer equipment, is our first fiscal quarter (October to December), followed by our second fiscal quarter (January to March). In addition, our international sales, mostly in the European market, were 68%, 73% and 77% of sales for the years ended September 30, 2003, 2002 and 2001, respectively. Our fiscal fourth quarter sales (July to September) can be potentially impacted by the reduction of activity experienced in Europe during the July and August summer holiday period.

To offset the above cycles, we target a wide range of customer types in order to moderate the seasonality of retail sales.

Liquidity and Capital Resources

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

	As of 9/30/2003	As of 9/30/2002	As of 9/30/2001
Cash	$ 5,838,160	$ 4,964,522	$ 4,422,239
Working Capital	10,859,953	11,276,942	10,258,143
Stockholders' Equity	11,468,685	11,966,612	11,185,618

We had cash and cash equivalents as of September 30, 2003 of $5,838,160, an increase of $873,638 over September 30, 2002.

The increase was due to:

Sources of cash:	
Proceeds from employee stock purchase plan	$ 31,227
Decrease in income taxes receivable	326,000
Decrease in inventories	2,617,121
Increase in accounts payable and other current liabilities	2,302,120
Less cash used for:	
Net loss adjusted for non cash items	(498,846)
Increase in accounts receivable	(3,542,502)
Increase in prepaid expenses and other current assets	(129,594)
Purchases of fixed assets	(196,246)
Purchase of treasury stock	(35,642)
Net cash increase	$ 873,638

Net cash of $1,074,299 provided by operating activities was primarily due to a reduction in inventories and income taxes receivable of $2,617,121 and $326,000, respectively, plus an increase in accounts payable and other liabilities of 2,302,120, offset by the net loss adjusted for non cash items of $498,846, an increase in accounts receivable of $3,542,502 and increases in prepaid assets and other current assets of $129,594. The decrease in inventories was due to an inventory reduction program instituted by the Company in response to sluggish economic conditions. The increase in accounts receivable was the result of an increase in sales for the three months ended September 30, 2003 over the three months ended September 30, 2002 in addition to a larger volume of component parts that our contract manufacturer purchased from us during September 30, 2003, due to an increase in our September and October 2003 production volume when compared to the same period of the prior year.

Cash of $196,246 and $35,642 was used to purchase fixed assets and purchase treasury stock. Proceeds from the stock purchased by employees through the employee stock purchase plan provided additional cash of $31,227. Since the Company's production is handled by third party contract manufacturers, our future anticipated capital expenditures are not material.

Our bank facility with JP Morgan Chase expired in April 2002. It is the intention of the Company, to procure a new credit facility on terms acceptable to the Company, however, there can be no assurance that we will secure a replacement line of credit at competitive terms, or secure a credit line at all.

On November 8, 1996, we approved a stock repurchase program. The program, as amended, authorizes the Company to repurchase up to 850,000 shares of our own stock. We intend to use the repurchased shares for certain employee benefit programs. On December 17, 1997, the stock repurchase program was extended by a resolution of our Board of Directors. As of September 30, 2003, we held 542,067 treasury shares purchased for $1,497,216 at an average purchase price of approximately $2.76 per share.

We believe that our cash and cash equivalents as of September 30, 2003 and our internally generated cash flow will provide us with sufficient liquidity to meet our currently foreseeable short-term and long-term capital needs.

Future Contractual Obligations

The following table shows the Company's contractual obligations related to lease obligations as of September 30, 2003:

		Payments due by period	
Contractual obligations	**Total**	**1 year**	**1-3 years**
Operating lease obligations	$ 1,592,748	$ 679,272	$ 913,476

Critical Accounting Policies and Estimates

Financial Reporting Release No. 60, which was recently released by the Securities and Exchange Commission, requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements.

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

- Revenue Recognition
- Management's estimates
- Hedging program for sales denominated in a foreign currency
- Translation of assets and liabilities denominated in non-functional currencies on our European financial statements

Revenue Recognition

Our revenues are primarily derived from the sale of computer boards which enable you to view television programs on your personal computer. Sales of computer boards are commonly classified as computer hardware. Our sales are primarily to retailers, distributors and original equipment manufacturers. Sales to our customers are documented by a purchase order which describes the conditions of sale. Sales are recorded when products are shipped to our customers, the product price is fixed and determinable, collection of the resulting receivable is probable and product returns are reasonably estimable. Revenue from freight charged to customers is recognized when products are shipped. Provisions for customer returns and other adjustments are provided for in the period the related sales are recorded based upon historical data.

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.

Hedging program for sales denominated in a foreign currency

Our European subsidiary accounts for approximately 67% and 71%of our net sales for fiscal 2003 and fiscal 2002. All of our European sales are denominated in local currencies, primarily the Euro and Great British Pound. As a result of this, we are a net receiver of currencies other than the U.S dollar. Changes in the exchange rate subject us to market risks resulting from the fluctuation of the Euro and Great British Pound to the U.S. dollar. In an attempt to minimize these risks, we enter into forward exchange contracts with financial institutions.

We do not enter into contracts for speculative purposes. We enter into monthly window contracts covering an average period of six months based on existing or anticipated future purchases. Although we enter into these contracts to reduce the short term impact of currency rate changes, the following risks are still inherent in hedging the Euro sales:

- Actual sales may fluctuate from our estimates, resulting in contracts in excess of collections
- Short term volatility of currency markets has the potential to reduce the effectiveness of our hedging program
- Historical volatility of the Euro has the potential to impact our revenues, gross margins and operating income
- The magnitude of the success of our hedging program is dependent upon movements in the Euro exchange rates. These movements are difficult to predict over an extended period of time

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, 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 "Non-operational USD to Euro currency re-measurement".

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.

Inflation

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

Euro

On January 1, 1999, the Euro was adopted in Europe as the common legal currency among 11 of the 15 member countries of the European Community. On that date, the participating countries established fixed Euro conversion rates (i.e. the conversion exchange rate between their existing currencies and the Euro). The Euro now trades on currency exchanges and is available for non-cash transactions. A new European Central Bank was established to direct monetary policy for the participating countries.

Prior to the adoption of the Euro, we billed our European customers in German Marks or Great British Pound, depending upon which currency the customer preferred to be billed in. Effective January 1, 1999, we began invoicing our customers, who are located in the eleven member countries, in Euros. We continue to bill customers located in the United Kingdom in Great British Pound. The benefits to billing customers in Euros were twofold:

- Our foreign currency hedging program was streamlined to the Euro and the Great British Pound
- The pricing from country to country was harmonized, eliminating price differences between countries due to the fluctuating local currencies

We handled the conversion to the Euro without any material disruptions to our operations.

Derivatives and Hedging Activities

Due to extensive sales to European customers with payment made to us in those local currencies (primarily the Euro and Great British Pound) and limited expenses paid in local currencies, we are a net receiver of currencies other than the U.S. Dollar. As such, we benefit from a weak Dollar and are negatively affected by a strong Dollar relative to the major worldwide currencies, especially the Euro and Great British Pound. Consequently, changes in exchange rates expose us to market risks resulting from the fluctuations in the foreign currency exchange rates to the U.S. Dollar. We attempt to reduce these risks by entering into foreign exchange forward contracts with financial institutions to protect against currency exchange risks associated with our foreign denominated sales.

Although we do not try to hedge against all possible foreign currency exposures because we can not fully estimate the size of our exposure, the contracts we procure are specifically entered into to as a hedge against existing or anticipated foreign currency exposure. We do not enter into contracts for speculative purposes. Although we maintain these programs to reduce the short term impact of changes in currency exchange rates, when the U.S. Dollar sustains a long term strengthening position against the foreign currencies in countries where we sell our products, our revenues, gross margins, operating income and retained earnings can be adversely affected. Factors that could impact the effectiveness of our hedging program include the volatility of the currency markets and the availability of hedging instruments.

The strength or weakness of the U.S. Dollar against the Euro and Great British Pound impacts our financial results. Changes in exchange rates may positively or negatively affect our revenues, gross margins, operating income and retained earnings (which are all expressed in U.S. Dollars). We use derivatives to reduce our exposure to fluctuations in foreign currencies. Foreign currency forward contracts are used to hedge the foreign currency market exposures underlying forecasted sales transactions with customers. As of September 30, 2003, we had foreign currency contracts outstanding of approximately $3,560,000 against the delivery of the Euro. The contracts expire through December 2003. Our accounting policies for these instruments are based on the designation of such instruments as cash flow hedging transactions. We do not enter into such contracts for speculative purposes. We record all derivative gains and losses on the balance sheet as a component of stockholders' equity under the caption "Accumulated other comprehensive income (loss)". As of September 30, 2003 and 2002, a deferred loss of $234,591 and a deferred gain of $190,919, reflecting the net mark-to-market losses and gains of our derivatives, was recorded as a component of accumulated other comprehensive income on our balance sheet.

For the year ended September 30, 2003, we recorded a decrease in sales of $1,895,200 related to our contracts that closed during this period and the changes in the fair value of our derivative contracts. For the twelve months ended September 30, 2002, we recorded an decrease in sales of $408,000 related to our contracts that closed during this period and the changes in the fair value of our derivative contracts.

Recent Accounting Pronouncements

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" (" SFAS 150"). SFAS 150 establishes standards for how an issuer classifies and measures three classes of freestanding financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability. SFAS 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company has not entered into any financial instruments within the scope of SFAS 150 since May 31, 2003, nor does it currently hold any significant financial instruments within its scope.

In January 2003, the FASB issued Interpretation No.46, Consolidation of Variable Interest Entities. Interpretation No. 46 requires companies with a variable interest in a variable interest entity to apply this guidance as of the beginning of the first reporting period ending after December 15, 2003. The application of the guidance could result in the consolidation of a variable interest entity. The only potential variable interest entity with which the Company is associated is the real estate partnership owned by certain of the Company's principal shareholders, as disclosed in Note 9 of the notice to "Consolidated Financial Statements". The Company is evaluating whether the partnership is a variable interest entity, whether the Company is the primary beneficiary and, if so, the impact of this interpretation on its financial position and results of operations.

With respect to Interpretation No. 46, the Company rents its principal office and warehouse space in Hauppauge, New York from a real estate partnership owned by certain of the Company's principal stockholders. The lease term expires on January 31, 2006 and includes an option to extend for three additional years. The lease provides for rent increases of 5% per year. Rent is currently at the annual rate of $431,454 and will increase to $453,027 annually as of February 1, 2004. On December 17, 1995 in connection with a re-negotiation of the lease term, the Company granted options to purchase 120,000 shares to a real estate partnership partially owned by the principal stockholder at an exercise price of $1.905 per share, which are exercisable through the lease term. The market price of the option equaled the exercise price at the date of the grant. The effect of imputing the fair value of the options granted was immaterial. The options were still outstanding as of September 30, 2003.

The Company had amounts payable to this related party for unpaid rent of $302,128 as of September 30, 2003 and 2002.

The indebtedness partially incurred by the principal stockholder to purchase the building is also guaranteed by the Company and totaled $745,567 at September 30, 2003.

Market Risks

Due to extensive sales to European customers with payment made to us in those local currencies (primarily the Euro and Great British Pound) and limited expenses paid in local currencies, we are a net receiver of currencies other than the U.S. dollar. As such, we benefit from a weak dollar and are negatively affected by a strong dollar relative to the major worldwide currencies, especially the Euro and Great British Pound. Consequently, changes in exchange rates expose us to market risks resulting from the fluctuations in the foreign currency exchange rates to the U.S. dollar. We attempt to reduce these risks by entering into foreign exchange forward contracts with financial institutions to protect against currency exchange risks associated with our foreign denominated sales.

The strength or weakness of the U.S. dollar against the Euro and Great British Pound impacts our financial results. Changes in exchange rates may positively or negatively affect our revenues, gross margins, operating income and retained earnings (which are all expressed in U.S. dollars). We engage in hedging programs aimed at limiting, in part, the impact of currency fluctuations. By selling foreign currency futures, we fix the rate of exchange at the time we enter into the contract. We deliver these currencies to the financial institutions at a later date when we actually receive the foreign currency. For the years ended September 30, 2003 and 2002, respectively, we recorded approximately $1,895,200 and $408,000 as a decrease to net sales related to the changes in the fair value of our derivative contracts.

Although we do not try to hedge against all possible foreign currency exposures because we can not fully estimate the size of our exposure, the contracts we procure are specifically entered into to as a hedge against existing or anticipated exposure. We do not enter into contracts for speculative purposes. Although we maintain these programs to reduce the short term impact of changes in currency exchange rates, when the U.S. dollar sustains a long term strengthening position against the foreign currencies in countries where we sell our products, our revenues, gross margins, operating income and retained earnings can be adversely affected. Factors that could impact the effectiveness of our hedging program include volatility of the currency markets and availability of hedging instruments.

market for common equity and related stockholder matters

(a) The principal market on which our common stock (the "Common Stock") is traded is the over-the- counter market. The Common Stock is quoted on the NASDAQ National Market and its symbol is HAUP. The table below sets forth the high and low bid prices of our Common Stock as furnished by NASDAQ for the periods indicated. Quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

Fiscal Year Ended September 30, 2003	High	Low
First Quarter	1.41	0.95
Second Quarter	1.67	1.28
Third Quarter	3.74	1.38
Fourth	3.10	2.34
Fiscal Year Ended September 30, 2002	**High**	**Low**
First Quarter	3.02	1.05
Second Quarter	2.40	1.59
Third Quarter	2.29	1.75
Fourth Quarter	2.04	1.24

(b) We have been advised by our transfer agent, North American Transfer Co. that the approximate number of holders of record of our Common Stock as of December 8, 2003 was 180. We believe there are in excess of 7,100 beneficial holders of our Common Stock.

(c) No cash dividends have been paid during the past two years. 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.

Consolidated Statement of Operations Data
(in thousands, except for per share amounts)

	Years ended September 30,				
	2003	**2002**	**2001**	**2000**	**1999**
Net Sales	$ 50,956	$ 42,797	$ 50,910	$ 66,292	$ 58,602
Cost of sales	38,715	31,661	42,056	54,425	43,027
Gross Profit	12,241	11,136	8,854	11,867	15,575
Selling , general and administrative expenses	10,896	9,069	10,282	12,231	9,865
Research & development expenses	1,902	1,592	1,510	1,666	1,257
Write off of goodwill	-	-	702	-	-
Litigation settlement	-	-	213	-	-
Income (loss) from operations	(557)	475	(3,853)	(2,030)	4,453
Other Income (Expense):					
Interest income	16	35	42	104	201
Interest expense	-	-	(31)	(15)	-
Life insurance proceeds	-	-	2,000	-	-
Foreign currency	(18)	5	7	(243)	(61)
Non operational USD to Euro re-measurement gain (loss)	52	(98)	(16)		
Other, net	-	-	-	1	-
Income (loss) before taxes	(507)	417	(1,851)	(2,183)	4,593
Income tax (benefit) provision	307	69	750	(1,184)	1,475
Income (loss) before cumulative effect of a change in accounting principle	(814)	348	(2,601)	(999)	3,118
Cumulative effect of a change in accounting principle	-	-	319	-	-
Net income (loss)	$ (814)	$ 348	$ (2,282)	$ (999)	$ 3,118
Per share results-basic:					
Income (loss) before cumulative effect of a change in accounting principle	$ (0.09)	$ 0.04	$ (0.29)	$ (0.11)	$ 0.36*
Cumulative effect of a change in accounting principle	$ -	$ -	$ 0.03	$ -	$ -
Net income (loss) per share-basic	$ (0.09)	$ 0.04	$ (0.26)	$ (0.11)	$ 0.36*
Per share results-diluted:					
Income (loss) before cumulative effect of a change in accounting principle	$ (0.09)	$ 0.04	$ (0.29)	$ (0.11)	$ 0.33*
Cumulative effect of a change in accounting principle	$ -	$ -	$ 0.03	$ -	$ -
Net income (loss) per share-diluted	$ (0.09)	$ 0.04	$ (0.26)	$ (0.11)	$ 0.33*
Weighted average shares outstanding:					
Basic	8,867	8,887	8,910	8,837	8,632*
Diluted	8,867	9,002	8,910	8,837	9,480*
Consolidated Balance Sheet Data (at period end):					
Working capital	$ 10,860	$ 11,266	$ 10,258	$ 11,767	$ 12,533
Total assets	21,650	19,846	18,784	26,316	27,728
Stockholders' equity	11,468	11,967	11,186	13,654	13,322

*Period restated to reflect 2 for 1 stock split

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Accountants and Consultants

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Report of Independent Certified Public Accountants

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, 2003 and 2002 and the related consolidated statements of operations, other comprehensive income (loss), stockholders' equity and cash flows for each of the three years in the period ended September 30, 2003. These financial statements are the responsibility of the management of Hauppauge Digital, Inc. and Subsidiaries. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Hauppauge Digital, Inc. and Subsidiaries as of September 30, 2003 and 2002 and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2003 in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

BDO Seidman, LLP
Melville, New York
December 4, 2003

Hauppauge Digital, Inc. and Subsidiaries

Assets

	September 30, 2003	September 30, 2002
Current Assets:		
Cash and cash equivalents	$ 5,838,160	$ 4,964,522
Accounts receivable, net of various allowances	9,182,758	5,683,738
Inventories	5,474,374	8,091,495
Prepaid expenses and other current assets	546,328	416,734
Total current assets	21,041,620	19,156,489
Property, plant and equipment, net	532,516	611,054
Security deposits and other non current assets	76,216	78,616
	$ 21,650,352	$ 19,846,159

Liabilities and stockholders' equity

	September 30, 2003	September 30, 2002
Current Liabilities:		
Accounts payable	$ 7,452,867	$ 6,105,588
Accrued expenses	2,539,678	1,442,475
Income taxes payable	189,122	331,484
Total current liabilities	10,181,667	7,879,547
Stockholders' Equity		
Common stock $.01 par value; 25,000,000 shares authorized, 9,420,315 and 9,392,164 issued, respectively	94,203	93,923
Additional paid-in capital	12,302,119	12,233,170
Retained earnings	99,987	914,019
Accumulated other comprehensive income	469,592	187,074
Treasury Stock, at cost, 542,067 and 517,317 shares, respectively	(1,497,216)	(1,461,574)
Total stockholders' equity	11,468,685	11,966,612
	$ 21,650,352	$ 19,846,159

See accompanying notes to consolidated financial statements

consolodated statement of operations

Hauppauge Digital, Inc. and Subsidiaries

	Years ended September 30,		
	2003	**2002**	**2001**
Net sales	$ 50,956,034	$ 42,796,726	$ 50,910,463
Cost of sales	38,715,103	31,661,073	42,056,859
Gross Profit	12,240,931	11,135,653	8,853,604
Selling, general and administrative expenses	10,896,111	9,069,045	10,282,474
Research & development expenses	1,901,843	1,591,551	1,510,092
Write off of goodwill	-	-	701,919
Litigation settlement	-	-	212,500
Income from operations (loss)	(557,023)	475,057	(3,853,381)
Other Income (expense):			
Interest income	15,858	34,781	42,137
Interest expense	-	-	(30,833)
Life insurance proceeds	-	-	2,000,000
Foreign currency	(17,913)	4,750	6,740
Non operational USD to Euro currency re-measurement	51,936	(98,066)	(15,863)
Total other (expense) income	49,881	(58,535)	2,002,181
Income before taxes on income (loss)	(507,142)	416,522	(1,851,200)
Income tax provision	306,890	69,000	749,497
(Loss) income before cumulative effect of a change in accounting principle	(814,032)	347,522	(2,600,697)
Cumulative effect of a change in accounting principle	-	-	319,000
Net (loss) income	($ 814,032)	$ 347,522	($ 2,281,697)
Net Income per share-basic and diluted:			
Income (loss) before cumulative effect of a change in accounting principle	($ 0.09)	$ 0.04	($ 0.29)
Cumulative effect of a change in accounting principle	-	-	$ 0.03
Net income (loss) per share-basic and diluted	($ 0.09)	$ 0.04	($ 0.26)

See accompanying notes to consolidated financial statements

consolodated statements of other comprehensive income (loss)

Hauppauge Digital, Inc. and Subsidiaries

	Years ended September 30,		
	2003	**2002**	**2001**
Other comprehensive income (loss):			
Net (loss) income	$ (814,032)	$ 347,522	$ (2,281,697)
Forward exchange contracts marked to market	(425,510)	190,919	-
Foreign currency translation gain (loss)	708,028	263,359	(267,204)
Other comprehensive (loss) income	$ (531,514)	$ 801,800	$ (2,548,901)

See accompanying notes to consolidated financial statements

Hauppauge Digital, Inc. and Subsidiaries

For the years ended September 30, 2003, 2002 and 2001

	Common Stock				Accumulated		
	Number of Shares	Amount	Additional Paid-in Capital	Retained Earnings	Other Comprehensive Income (loss)	Treasury Stock	Total
BALANCE AT SEPTEMBER 30, 2000	9,312,578	$ 93,126	$ 12,046,421	$ 2,848,194	-	$ (1,334,064)	$ 13,653,677
Net (loss) for the year ended September 30, 2001	-	-	-	(2,281,697)	-	-	(2,281,697)
Purchase of treasury stock	-	-	-	-	-	(37,498)	(37,498)
Exercise of Stock Options	11,000	110	15,712	-	-	-	15,822
Foreign currency translation loss and change in fair value of forward contracts	-	-	-	-	(267,204)	-	(267,204)
Compensation in options for consulting services	-	-	38,004	-	-	-	38,004
Stock issued to pay bonuses	800	8	1,755	-	-	-	1,763
Stock issued through Employee Stock Purchase plan	39,981	400	62,351	-	-	-	62,751
BALANCE AT SEPTEMBER 30, 2001	9,364,359	$ 93,644	$ 12,164,243	$ 566,497	$ (267,204)	$ (1,371,562)	$ 11,185,618
Net income for the year ended September 30, 2002	-	-	-	347,522	-	-	347,522
Purchase of treasury stock	-	-	-	-	-	(90,012)	(90,012)
Foreign currency translation gain and change in fair value of forward contracts	-	-	-	-	454,278	-	454,278
Compensation in options for consulting services	-	-	38,000	-	-	-	38,000
Stock issued through Employee Stock Purchase plan	27,805	279	30,927	-	-	-	31,206
BALANCE AT SEPTEMBER 30, 2002	9,392,164	$ 93,923	$12,233,170	$ 914,019	$ 187,074	$ (1,461,574)	$ 11,966,612
Net (loss) for the year ended September 30, 2003	-	-	-	(814,032)	-	-	(814,032)
Purchase of treasury stock	-	-	-	-	-	(35,642)	(35,642)
Exercise of Stock Options	3,000	30	3,445	-	-	-	3,475
Foreign currency translation gain and change in fair value of forward contracts	-	-	-	-	282,518	-	282,518
Compensation in options for consulting services	-	-	38,002	-	-	-	38,002
Stock issued through Employee Stock Purchase plan	25,151	250	27,502	-	-	-	27,752
BALANCE AT SEPTEMBER 30, 2003	9,420,315	$ 94,203	$ 12,302,119	$ 99,987	$ 469,592	$(1,497,216)	$ 11,468,685

See accompanying notes to consolidated financial statements

Hauppauge Digital, Inc. and Subsidiaries

	Years ended September 30,		
	2003	2002	2001
Cash Flows From Operating Activities:			
Net (loss) income	$ (814,032)	$ 347,522	$ (2,281,697)
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depreciation and amortization	274,784	318,801	400,438
Goodwill write-down	-	-	701,919
Provision for uncollectible accounts receivable	-	20,000	10,000
Provision for inventory reserve	-	(386,409)	1,862,776
Deferred tax expense	-	-	1,082,797
Other non cash items	40,402	44,212	39,768
Changes in current assets and liabilities:			
Accounts receivable	(3,542,502)	(504,866)	1,652,195
Income taxes receivable	326,000	-	995,045
Inventories	2,617,121	466,481	2,255,632
Prepaid expenses and other current assets	(129,594)	101,531	(61,834)
Accounts payable	1,347,279	372,617	(4,748,743)
Accrued expenses and income taxes	954,841	(91,592)	871,068
Total adjustments	1,888,331	340,775	5,061,061
Net cash provided by operating activities	1,074,299	688,297	2,779,364
Cash Flows From Investing Activities:			
Purchases of property, plant and equipment	(196,246)	(87,208)	(143,055)
Net cash used in investing activities	(196,246)	(87,208)	(143,055)
Cash Flows From Financing Activities:			
Loan repayments	-	-	(1,000,000)
Proceeds from employee stock purchases	31,227	31,206	78,573
Purchase of treasury stock	(35,642)	(90,012)	(37,498)
Net cash (used in) financing activities	(4,415)	(58,806)	(958,925)
Net increase in cash and cash equivalents	873,638	542,283	1,677,384
Cash and cash equivalents, beginning of year	4,964,522	4,422,239	2,744,855
Cash and cash equivalents, end of year	$ 5,838,160	$ 4,964,522	$ 4,422,239
Supplemental disclosures:			
Interest paid	$ -	$ -	$ 24,546
Income taxes paid	$ 40,262	$ 31,948	$ 4,506

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. and its wholly-owned subsidiaries, Hauppauge Computer Works, Inc., HCW Distributing Corp., Eskape Acquisition Corporation and Hauppauge Digital Europe S.à.r.l. and its wholly-owned subsidiaries, Hauppauge Digital Asia Pte Ltd, Hauppauge Computer Works, GmbH, Hauppauge Computer Works, Ltd., and Hauppauge Computer Works S.à.r.l. All inter-company accounts and transactions have been eliminated.

Nature of Business

We engineer, develop, subcontract for manufacture, market and sell products for the personal computer ("PC") market and the Apple® Macintosh® market. We also offer products for the home entertainment market.

We have two primary product categories: analog TV products and digital TV products.

We offer several types of analog products. Our WinTV® analog TV receivers allow PC users to watch television on their PC screen in a resizable window, and also enable recording of TV shows to a hard disk. Our WinTV®-PVR TV personal video recorder products include hardware MPEG encoders, which improve the performance of TV recording and add instant replay and program pause functions, plus also enable the 'burning' of TV recordings onto DVD or CD media. Our Eskape™ Labs products allow users of Apple®Macintosh® computers to watch television on their computer screen.

We offer three types of digital TV receivers. Our WinTV® digital receivers can receive digital TV transmissions and display the digital TV show in a re-sizeable window on a user's PC screen. Our Digital Entertainment Center products ("DEC") allow users to receive digital TV broadcasts and display the digital TV on either a TV set or a PC screen. Our MediaMVP™ product was designed to allow PC users to play digital media such as digital music, digital pictures and digital videos on a TV set via a home network.

We sell our products through computer and electronic retailers, computer products distributors and original equipment manufacturers ("OEMs").

Product segment and Geographic Information

The Company sells its product through a worldwide network of distributors and retailers. Net sales to international and domestic customers were approximately 68% and 32%, 73% and 27%, and 77% and 23% of total sales for the years ended September 30, 2003, 2002 and 2001, respectively. It maintains sales offices in both Europe and Asia.

Net sales to customers by geographic location consist of:

	Years ended September 30,		
Sales to:	2003	2002	2001
United States	32%	27%	23%
Germany	30%	37%	41%
United Kingdom	15%	14%	12%
France	8%	8%	6%
Asia	1%	2%	7%
Italy	2%	2%	2%
Netherlands	3%	2%	1%
Other Countries	9%	8%	8%
Total	100%	100%	100%

Product Segment and Geographic Information

We offer several types of analog products. Our WinTV® analog TV receivers allow PC users to watch television on their PC screen in a resizable window, and also enable recording of TV shows to a hard disk. Our WinTV®-PVR TV personal video recorder products include hardware MPEG encoders, which improve the performance of TV recording and add instant replay and program pause functions, plus also enable the 'burning' of TV recordings onto DVD or CD media. Our Eskape™ Labs products allow users of Apple®Macintosh® computers to watch television on their computer screen.

We offer three types of digital TV receivers. Our WinTV® digital receivers can receive digital TV transmissions and display the digital TV show in a re-sizeable window on a user's PC screen. Our Digital Entertainment Center products ("DEC") allow users to receive digital TV broadcasts and display the digital TV on either a TV set or a PC screen. Our MediaMVP™ product was designed to allow PC users to play digital media such as digital music, digital pictures and digital videos on a TV set via a home network.

Our products are either sold, or can be sold, by the same retailers and distributors in our marketing channel. We also sell product directly to OEM customers. The Company evaluates its product lines under the functional categories of analog and digital products. Sales by functional category are as follows:

	Years ended September 30,		
Product line sales	**2003**	**2002**	**2001**
Analog sales	$ 38,219,898	$ 34,526,717	$ 43,483,587
Digital sales	12,736,136	8,270,009	7,426,876
	$ 50,956,034	$ 42,796,726	$ 50,910,463

Net long lived assets located in the United States, Europe and Asia locations were approximately 70%, 26% and 4% of total net long lived assets, respectively, at September 30, 2003, and 73%, 22% and 5% , respectively , at September 30, 2002.

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 the 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 8). Although the Company operates in one industry segment, it does not believe that it has a material concentration of credit risk either from an individual counter party or a group of counter parties, due to the large and diverse user group for its products. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. The Company maintains allowances to cover potential or anticipated losses for uncollectible amounts.

Shipping and Handling Costs

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

Revenue Recognition

We sell through a sales channel which consist of retailers, OEMS and distributors. Our prices are fixed consistently over the entire sales channel. The majority of our customers are granted open payment terms. Those customers deemed as large credit risks either pay in advance or issue us 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 products we sell are analog 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 it customers a right of return, but does not offer stock balancing. Our accounting complies with SFAS 48 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 our business coupled with the changing economic environment, management exercises some judgement with regard to the historical data to arrive at the reserve.

Warranty Policy

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

Inventories

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

Property, Plant and Equipment

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

Office Equipment and Machinery: 5 to 7 years
Leasehold improvements: Asset life or lease term, whichever is shorter

Income taxes

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

Long-Lived Assets

Long-lived assets, such as property and equipment and goodwill, 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. (See Note 11)

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. Certain assets and liabilities of these subsidiaries are translated at the exchange rate in effect at each year end. Euro-denominated income statement accounts that pertain to sales are translated at the average monthly forward exchange contract rate. Currencies other than Euros (primarily Great British Pound) and Euro accounts other than sales are translated at the average prevailing exchange 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. During the years ended September 30, 2003 and 2002, the Company recorded on the balance sheet translation gains of $708,028 and $215,142, respectively, under other comprehensive income (loss) in stockholders' equity section.

Derivatives and Hedging Activities

Due to extensive sales to European customers with payment made to us in local currencies (primarily the Euro and Great British Pound), the Company uses derivatives to reduce its exposure to fluctuations in foreign currencies. Derivative products, such as foreign currency forward contracts, are used to hedge the foreign currency market exposures underlying forecasted sales transactions with customers. The Company's accounting policies for these instruments are based on its designation of such instruments as cash flow hedging transactions. The Company does not use derivative instruments for purposes other than hedging. All open derivative contracts are recorded on the balance sheet under accounts receivable at fair value. Prior to July 1, 2002, the Company did not qualify for cash hedge accounting under FAS 133, therefore material gains or losses were recorded through operations.

The Company recognizes gains and losses on closed derivative contracts as an adjustment to net sales.

Derivatives and Hedging Activities

For derivative instruments that are designated and qualify as a fair value hedge (i.e., hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk), the gain or loss on the derivative instrument as well as the offsetting gain or loss on the hedged item attributable to the hedged risk are recognized in earnings in the current period. For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure of variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of Accumulated Other Comprehensive Income (Loss) (a component of stockholders' equity) and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument, if any (i.e. the ineffective portion and any portion of the derivative excluded from the assessment of effectiveness) is recognized in earnings in the current period. For derivative instruments not designated as hedging instruments, changes in their fair values are recognized in earnings in the current period.

The effect of implementing SFAS No.133, "Accounting for Derivative Instruments and Hedging Activities", which was adopted on October 1, 2000, is presented in this annual report on form 10-K as a cumulative effect of a change in accounting principle.

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, 2003 and 2002 because of the relatively short term maturity of these instruments.

Net income (loss) per share

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

	Years ended September 30,		
	2003	**2002**	**2001**
Weighted average common stock outstanding-basic	8,867,309	8,887,107	8,910,117
Common stock equivalents-stock options	-	115,043	-
Weighted average shares outstanding-diluted	8,867,309	9,002,150	8,910,117

Options to purchase 1,896,101, 825,322 and 1,827,326 shares of Common Stock at prices ranging $1.05 to $ 10.06, $2.07 to $10.06 and 1.05 to $10.06, respectively, were outstanding as of September 30, 2003, 2002 and 2001, but were not included in the computation of diluted net income (loss) per share of Common Stock because they were anti-dilutive.

Stock Based Compensation

The Company accounts for its stock option awards under the intrinsic value based method of accounting as prescribed by APB Opinion Number 25, "Accounting for Stock Issued to Employees". Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. The Company discloses the pro forma impact on net income and earnings per share as if the fair value based method had been applied as required by SFAS No. 123, "Accounting for Stock Based Compensation".

Stock Based Compensation

SFAS Statement 123 "Accounting for Stock Based Compensation," ("SFAS 123") requires the Company to provide pro forma information regarding net income or (loss) and net income or (loss) per share as if compensation cost for the Company's stock option plans had been determined in accordance with the fair value based method prescribed in SFAS123. 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 for 2003, 2002 and 2001: risk free interest rates of 3.25%, 3.25% and 4.25%, volatility factor of the expected market price of the Company's stock of 40%, 40% and 40% and expected lives of either five or ten years. The weighted average fair value ranges of options granted in 2003, 2002 and 2001 were $0.43 to $1.22, $0.42 and $0.57 to $1.72, respectively.

Under the accounting provisions of FASB Statement 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

	Years ended September 30,		
	2003	**2002**	**2001**
Net (loss) income as reported	$ (814,032)	$ 347,522	$ (2,281,697)
Deduct: Total stock-based employee compensation expense			
Determined under fair value method, net of related taxes	(99,154)	(79,461)	(288,196)
Pro forma net income (loss)	$ (913,186)	$ 268,061	$ (2,569,893)
Net income per share - as reported:			
Basic and diluted	$ (0.09)	$ 0.04	$ (0.26)
Net income per share - pro forma:			
Basic and diluted	$ (0.10)	$ 0.03	$ (0.29)

Recent Accounting Pronouncements

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" (" SFAS 150"). SFAS 150 establishes standards for how an issuer classifies and measures three classes of freestanding financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability. SFAS 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company has not entered into any financial instruments within the scope of SFAS 150 since May 31, 2003, nor does it currently hold any significant financial instruments within its scope.

In January 2003, the FASB issued Interpretation No.46, Consolidation of Variable Interest Entities. Interpretation No. 46 requires companies with a variable interest in a variable interest entity to apply this guidance as of the beginning of the first reporting period ending after December 15, 2003. The application of the guidance could result in the consolidation of a variable interest entity. The only potential variable interest entity with which the Company is associated is the real estate partnership owned by certain of the Company's principal shareholders, as disclosed in Note 9. The Company is evaluating whether the partnership is a variable interest entity, whether the Company is the primary beneficiary and, if so, the impact of this interpretation on financial position and results of operations.

2. Accounts receivable

Receivables consist of:

- Trade receivables from sales to customers
- Receivables pertaining to component parts purchased from us by our contract manufacturer, which are excluded from sales
- General services tax (GST) and value added tax (VAT) reclaimable on goods purchased by our Singapore and Ireland locations
- Allowances, consisting of sales and bad debt
- Income tax receivables

• Other minor non trade receivables

Attached below is a listing by category of our accounts receivable as of September 30, 2003 and 2002.

	September 30,	
	2003	**2002**
Trade receivables	$ 7,435,539	$ 6,027,048
Receivable from contract manufacturers	4,134,456	1,345,584
GST and VAT taxes receivables	289,700	659,667
Income tax receivables	175,000	501,000
Allowances	(2,887,184)	(2,887,184)
Other	35,247	37,623
	$ 9,182,758	$ 5,683,738

3. Inventories

Inventories consist of the following:

	September 30,	
	2003	**2002**
Component Parts	$1,446,670	$2,842,460
Work in Process	-	42,616
Finished Goods	4,027,704	5,206,419
	$5,474,374	$8,091,495

In recognition of the sales decline experienced in during fiscal 2001, which primarily occurred in the third and fourth quarters of fiscal 2001, slower sales of older product lines and engineering changes to products during the latter part of fiscal 2001, the Company reviewed the net realizable value of its inventory. The Company deemed it necessary to increase its reserve for obsolete and slow moving inventory. An additional reserve of approximately $1,863,000 was recognized during the fourth quarter of fiscal 2001 and charged to cost of sales. During fiscal 2002, the Company recorded a net reduction to cost and sales of $386,000 for adjustments to inventory allowances.

4. Property, Plant and Equipment

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

	September 30,	
	2003	**2002**
Office Equipment and Machinery	$2,095,268	$1,885,094
Leasehold Improvements	77,916	76,622
	2,173,184	1,961,716
Less: Accumulated depreciation and amortization	1,640,668	1,350,662
	$ 532,516	$ 611,054

Depreciation expense totaled $ 274,784, $ 302,401 and $ 294,234 for the total years ended September 30, 2003, 2002 and 2001, respectively.

5. Income Taxes

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

	Years ended September 30,		
	2003	**2002**	**2001**
Current tax expense (benefit):			
Federal income tax (benefit)	$ -	$ -	$(439,985)
State income taxes (benefit)	-	-	(61,015)
Foreign income taxes	108,465	69,000	167,700
Adjustment of prior year estimated income taxes	198,425	-	-
Total current	306,890	69,000	(333,300)
Deferred tax expense (benefit)			
Federal	-	-	969,103
State	-	-	113,694
Total deferred	-	-	1,082,797
Total taxes on income	$ 306,890	$ 69,000	$ 749,497

Components of deferred taxes are as follows:

	Years ended September 30,	
	2003	**2002**
Deferred tax assets:		
Net operating loss carry forwards	$ 2,554,807	$ 1,498,761
Tax credit carry forward	407,971	407,971
Inventory allowances	1,061,750	1,038,333
Warranty reserve	9,158	9,158
Allowance for doubtful accounts	76,853	76,853
Deferred rent payments	5,344	24,344
Capitalized inventory costs	16,130	92,130
Sales return reserve	289,826	289,826
Goodwill amortization	239,926	258,496
Other allowances	(1,637)	(16,839)
Total deferred assets	4,660,128	3,679,033
Valuation allowance	(4,660,128)	(3,679,033)
Net deferred assets	-	-

As of September 30, 2003, the Company had $125,295 of restricted net operating losses, (which expire in the years through 2010) and $6,597,885 of unrestricted net operating losses (which expire between 2010 and 2022) available to offset future taxable income. As of September 30, 2003, the Company has an income tax receivable for $175,000, relating to the anticipated refund of taxes paid for fiscal 1999. In addition, as of September 30, 2003, the Company has a tax credit carry forward for research and development expenses totaling $407,000.

For the last four fiscal years, the Company's domestic operation has incurred losses. On September 30, 2000, the Company's domestic operation had a deferred tax benefit of $1,267,997. The Company analyzed the future realization of the deferred tax asset during the fourth quarter of fiscal 2001 and it concluded that under the present circumstances, it would be appropriate for the Company to record a valuation allowance against the deferred tax asset and reduce certain income tax liabilities. The net result was a charge to the Company's tax provision for approximately $1,082,000. Due to the domestic losses incurred for the last four fiscal years , as of September 30, 2003, the Company has recorded a valuation allowance of $4,660,138 against the deferred tax asset.

5. Income Taxes

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

	Years ended September 30,		
	2003	2002	2001
Income tax (benefit) at federal statutory rate	$ (886,322)	$ (1,040,729)	$ (629,408)
Increase in deferred income tax valuation allowance	981,095	1,175,298	3,122,292
Change in estimate of prior year income taxes	198,425	-	(300,000)
Permanent differences-life insurance	3,400	884	(680,000)
Permanent differences-other	5,100	3,400	11,590
Income taxed at lower than statutory rates	-	-	(822,579)
State income taxes, (benefit) net of federal benefit	(104,273)	(108,481)	(34,768)
Foreign income taxes	108,465	69,000	167,700
Other	1,000	(30,372)	(85,330)
Taxes on income	$ 306,890	$ 69,000	$ 749,497

Effective October 1, 1999, the Company restructured its foreign operations. The result of the restructuring eliminated the foreign sales corporation and established a new Luxembourg corporation which functions as the entity which services the Company's European customers. The new structure created separate domestic and foreign tax entities, with the new Luxembourg entity paying a license fee to the Company's domestic operation for use of the Hauppauge name.

During the fiscal year ended September 30,2003, the Company adjusted the prior year provision for estimated income tax receivable and income tax payable, based in part upon the completion of a tax examination. The net result was a change of $198,425.

For the years ended September 30, 2003, 2002 and 2001 the Company's domestic operation incurred a pretax loss of $2,606,829, $2,623,414 and $3,951,550 respectively, and the Company's international operations had pretax net income of $2,099,687, $3,039,936 and $2,419,350, respectively.

6. Line of Credit

On April 5, 2001, the Company extended its agreement with Chase Manhattan Bank, to provide it with a $6,500,000 credit facility. The facility was secured by our assets, and expired in fiscal 2002. It is the intention of the Company to procure a new credit facility on terms acceptable to the Company. However, there can be no assurance that we will secure a replacement line of credit at competitive terms, or secure a credit line at all.

7. Stockholders' Equity

a. Treasury Stock

On November 8, 1996, the Company approved a stock repurchase program. The program, as amended, authorizes the Company to repurchase up to 850,000 shares of its own Common Stock. The repurchased shares will be used by the Company for certain employee benefit programs. As of September 30, 2003 and 2002, 542,067 and 517,317 treasury shares with an accumulated cost of $1,497,216 and $ 1,461,574 and average prices of $ 2.76 and $2.84 were held by the Company as treasury shares.

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, up to 400,000 options may be granted for up to ten years with exercise prices at the fair market value of the Common Stock at the date of the grant, subject to adjustment as provided in the plan. As of September 30, 2003, 2002 and 2001, 118,500, 118,500 and 151,000 options were outstanding, respectively, ranging in prices from $1.35 to $2.55.

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 terminates on March 5, 2006. This plan does not qualify for treatment as an incentive stock option plan under the Internal Revenue Code. There are various tax benefits which could accrue to the Company upon exercise of non-qualified stock options that may not be available to the Company upon exercise of qualified incentive stock options. The purpose of the plan is to provide the Company greater flexibility in rewarding key employees, consultants, and other entities without burdening the Company's cash resources. As of September 30, 2003, 2002 and 2001, 346,479, 235,404 and 328,804 options ranging in prices from $1.08 to $10 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 its 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 terminates on December 16, 2007. The options terms may not exceed ten years. Options cannot be granted at less than 100% of the market value at the time of grant. Options granted to employees who own more than 10% of the Company's outstanding common stock cannot be granted at less than 110% of the market value at the time of grant. As of September 30, 2003, 2002 and 2001, 634,122, 545,822 and 603,822 options were outstanding with exercise prices from $1.08 to $ 10.06.

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 its July 18, 2000 annual stockholders' meeting. The purpose of the 2000 Plan is to attract, retain and motivate key employees, directors and non-employee consultants.

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

The 2000 Plan allows the granting of options as either incentive stock options or non-qualified options. Non-employee directors and non-employee consultants may only be granted Non-Qualified Stock Options. Incentive stock options are priced at the market value at the time of grant and shall be exercisable no more than ten years after the date of the grant. Incentive stock options granted to employees who own 10% or more of the Company's combined voting power cannot be granted at less than 110% of the market value at the time of grant. Non-qualified options shall be granted at a price determined by the Board of Directors, or a committee thereof, and shall be exercisable no more than 10 years and one month after the grant. The aggregate fair market value of shares subject to an incentive stock option granted to an optionee in any calendar year shall not exceed $100,000.

As of September 30, 2003, 2002 and 2001, 497,000, 243,100 and 263,700 shares have been issued 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 its September 22, 2003 annual stockholders' meeting. The purpose of the 2003 Plan is to provide equity ownership opportunities and performance based incentives to attract and retain the services of key employees, Directors and non-employee consultants of the Company and to motivate such individuals to put forth maximum efforts on behalf of the Company.

The 2003 Plan as adopted reserves up to 500,000 shares of Common Stock to be issued pursuant to stock options grants or other awards, subject to adjustment for any merger, reorganization, consolidation, recapitalization, stock dividend, stock split or any other changes on corporate structure affecting the common stock. All of the Common Stock which may be awarded under the 2003 Plan may be subject to delivery through Incentive Stock Option Plans. The 2003 Plan will be administered by the Board of Directors or a Committee thereof composed of two or more members who are non-employee Directors (the "Committee"). Grants of awards under the 2003 Plan to non-employee Directors require the approval of the Board of Directors.

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. As of September 30, 2003, no stock options have been granted under the 2003 Plan. 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 award.

Long term performance awards (or "Award) may be awarded either alone or in addition to other awards granted under the 2003 Plan. The Board or the Committee shall determine the nature, length, and starting date of the performance period which shall generally be at least two years. The maximum award for any individual with respect to any one year of any applicable performance period shall be 100,000 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 203 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 stockholders at its 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 has reserved 100,000 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 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. This plan terminates on December 31, 2003. The maximum number of shares that may be issued in any quarterly offering is 10,000, plus unissued shares from prior offerings whether offered or not. At our September 6, 2002 stockholders' meeting, our stockholders' approved an increase in shares reserved under this plan to 180,000, and extended the plan termination date to December 31, 2004. As of September 30, 2003 and 2002, 97,937 and 67,786 Common Stock were purchased under this plan.

A summary of the status of the Company's fixed options plans as of September 30, 2003, 2002 and 2001 and changes during the years ending those dates is presented below:

	ISO	Weighted Average Exercise Price	Non Qualified	Weighted Average Exercise Price
Balance at September 30, 2000	848,922	$3.40	641,304	$ 2.71
Granted	194,500	1.38	47,500	3.99
Exercised	(11,000)	1.43	-	-
Forfeited	(13,900)	4.73	-	-
Balance at September 30, 2001	1,018,522	$3.02	688,804	$ 2.80
Granted	123,000	1.36	-	-
Exercised	-	-	-	-
Forfeited	(142,100)	3.21	(273,400)	1.81
Balance at September 30, 2002	999,422	$2.79	415,404	$ 3.45
Granted	272,600	1.08	111,075	2.50
Exercised	(3,000)	1.16	-	-
Forfeited	(19,400)	1.22	-	1.81
Balance at September 30, 2003	1,249,622	$2.45	526,479	$ 3.25
Options exercisable at September 30, 2003	715,976	$ 2.82	421,675	$ 2.40

The following table summarizes information about stock options outstanding at September 30, 2003:

Options Outstanding Range of Exercise Prices	Number Outstanding	Weighted Avergae Remaining Contractual Life	Weighted Average Exercise Price	Number Exersisable	Weighted Average Exercise Price
$1.35	44,204	0.2 years	$1.35	42,204	$1.35
1.50	30,000	2.4	1.50	30,000	1.50
1.58	180,000	2.3	1.58	180,000	1.58
1.47	1,600	0.6	1.47	1,600	1.47
1.87	33,200	0.2	1.87	33,200	1.87
2.07	9,000	0.5	2.07	9,000	2.07
2.54	90,000	0.2	2.54	90,000	2.55
2.32	60,000	4.3	2.32	60,000	2.32
2.25	124,500	0.2	2.25	122,500	2.25
3.87	10,000	0.3	3.87	10,000	3.87
10.00	50,000	0.8	10.00	40,000	10.00
3.94	250,322	0.5	3.94	166,322	3.94
2.82	60,000	0.2	2.82	60,000	2.82
8.75	20,000	0.7	8.75	16,000	8.75
10.06	10,000	1.3	10.06	6,000	10.06
5.25	59,400	1.8	5.25	43,740	5.25
5.78	34,600	1.8	5.78	20,760	5.78
3.99	47,500	2.1	3.99	44,166	3.99
1.38	167,100	3.3	1.38	64,324	1.38
1.05	50,000	4.6	1.05	12,500	1.05
1.81	71,000	3.0	1.81	8,500	1.81
3.05	80,000	4.7	3.05	20,000	3.05
1.08	293,675	5.0	1.08	56,835	1.08
	1,776,101			1,137,651	.

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 will be issued for each share of common stock, par value $0.01 per share, of the Company ("Common Stock") outstanding as of August 5, 2001. Each of the Rights will entitle 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 a of July 19, 2001 will be grandfathered at a their current level plus 1% unless they later fall below the 10% threshold. The Rights are redeemable under certain circumstances at $0.001 per Right and will expire, unless earlier redeemed or extended, on July 19, 2011.

8. Significant Customer Information

For the years ended September 30, 2003 and 2002 the Company had no single customer who accounted for more than 10% of net sales. As of September 30, 2003 and 2002, the Company had fourteen customers who accounted for 74% and 79% , respectively of the net accounts receivable.

9. Related Party Transactions

The Company rents its principal office and warehouse space in Hauppauge, New York from a real estate partnership owned by certain of the Company's principal stockholders. The lease term expires on January 31, 2006 and includes an option to extend for three additional years. The lease provides for rent increases of 5% per year. Rent is currently at the annual rate of $431,454 and will increase to $453,027 annually as of February 1, 2004. On December 17, 1995 in connection with a re-negotiation of the lease term, the Company granted options to purchase 120,000 shares to a real estate partnership partially owned by the principal stockholder at an exercise price of $1.905 per share, which are exercisable through the lease term. The market price of the option equaled the exercise price at the date of the grant. The effect of imputing the fair value of the options granted was immaterial. The options were still outstanding as of September 30, 2003.

The Company had amounts payable to this related party for unpaid rent of $302,128 as of September 30, 2003 and 2002.

The indebtedness partially incurred by the principal stockholder to purchase the building is also guaranteed by the Company and totaled $745,567 at September 30, 2003.

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

Year September 30,	
2004	679,272
2005	673,673
2006	239,803
Total	$1,592,748

Rent expense to related parties and third parties totaled approximately $622,000, $619,000 and $623,000 for the years ended September 30, 2003, 2002 and 2001 respectively. The Company pays the real estate taxes and it is responsible for normal building maintenance.

10. Commitments and Contingencies

a. Litigation

In the normal course of business, the Company is party to various claims and/or litigation. Management and its legal counsel believe that the settlement of all such claims and or/litigation, considered in the aggregate, will not have a material adverse effect on the Company's financial position and results of operations.

We are presently involved in arbitration proceedings before the American Arbitration Association, which had been brought against the Company by the estate of the late Mr. Kenneth Aupperle ("Estate"). The Estate is claiming property rights and interest in the Company, certain amounts due and owing to the Estate based on various corporate agreements with Mr. Aupperle and certain insurance policies, such amount to be no less than $2,500,000. Based on the information presented to us, management believes that the claim and the basis for proceeding with arbitrating such claim is without merit and will vigorously defend it. However, due to the uncertainties inherent in litigation, we are unable to predict the ultimate outcome.

b. Employment Contract

As of January 10, 1998, after the expiration of a prior employment agreement with the Company, Kenneth Plotkin entered into an employment agreement (the "1998 Employment Agreement") with the Company to serve in certain offices of the Company. The 1998 Employment Agreement provided for a three-year term, which term automatically renews from year to year thereafter unless otherwise terminated by the Board of Directors or the executive. The 1998 Employment Agreement provided for an annual base salary of $125,000 during the first year, $150,000 during the second year, and $180,000 during the third year. For each Annual Period (as defined in the 1998 Employment Agreement) thereafter, the 1998 Employment Agreement provides that compensation shall be as mutually determined between the Company and the executive, but not less than that for the preceding Annual Period. In addition, the 1998 Employment Agreement provides for a bonus to be paid as follows: an amount equal to 2% of the Company's earnings, excluding earnings that are not from operations and before reduction for interest and income taxes ("EBIT"), for each fiscal year starting with the year ended September 30, 1998, provided that the Company's EBIT for the applicable fiscal year exceeds 120% of the prior fiscal year's EBIT, and if not, then 1% of the Company's EBIT. The determination of EBIT shall be made in accordance with the Company's audited filings with the Securities and Exchange Commission on its Form 10-KSB or Form 10-K. Pursuant to the 1998 Employment Agreement, on January 21, 1998, incentive stock options to acquire a total of 90,000 Common Shares each were granted to Mr. Plotkin, exercisable, beginning on January 21, 1999, in increments of 33 1/3% per year at $2.544 per share. Each increment of these options expires five (5) years after it first becomes exercisable. Also on January 21, 1998, pursuant to the 1998 Employment Agreement, non-qualified options to acquire a total of 60,000 Common Shares each were granted to Mr. Plotkin, exercisable immediately for a period of ten (10) years. These options expire as of January 20, 2008. Options granted under the 1998 Incentive Stock Option Plan shall become immediately vested and exercisable in the event of a Change in Control (as defined in the 1998 Incentive Stock Option Plan). The 1998 Employment Agreement further provides for disability benefits, the obligation of the Company to pay the premiums on a term life insurance policy or policies in the amount of $500,000 on the life of Mr. Plotkin owned by Mr. Plotkin or his spouse, or a trust for his respective benefit or for the benefit of his family, a car allowance of $500 per month, reasonable reimbursement for automobile expenses, and medical insurance as is standard for executives of the Company. The 1998 Employment Agreement further provides that the Company may apply for and own life insurance on the life of Mr. Plotkin for the benefit of the Company, in such amounts as the Board of Directors of the Company may from time to time determine. As set forth in the 1998 Employment Agreement, the Company shall pay the premiums as they become due on any such insurance policies, and all dividends and any cash value and proceeds on such insurance policies shall belong to the Company. In the event of a termination of employment associated with a Change in Control of the Company (as defined in the 1998 Employment Agreements), a one-time bonus shall be paid to the executive equal to three times the amount of the executive's average annual compensation (including salary, bonus and benefits, paid or accrued) received by him for the thirty-six month period preceding the date of the Change of Control.

As of May 1, 2002, Dean Cirielli entered into an Employment Agreement with the Company (the "Cirielli Employment Agreement"). The Cirielli Employment Agreement provides for a two-year term, unless terminated earlier by either Mr. Cirielli or the Company. The Cirielli Employment Agreement provides that Mr. Cirielli shall be paid an annual salary of $175,000 for the first year of the Cirielli Employment Agreement, with annual performance evaluations and upward adjustments as determined by the Compensation Committee of the Board of Directors, based on his performance. In addition, the Cirielli Employment Agreement provides that he shall also receive a yearly bonus totaling one percent of the operating income of the Company, provided that earnings are at least 120% of the prior fiscal year's earnings. Pursuant to the Cirielli Employment Agreement, Mr. Cirielli was granted an option to purchase 50,000 shares of Common Stock of the Company, on May 1, 2002 at an exercise price of $1.81 per share (for the purposes of the Company's 2000 Performance and Equity Incentive Plan, the fair market value of the Company's Common Stock as May 1, 2002) was $1.81 per share. Such options are exercisable to the extent of 12,500 shares on each of May 1, 2003, 2004, 2005 and 2006, with each installment being exercisable over a ten year period commencing on the date of grant of the options; and that such options are not intended to qualify as incentive stock options, as defined in section 422 of the Internal Revenue Code, as amended. All outstanding options as of the date such Change in Control (as defined in the Company's 2000 Performance and Equity Incentive Plan) shall become fully exercisable and vested, unless the terms of the award provide otherwise. Pursuant to the Cirielli Employment Agreement, the Company and Mr. Cirielli entered into a Relocation Package Agreement providing for, amongst other things, a relocation reimbursement of no more than $100,000. Such relocation reimbursement shall be paid as follows:

(i) 50% of the Relocation Costs (as defined in his Relocation Package Agreement) or $50,000 (whichever is the lower) on or before he physically and permanently relocates to Long Island, NY, such date to be the date of signing a definitive sale and purchase agreement to either sell his existing residence or buy a housein the Long Island area, NY, whichever is the earlier (the "Relocation Date"),

(ii) 25% of the Relocation Costs or $25,000 (whichever is the lower) on the first anniversary of the Relocation Date and (iii) 25% of the Relocation Costs or $25,000 (whichever is the lower) on the second anniversary of the Relocation Date.

c. Forward Exchange Contracts

Due to extensive sales to European customers denominated in local currencies (primarily the Euro and Great British Pound), the Company is a net receiver of currencies other than the U.S. dollar and as such, benefit from a weak dollar and are adversely affected by a strong dollar relative to the major worldwide currencies, especially the Euro and Great British Pound. Consequently, changes in exchange rates expose the Company to market risks resulting from the fluctuations in the foreign currency exchange rates to the U.S. dollar. The Company attempts to reduce these risks by entering into foreign exchange forward contracts with financial institutions to protect against currency exchange risks.

As of September 30, 2003, the Company has foreign currency forward contracts outstanding of $3,560,000 against delivery of the Euro. The contracts expire through December, 2003.
For the years ended September 30, 2003 and 2002, the Company recorded approximately $1,395,200 and $408,000 as a decrease to net sales related to the changes in the fair value of the Company's derivative contracts.

11. Business Acquisition

On June 1, 2000 the Company acquired certain assets of Eskape Labs Inc. ("Eskape"), a California-based company specializing in designing and manufacturing TV and video products for Apple® Macintosh® computers. The purchased assets expand and complement the Company's product line into the Apple® Macintosh® market. The cash price for the acquisition, which was accounted for under the purchase method, was approximately $900,000, including $100,000 for direct transactions costs and a restrictive covenant totaling $50,000. The excess of the acquisition cost over the fair value of identifiable assets acquired totaled approximately $810,000 and was amortized on a straight line basis over 10 years and the restrictive covenant on a straight line basis over two years.
In connection with the acquisition the Company had recorded goodwill of approximately $810,000. Due to changing conditions that occurred during the second half of fiscal 2001, such as declining sales, lost market share and the market changes caused by the introduction of a new Macintosh operating system, the following events and circumstances indicated to the Company that its goodwill asset

has been impaired and is not likely to be recovered:

- The Eskape™ Labs division was not profitable during fiscal 2001 and did not contribute, nor is to expected to contribute, any positive cash flow stream
- The asset value was greater than the estimated future cash flows
- Eskape™ Labs division did not fulfill its internal sales forecast for fiscal 2001
- At the time of the acquisition, the Company hired approximately 10 of the EsKape™ Labs' employees, including three from senior management. Only four employees remain.
- Certain Eskape™ Labs products have been deemed by management as slow moving products

In recognition of the above events, the Company recognized an impairment loss during the fourth quarter of fiscal 2001 for the entire remaining goodwill balance of $701,919.

The Company recorded the impairment loss as a component of income (loss) from operations for fiscal 2001.

12. Life Insurance Proceeds

On January 29, 2001 the Company's President unexpectedly passed away. Pursuant to key man life insurance policies the Company had on its President, it collected life insurance proceeds in the aggregate of $2 million from these policies, $1 million of which was recorded in the quarter ended June 30, 2001, while the other $1 million was recorded during the quarter ended September 30, 2001. The proceeds were reported on the Company's statement of operations in "Other income (expense)" under the caption " Life insurance proceeds".

13. Quarterly Information (Unaudited)

The following presents certain unaudited quarterly financial data:

	(In thousands, except per share data)			
	Quarters ended 12/31/2002	Quarters ended 3/31/2003	Quarters ended 6/30/2003	Quarters ended 9/30/2003
Net Sales	$ 15,520	$ 13,919	$ 10,011	$ 11,506
Gross Profit	3,920	3,369	2,254	2,696
Operating income (loss)	721	197	(872)	(604)
Net income (loss)	656	261	(855)	(876)
Net income (loss) per share:				
Basic and diluted	$ .07	$.03	$(0.10)	$ (.09)

Quarterly Information (Unaudited)

	(In thousands, except per share data)			
	Quarters ended 12/31/2001	Quarters ended 3/31/2002	Quarters ended 6/30/2002	Quarters ended 9/30/2002
Net Sales	$12,062	$ 10,748	$ 10,113	$ 9,872
Gross Profit	2,919	2,824	2,669	2,724
Operating income (loss)	393	165	74	(157)
Net income (loss)	284	217	26	(179)
Net income (loss) per share:				
Basic and diluted	$ .03	$.02	$ 0.00	$ (.01)

Since the Company sells primarily to the consumer market, it has experienced certain revenue trends. The sales of the Company's products, which are primarily sold through distributors and retailers, have historically been stronger during the Company's first fiscal quarter (October to December), which due to the holiday season, is a strong quarter for computer equipment sales. In addition, the Company's international sales, mostly in the European market, were 68%, 73% and 77% of sales for the years ended September 30, 2003, 2002 and 2001, respectively. Due to this, the Company's sales for its fourth fiscal quarter (July to September) can be potentially impacted by the reduction of activity experienced with Europe during the July and August summer holiday period.

During the 4th quarter of the fiscal year ended September 30, 2001, the Company recorded the following adjustments:

- The Due to the decline in sales during the third and fourth quarters of the current fiscal year, the Company deemed it necessary to increase its reserve for obsolete and slow moving inventory. An additional reserve of approximately $1,863,000 was recognized during the fourth fiscal quarter of fiscal 2001 and charged to cost of sales (see Note 2)
- The Company analyzed the future realization of the deferred tax asset during the fourth quarter of fiscal 2001 as a result of the operating losses incurred in the third and fourth quarters of 2001, and it concluded that under the present circumstances, it would be appropriate for the Company to record a valuation allowance against the deferred tax asset and reduce certain income tax liabilities. The net result was a charge to the Company's tax provision for $1,082,000 (see Note 4)
- Due to changing conditions that occurred during the second half of fiscal 2001, such as declining sales, lost market share and the market changes caused by the introduction of a new Macintosh operating system, the Company deemed it necessary to write off approximately $701,000 of goodwill related to its June 2000 acquisition of Eskape Labs (see Note 10)

During the 4th quarter of the fiscal year ended September 30, 2003, the Company recorded the following adjustments:

- During the fiscal year ended September 30,2003, the Company adjusted the prior year provision for estimated income tax receivable and income tax payable, based in part upon the completion of a tax examination. The net result was a change of $198,425.

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