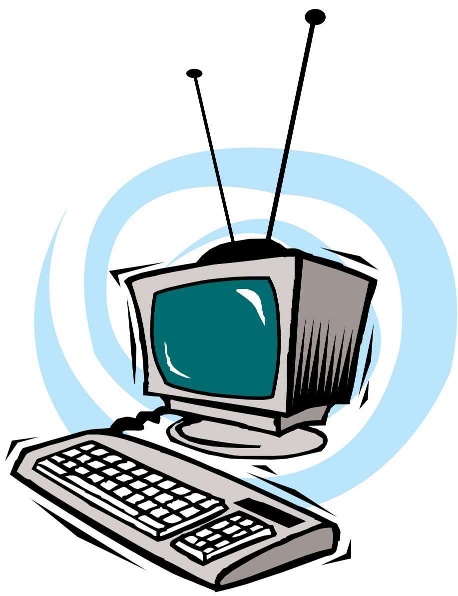
watch TV on your PC



1999 annual report

Hauppauge!®

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selectedfinancialdata

Years ended September 30,	1999	1998	1997
	(in thousands, except for per share amounts)		
Net Sales	$ 58,602	$ 38,757	$ 25,613
Income (loss) before taxes on income	$ 4,593	$ 2,482	$ 1,042
Net income, (loss)	$ 3,118	$ 1,958	$ 986
Diluted	$ 0.66	$ 0.42	$ 0.22
Shares Outstanding (diluted) millions	4,740	4,677	4,435
Balance Sheet Data (at period end):			
Working capital	$ 12,533	$ 9,536	$ 8,689
Total assets	$ 27,728	$ 22,897	$ 14,471
Stockholders' equity	$ 13,322	$ 10,037	$ 8,966

corporate profile

Hauppauge Digital, Inc. is the worldwide leader in TV-in-a-window products for the Personal Computer (PC) market. Sold under the "WinTV" name, these digital video boards allow PC users to watch television on their PC screens, video conference and create both still video images and digital video movies.

WinTV boards are installed in PC's to display video in a PC window, and enhance the usefulness of professional and consumer PC's by allowing users to watch live television in a resizeable window on their PC screen and view video images from cameras and video conference through their PC, while simultaneously allowing traditional PC applications to be run. In addition to allowing PC users to "watch TV on their PC", the WinTV boards can be used to receive data broadcasts worldwide.

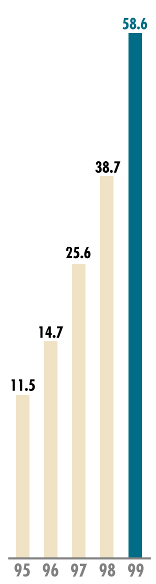
WinTV boards can be added as upgrades to existing personal computers or incorporated by original equipment manufacturers (OEM's) into their multimedia personal computer packages, and are sold worldwide through retailers and distributors.

Hauppauge develops both hardware and software using its internal Research and Development teams plus licenses hardware and software from third parties.

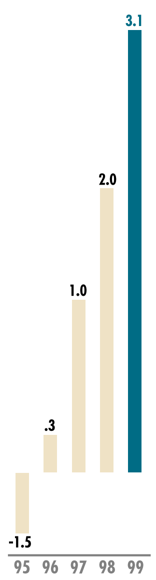
Hauppauge Digital, Inc. and its operating subsidiary, Hauppauge Computer Works, are headquartered in Hauppauge, New York, with sales offices in Germany, London, Paris, The Netherlands, Sweden, Italy, Singapore and California. Information on the company and its products can be obtained by visiting Hauppauge's web site at http://www.hauppauge.com.

financial highlights

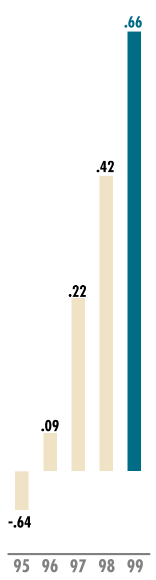
netsales
(in millions)



netincome(loss)
(in millions)



netincome(loss)
per share



to our share holders

"Hauppauge Digital is making investments in digital television, in data broadcasting, in the digital recording marketing, in the Mac market, in the Asia market and in e-commerce.

We believe that our intellectual property and market strengths, aggressively applied in these areas, will bring Hauppauge the highest likelihood of future returns."

dearshareholders

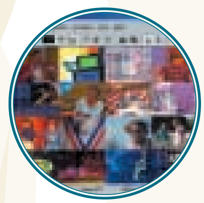
Let us first begin by saying that we are extremely pleased with Hauppauge's financial performance in Fiscal 1999. Our sales increase of 51% to over $58 million and our Income from operations increase of 116% to over $4.4 million has built tremendous momentum to take us strongly into the New Year, and of course the new millennium.

Since entering the television-in-the-PC market in 1991, Hauppauge Digital has focused on four strategic fronts: (1) To consistently innovate and diversify our product line, (2) To forge strategic relationships with strong industry players, (3) To market aggressively to increase sales and finally, (4) To improve our profitability.

We believe we've made significant accomplishments this year in each of these areas, and our success in each has enabled Hauppauge Digital to excel in the television-in-the-PC marketplace.

We launched innovative products and diversified our product line with the introduction of …

- WinTV-Theater and WinTV-Wave - high value TV receivers, with Wave Systems E-Commerce capabilities
- WinTV-Go - currently the market leader in low cost TV receivers
- WinTV-USB - our first external TV receiver product
- Your Video on the Web - for creating consumer "home video" web sites
- WinTV-DVBsat - for satellite digital TV and high speed Internet access in the European and Asian markets
- WinTV-D - the first digital television (DTV) receiver board for the U.S. market
- WinTV 2000 - A single, easy-to-use human interface that unites all of Hauppauge's products, allowing the consumer to learn and use one "look and feel" for all TV-in-a PC needs, be they analog, digital, or for external devices such as the WinTV-USB.



With the WinTV-D and the WinTV-DVBsat, we have entered into the digital television and digital data reception fields. Here in the United States, the ongoing transition to digital broadcast signals will enable networks and broadcasters to package - or datacast, as it is called - along with a DTV signal, a range of information formats for PCs at speeds several times faster than cable modems. With over 100 stations currently broadcasting a digital TV signal, and more signing on throughout the year 2000, customers can be offered a wide range of digital content, from television programming to datacasted music, video games and e-commerce content.

In Europe, our WinTV-DVBsat product will allow consumers to receive digital television via satellite and, with an account with an appropriate Internet service provider, receive high speed Internet data.

Over the course of 1999, we forged numerous important strategic relationships with a wide range of companies including suppliers, OEMs, broadcasters, and internet and e-commerce solutions providers.

We worked with Nogatech, an Israeli semiconductor company, to bring our first external TV receiver to market, WinTV-USB. The external TV receiver product line is expected to play an important role in our retail sales over the next few years, as more PC's are brought to market without internal expansion connectors.

We also worked with Conexant Systems, the world's largest independent company focused exclusively on providing semiconductor products for communications electronics, to include Fusion 878A, their single-chip solution for audio and video capture, in Hauppauge's WinTV-D boards. This relationship allowed us to leverage our existing investment in software for analog television receiver cards while quickly bringing Hauppauge's digital television products to market.

We also continued our work with Wave Systems on WinTV-Wave, our E-Commerce enabled receiver board launched in the 3rd quarter of this year. We expect this product to contribute to revenues in 2000 and beyond as the pay-as-you-go marketplace for low-cost content online increases over the next few years.

This Spring, we sold our millionth analog WinTV board, giving Hauppauge Digital the largest installed base of TV-in-the-PC boards in the market. As we approached the end of the fiscal year, our combined shipping rate for WinTV products exceeded 100,000 units per month. That trend continued into the first fiscal quarter of the year 2000, and we expect to ship our second millionth WinTV this year.

With our line of analog WinTV boards still generating the bulk of our revenues, we have, as of the end of fiscal 1999, over 20 different products in the marketplace, ranging from our VCB for videoconferencing applications, to WinTV-D, our new digital television receiver board.

On the marketing front, we continued to aggressively promote our line of products in the U.S. and bolster Hauppauge Digital's strong sales in Europe. We also entered the Asia-Pacific market by opening a sales and R&D facility in Singapore this summer, and will look to generate increased revenue from that region in the future.

Our established brand and first-to-market position is certainly helping us take a significant portion of the shelf space allocated to TV-in-the-PC applications, and it helps to make the roll-out of new products into our established retail channel easier.

As the year closed, the Company started discussions with a private company, Eskape Laboratories, which has created products similar to Hauppauge's, but which are designed for the Apple Macintosh market. We have entered into an agreement to purchase certain assets of Eskape Labs, and to establish a Macintosh products division.

Continuing our strategy of outsourcing production, our bottom line benefited this year from our decision to move manufacturing for sales in Europe to a subcontractor in Scotland. Our unit production costs have dropped significantly by eliminating duty on completed boards and reducing shipping expenses into the European market, which accounts for about 70% our sales.

We are also establishing a new packaging and warehousing operation in Ireland, which should both reduce our costs to manufacture in Europe and lower our overall effective tax rate.

Hauppauge Digital is making investments in digital television, in data broadcasting, in the digital recording marketing, in the Mac market, in the Asia market and in e-commerce.

We believe that our intellectual property and market strengths, aggressively applied in these areas, will bring Hauppauge the highest likelihood of future returns.

We want to thank you, our shareholders, for your trust and our customers for their business, and our employees for the enthusiasm, loyalty and hard work – all of which have combined to make fiscal 1999 such a successful year. We look to continue these great relationships in the new Millennium!

Sincerely,

Hauppauge Digital, Inc.

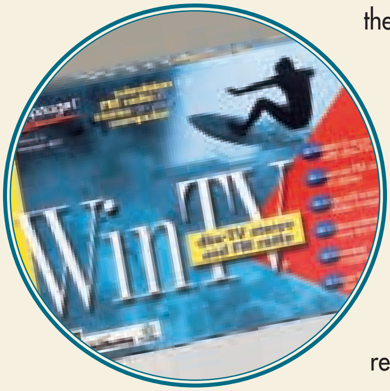
Kenneth R. Aupperle, President

Kenneth Plotkin, Chairman

One of the most gratifying aspects of working for the leading TV-in-a-PC company is the customer feedback - real people telling us about the benefits of having television on their PC! They report that they are more effective at work by having up-to-the-minute news, and that they enjoyed the discussion about last night's sitcom, which they were able to watch while catching up on their email at home. They tell us that they chat online about the ball game while actually watching the game on their PC, or how they kept awake with the help of music videos while finishing that term paper!

They tell us about using their camcorder and WinTV to videoconference with far-away friends, and how they are making home videos of life's precious moments and streaming them over the Internet for relatives to enjoy. Every day, Hauppauge products bring information and entertainment to over a million PC users, with more folks joining the fun all the time! And it's all made possible and affordable through an incredible series of advances in technology.

Hauppauge has developed four generations of WinTV since first introducing concept in 1991. The first generation of ISA-bus based WinTVs put the live image on the PC screen using a technique called "chroma keying," and required a dedicated "feature connector cable" between the WinTV and the PC's VGA board. For the first time a PC user could watch television in a resizable window on their PC screen! Introduced at $495, initial customers were mostly professional PC users who spent many hours on their PCs and found having television in a window on their desktop useful and entertaining. For example, PC users involved in financial markets were now able to see stock market related news while they worked. Video clip capture and Teletext capabilities, valued features in today's models, can also trace their origins to the first WinTV generation.



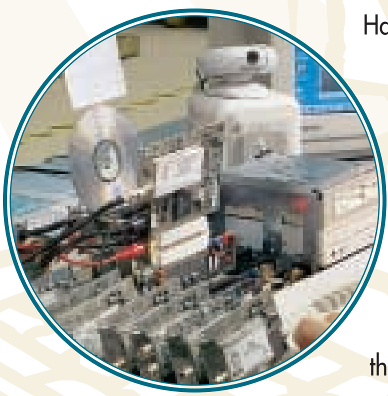
In 1993 Hauppauge invented a technique called "smartlock", which eliminated the need for the problematic "feature connector cable." In 1994 we introduced the "WinTV-Celebrity" generation of TV tuner boards based on "smartlock" technology, greatly improving customer satisfaction. The CinemaPro series of WinTV boards used smartlock and other techniques to reduce cost and improve performance. The CinemaPro is still used in some high end WindowsNT systems!

In June of 1996, Hauppauge introduced the WinTV-pci generation, which reduced cost even further by completely eliminating the "smartlock" circuitry and memory used on the previous generation, through a technique called "PCI Push." The emerging Intel Pentium-based PCs used the new PCI bus for add-in boards, which allowed data to be moved at a much higher rate than the older ISA bus. The "PCI Push" technique moves the live video image 30 times per second (in Europe the image is moved 25 times a second) over the PCI bus!

In addition to allowing a new low price point, WinTV-pci had higher digital video capture performance than previous models, capturing video at up to 30 frames per second. With this higher performance capture capability, the WinTV-pci found new uses in video conferencing, video surveillance and Internet streaming video applications. From $495 in 1991, advances in circuit integration have allowed us to continually drive costs downward; at $49 in 1999, the extremely popular WinTV-Go finally made TV-in-a-PC affordable for everyone!

Our newest boards are digital TV receivers, reflecting the transition from analog to digital television in both the United States and Europe. WinTV-D, developed during 1999 and introduced at the beginning of fiscal 2000, is the first product for the U.S. market which allows PCs to receive and display both analog and digital TV signals. We also began shipping the WinTV-DVBsat board for the European market, bringing digital satellite TV to PCs using the European Digital Video Broadcast standard.

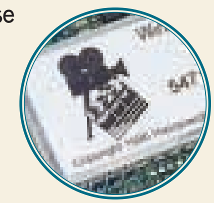
In addition to displaying digital TV in a resizable window, both WinTV-D and WinTV-DVBsat have the ability to receive data which broadcasters may send along with the digital TV signal. Data broadcasts on digital TV can be transmitted at several million bits per second. Hauppauge has developed proprietary software which can decode and display some of these data broadcasts, and we expect to continue this work as such broadcasts become more widespread.

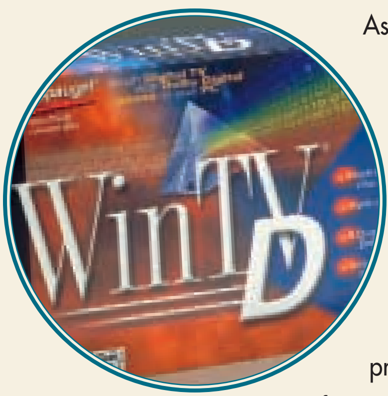


Finally, in 1999 we introduced our first external television receiver for PCs, that plugs into the USB port that most new PCs are equipped with. Marking a new point in ease of installation, WinTV-USB has proven to be popular with desktop PC users as well as laptop owners. With the sealed design of some newer PCs, we expect external TV products to be an important category in the future.

Innovations in hardware design must be paced by advances in software; in fact, Hauppauge has more software engineers than hardware engineers! Our software team makes sure that each WinTV owner gets the full use and enjoyment out of the product, whatever PC or operating system it is used with. Our new "WinTV-2000" application, which was developed during 1999, brings a consistent, stylish user interface to all WinTV products, including the popular PCI-based analog boards, the new WinTV-D digital receiver boards, and the WinTV-USB external television receivers.

Hauppauge's development efforts are currently focused on digital television products, externally attached television products, and the application of new video compression technologies. We are also developing more highly integrated versions of our hardware products to further improve performance and cost points, and new versions of our software to add features, improve ease of use, and provide support for new operating systems. And, we are developing additional capabilities in the data broadcasting field, in the e-commerce area, and exploring the application of our products to the Apple Macintosh market. Our Singapore R&D team is mainly focused on external television products, and on Asian-language adaptations of our products.





As you can see, the technologies underlying our products are subject to rapid change, and the introduction of new innovations creates the opportunity to enhance performance, ease of use, and cost-effectiveness. We maintain an aggressive research and development program in order to be able to respond quickly to technological advances by developing and introducing new products, successfully incorporating such advances in existing products, and obtaining licenses, patents, or other proprietary technologies to be used in connection with new or existing products. We more than doubled our research and development expenditures from 1997 to 1999 and we will continue to grow this investment in our future, and in our customers' enjoyment!

resultsofoperations

Years ended September 30, 1999 and 1998

Sales for the year ended September 30, 1999 were $58,601,611 compared to $38,757,443 for the year ended September 30, 1998, resulting in an increase of $19,844,168 or 51%, comprised of an increase in domestic sales of 44% and an increase in international sales of 54%. The primary forces driving the sales growth were:

- The full year effect of the increase in the Company's domestic distribution and retail channel to approximately 3,000 locations.
- Increased European sales due to the Company's expansion into new geographic markets combined with increased sales to the Company's existing European customers.
- Growth in sales to direct corporate customers.

Unit sales for the year ended September 30, 1999 increased 62% to approximately 670,000 as compared to approximately 413,000 for the prior year. Domestic sales were 27% of net sales for the current year compared to 28% for the prior year. International sales were 73% of net sales for the current year compared to 72% for the prior year.

Gross profit increased to $16,166,999 from $10,113,600, an increase of $6,053,399 or 60% over the prior year. The gross profit percentage was 27.6% for the year ended September 30, 1999 compared to 26.1% for the year ended September 30, 1998.

The increase in gross profit was primarily due to:

- Shifting the majority of the Company's production to subcontractors in Scotland and Malaysia, resulting in a reduction of import duties and lower unit manufacturing costs.
- A reduction in material, labor and other subcontractor production costs due to the benefits of increased production volume, which resulted in improved material prices and allocation of fixed production overhead spread over a larger volume of boards.

The chart below illustrates the components of Selling, General and Administrative expenses:

	Twelve months ended September 30,					
	Dollar Costs			Percentage of Sales		
	1999	1998	Increase	1999	1998	Increase/ (Decrease)
Sales & Promotional	$ 6,073,732	$4,603,989	$1,469,743	10.4%	11.9%	(1.5%)
Customer Support..........	447,860	301,860	146,000	.8%	.8%	–
Product Handling	592,494	449,999	142,495	1.0%	1.2%	(.2%)
General & Admin..........	3,343,627	1,887,970	1,455,657	5.7%	4.9%	.8%
Total	$10,457,713	$7,243,818	$3,213,895	17.9%	18.8%	(.9%)

As a percentage of sales, Selling, General and Administrative expenses for the year ended September 30, 1999 declined by .9% when compared to the prior year. Sales and Promotional expenses and Product Handling expenses declined 1.5% and .2% respectively. General and Administrative expenses increased by .8%. Represented in dollars, Selling General and Administrative expenses increased $3,213,895 compared to the prior year.

The increase in Sales and Promotional expenses of $1,469,743 was primarily due to:

- Increase in marketing and promotional programs to support product visibility at a greater number of retail locations.
- Higher commissions resulting from the 51% net sales increase.
- The opening of sales offices in the United Kingdom and France
- Additional marketing personnel required to handle expanded market locations.

Customer Support and Product Handling expenses increased $146,000 and $142,495 respectively. Customer Support costs increased due to the additional staff required to maintain a high level of customer service to support the Company's expanding domestic and international customer base. Increased Product Handling costs was a function of greater shipment volume to customers.

The increase in General and Administrative costs of $1,455,657 was primarily due to:

- Contractual wage increases for senior executives.
- Retaining professional services for public relations and investment banking advice.
- Fees for legal and accounting services, primarily for tax consultation, patent issues and acquisition advice.
- Larger incentive bonus accruals based on increased profitability.
- Increased bad debt expense, due primarily to a customer filing for bankruptcy

Research and Development expenses increased $448,448 or approximately 56%. The increase was due to the initiation and completion of several projects in fiscal 1999 which led to the introduction of several new products in the USB and digital video areas.

The Company had net other income for the twelve months ended September 30, 1999 of $139,878 compared to net other income for the prior year of $420,796. The decrease in net other income was primarily due to lower returns on monies invested throughout the year and foreign currency exchange losses due to the decline of the Euro.

Provision for income taxes was $1,475,000, or an effective tax rate of 32% for the year ended September 30, 1999 compared to $523,937 or an effective tax rate of 21% for the year ended September 30, 1998. The net effective rate for fiscal 1999 and 1998 was reduced by a reduction in the deferred tax valuation allowance of $127,000 and $503,131, recorded during the fourth quarters of fiscal 1999 and 1998, respectively. The reduction lowered the effective rate tax rate from 35% to 32% in fiscal 1999 and 41% to 21% in fiscal 1998, respectively.

The reduction in the effective tax rate, before the reduction of the deferred tax valuation allowance, for 1999 to 35% from 41% for 1998, was due to the tax benefits derived primarily from the allocation of income to a foreign sales corporation.

As a result of the above, the Company recorded net income after taxes for the year ended September 30, 1999 of $3,117,628, or an increase of 59%, when compared to $1,958,553 for the year ended September 30, 1998. Earnings per share, on a basic and diluted basis were, $0.72 and $0.66, respectively, for 1999, on weighted average basic and diluted shares outstanding of 4,316,216 and 4,739,874, respectively. Earnings per share, on a basic and diluted basis for 1998 were $0.44 and $0.42, respectively for 1998 on weighed average basic and diluted shares outstanding of 4,403,357 and 4,676,747, respectively.

resultsofoperations

Years ended September 30, 1998 and 1997

Sales for the year ended September 30, 1998 were $38,757,443 compared to $25,613,252 for the prior fiscal year, resulting in an increase of $13,144,191 or 51%. The increase in sales was primarily due to the expansion of the Company's domestic distribution and retail channels from approximately 300 retail locations carrying the Company's product to approximately 3,000 retail locations, promotions and increases in inventory at the retail level leading up to the launch of Windows98, continued sales growth in Europe due to expanding sales from existing customers plus expansion to new geographic markets in Europe, plus strong sales to direct corporate customers.

Unit sales for the year ended September 30, 1998 increased 47% to approximately 413,000 as compared to approximately 281,000 for the prior year. Sales to domestic customers were 28% of net sales for the current year compared to 34% for the prior year. Sales to international customers were 72% of net sales for the current year compared to 66% for the prior year.

Gross profit increased to $10,113,600 from $5,651,217, an increase of $4,462,383 or 79% over the prior fiscal year. The gross profit percentage was 26.1% for the year ended September, 1998 compared to 22.1% for the prior year. The increase in gross profit was primarily due to the absorption of manufacturing overhead over a greater number of units, a program of hedging foreign sales currency exposure, primarily for German Marks and British Sterling, which has stabilized the effect of foreign currency fluctuations, and the shifting of production for most of the Company's European sales to a subcontractor in Scotland, which resulted in lower unit production costs, the elimination of duty on completed boards and reduced shipping costs.

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

	Dollars Costs			Percentage of Sales		
	1998	1997	Increase	1998	1997	Increase/ (Decrease)
Sales & Promotional	$ 4,603,989	$ 2,082,782	$ 2,521,207	11.9%	8.1%	3.8%
Customer Support	301,860	232,740	69,120	.8%	.9%	(.1%)
Product Handling	449,999	311,961	138,038	1.2%	1.2%	–
General & Admin	1,887,970	1,655,847	232,123	4.9%	6.5%	(1.6%)
Total	$ 7,243,818	$ 4,283,330	$ 2,960,488	18.8%	16.7%	2.1%

Although Customer Support and General and Administrative expenses as a percentage of sales declined in total by 1.7 percent compared to last year, Sales and Promotional expense as a percentage of sales increased 3.8 percent compared to the prior year, resulting in an overall increase in Selling, General and Administrative expenses as a percentage of sales of 2.1 percent. Represented in dollars, Selling General and Administrative expenses increased $2,960,488 over fiscal 1997. The largest component of this increase was Sales and Promotional expenses whose increase of $2,521,207 over the prior year represents about 85% of the total increase. The increase in sales and promotional expenses was primarily due to the Company allocating approximately $1 million of additional marketing funds to participate, as a Microsoft Windows98 launch partner, in the marketing, promotional and media campaign associated with the introduction of Windows98. In addition, the Company during fiscal 1998 embarked on a commitment to increase its domestic market presence. To achieve this goal, the Company has increased its outside sales staff, paid higher commissions resulting from the 51% net sales increase, and incurred higher marketing and promotional costs in support of increased distribution and retail locations. As a result of this program, the number of retail stores carrying the Company's products increased from approximately 300 retail locations at the start of the year to approximately 3,000 as of September 30, 1998.

Customer Support, Product Handling, and General and Administrative expenses, which represents about 15% of the increase over the prior year, increased $69,120, $138,038 and $232,123 respectively. Additional staff required to consistently maintain a high level of customer support in light of the Company's expanding customer base caused the Customer Support costs to increase. Increased Product Handling costs was a function of greater shipment volume to customers. The increase in General and Administrative costs was mainly for contractual wage increases, higher rent, utilities and building costs for the Company's sales office in California, which opened in June 1997, higher communication costs due to increased voice and data traffic, and approximately $60,000 in listing fees related to the Company's move to the NASDAQ National Market from the NASDAQ Small Cap Market.

Research and development expenses increased $247,721 or approximately 44%. The increase was due to the strategic addition of personnel which is in line with the Company's commitment to expand its engineering research and development resources to continually enhance current products and further develop future product lines.

The Company had net other income of $420,796 compared to net other income for the prior fiscal year of $234,291. The increase in net other income was primarily foreign currency exchange rate gains as a result of favorable foreign rates.

Provision for income taxes was $523,937, or an effective tax rate of 21% in fiscal 1998 compared to $56,003 or an effective tax rate of 5% for fiscal 1997. The 16% increase in the effective tax rate is due primarily to the utilization of all the remaining unrestricted net operating loss carry forwards in fiscal 1997 and the tax benefit realized in the fourth quarter of fiscal 1997 for the disposal of approximately $400,000 of obsolete inventory.

During the fiscal years prior to 1997, the Company, due to unpredictable sales, new product introduction, rapid product change and the limited track record of profitability, had recorded full valuation allowances against deferred tax assets. At September 30, 1997, the company had $513,798 in deferred tax assets offset by a valuation allowance of $419,798, resulting in a net deferred tax asset of $94,000. At the end of fiscal 1998, in recognition of the continued profitability of the Company, the ability to carry back deferred tax benefits to offset prior year taxable income and projected profitability, the Company decided to not only substantially reduce the existing valuation, but to forego recording a valuation on deferred tax assets recorded in fiscal 1998. In recognition of this, the Company reduced the valuation allowance by $292,798 during the fourth quarter. Also in the fourth quarter, the Company recognized a net addition to deferred tax assets of $210,333. The reduction of the valuation allowance and the increase in 1998 deferred tax assets without any corresponding valuation allowance resulted in a reduction in the tax provision of $503,131. As of September 30, 1998, the company had deferred tax assets of $ 724,131 offset by a valuation allowance of $127,000, resulting in a net deferred tax asset of $ 597,131.

As a result of the above, the Company recorded net income after taxes for the year ended September 30, 1998 of $1,958,553, which resulted in basic and diluted earnings per share of $0.44 and $0.42 respectively, on weighed average basic and diluted shares outstanding of 4,403,357 and 4,676,747, respectively, compared to net income after taxes of $985,808 for the year ended September 30, 1997, which resulted in basic and diluted earnings per share of $0.22 on weighted average basic and diluted shares of 4,427,440 and 4,434,598, respectively.

Since the Company sells primarily to the consumer market, the Company has experienced certain revenue trends. The sales of the Company's products, which are primarily sold through distributors and retailers, has historically recorded stronger sales results 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 73%, 72 % and 66% of sales for the years ended September 30, 1999, 1998 and 1997, 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.

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

liquidity&capitalresources

The Company's cash, working capital and stockholders' equity position is disclosed below:

	As of September 30,		
	1999	1998	1997
Cash	$ 6,122,922	$ 6,281,852	$ 5,602,412
Working Capital	12,533,310	9,536,450	8,689,914
Stockholders' Equity	13,322,091	10,036,898	8,966,772

The significant items of cash provided by and cash (consumed) for the fiscal year ended September 30, 1999 are detailed below:

Net income (adjusted for non cash items), excluding deferred tax benefits	$ 3,349,994
Changes to deferred tax assets	120,057
Increase in investment for current assets	(4,855,784)
Operations funded by current liabilities-net	1,544,937
Purchase of Property, Plant & Equipment	(431,288)
Other	113,154
Net Cash Consumed	(158,930)

Net cash of $ 159,204 provided by operating activities was primarily due to cash generated from net income (adjusted for non cash items) of $3,349,994, a net decrease in deferred tax assets of $ 120,057 and operations funded by the increase in current liabilities of $1,544,937, offset partially by cash invested in current assets of $4,855,784.

Cash of $431,288 was used to purchase fixed assets. The exercise of employee options provided additional cash of $192,691. The purchase of treasury shares consumed $63,525 in additional cash.

The Company's asset based credit facility expired on February 28, 1998. The Company has chosen not to renew the loan facility. The Company feels it is in a position to obtain new financing at more competitive rates, and is currently negotiating with new institutions to replace the expired loan facility.

On November 8, 1996, the Company approved a stock repurchase program for the repurchase of up to 300,000 shares of its own stock. The Company will use the repurchased shares for certain employee benefit programs. On December 17, 1997, the stock repurchase program was extended by a resolution of the Board of Directors. Through September 30, 1999, the Company had repurchased 214,300 shares for $1,267,129 at an average purchase price of approximately $5.91 per share.

The Company believes that its current cash position and its internally generated cash flow will be sufficient to satisfy the Company's anticipated operating needs for at least the ensuing twelve months.

inflation

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

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.

Effective January 1, 1999, the Company began invoicing its customers, located in the eleven member countries, in Euros. The benefits to the Company were twofold:

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

The conversion to the Euro was handled by the Company without any material disruptions to the Company's operations.

effect of new accounting pronouncements

investment derivatives and hedging activities income

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133 ("SFAS 133"), Accounting for Derivative Investments and Hedging Activities Income. SFAS 133 is effective for transactions entered into after June 15, 2000. SFAS 133 requires that all derivative instruments be recorded on the balance sheet at fair value. Changes in the fair value of the derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designed as part of the hedge transaction and the type of hedge transaction. The ineffective portion of all hedges will be recognized in earnings. The Company is in the process of determining the impact that the adoption of SFAS 133 will have on its results of operations and financial position.

year2000

Many computer systems were not designed to handle dates beyond the year 1999. The Company evaluated the effect of Year 2000 issues relating to its internal computer systems and has concluded that its system was not Year 2000 compliant. In recognition of this, the Company purchased and installed new software and upgraded its computer hardware during fiscal 1999. Testing was performed in house by Company personnel, with assistance from an outside consultant. The hardware upgrades and the implementation of new software began in January 1999. The new system was fully operational on October 1, 1999. The cost to the Company to become Year 2000 compliant was approximately $150,000, which was funded through internally generated cash flow, capitalized to fixed assets and will be amortized over a period as prescribed by generally accepted accounting principles.

The Company has been advised by its vendor that the Company's phone system, installed during fiscal 1998, is Year 2000 compliant. The Company's facility security system was upgraded during fiscal 1999 and the Company has been advised by its vendor that such system is Year 2000 compliant.

During fiscal 1999, the company sent Year 2000 questionnaires to third parties the Company does business with in order to identify, if possible, the status of the third parties' Year 2000 readiness. The Company received a majority of responses back by the close of the 1999 fiscal year. Although the responses showed that these third parties were either Year 2000 compliant or working to resolve their Year 2000 compliance issues, the Company has limited or no control over the actions taken by these third parties. Accordingly, there can be no assurance that all the third parties the Company does business with will successfully resolve all of their Year 2000 issues. The failure of these third parties to resolve their Year 2000 issues could have a potentially adverse affect on the Company. The Company continues to monitor the readiness of third parties we currently due business with and look to procure new third parties who are year 2000 compliant in an effort minimize the risk to the Company.

The Company has a contingency plan to respond to the possible effects the Year 2000 problem has on third parties that are important to the Company's operations. The Company has communicated with its critical suppliers, vendors, customers, utilities, financial institutions and telecommunication providers with whom it does significant business to identify any Year 2000 issues. The Company will continue to communicate with and review the progress of these third party enterprises in resolving their Year 2000 issues. The ability to accurately assess the Company's third parties' readiness is dependent in large part upon the reliability and completeness of their representations.

riskfactors

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

marketrisks

Since the Company has extensive sales to European customers, the Company is exposed to market risks resulting from the fluctuations in the foreign currency exchange rates to the dollar. The Company attempts to reduce these risks by utilizing foreign exchange hedging contracts.

The value of the Euro and British Pound against the dollar can affect the Company's financial results. Changes in exchange rates may positively or negatively affect the Company's revenues (as expressed in U.S. dollars), gross margins, operating income and retained earnings. Where it deems prudent, the Company engages in hedging programs aimed at limiting, in part, the impact of currency fluctuations. Primarily selling foreign currencies through window contracts, the Company attempts to hedge its foreign sales against currency fluctuations.

As of September 30, 1999, the Company has foreign currency forward contracts outstanding of approximately $4.0 million for the Euro. The contracts expire through January 2000. As of September 30, 1999, the Company had deferred gains from foreign currency forward contracts of under $2,000.

These hedging activities provide only limited protection against currency exchange risks. Factors that could impact the effectiveness of the Company's programs include volatility of the currency markets and availability of hedging instruments. The contracts the Company procures are specifically entered into to as a hedge against existing or anticipated exposure. The Company does not enter into contracts for speculative purposes. Although the Company maintains these programs to reduce the impact of changes in currency exchange rates, when the U.S. dollar sustains a strengthening position against the currencies in which the Company sells it products, the Company's revenues can be adversely affected.

selected

financial

data

Fiscal 1999 was a great year for Hauppauge Digital with a 51% increase in revenue over fiscal 1998.

Years ended September 30,	1999	1998	1997	1996	1995
		(in thousands, except for per share amounts)			
Net Sales	$ 58,602	$ 38,757	$ 25,613	$ 14,695	$ 11,551
Cost of sales	42,435	28,643	19,962	11,014	9,244
Gross Profit	16,167	10,114	5,651	3,681	2,307
Selling, General and Administrative Expenses	10,458	7,244	4,283	3,022	3,151
Research & Development Expenses	1,256	808	560	448	269
Income (loss) from operations	4,453	2,062	808	211	(1,113)
Other Income (Expense):					
Interest Income	201	236	243	82	29
Other, net	(61)	184	(9)	16	(439)
Income (loss) before taxes on income	4,593	2,482	1,042	309	(1,523)
Income tax provision	1,602	1,027	150	30	–
Reduction in deferred tax valuation allowance	(127)	(503)	(94)	–	–
Net tax provision	1,475	524	56	30	–
Net income, (loss)	$ 3,118	$ 1,958	$ 986	$ 279	$ (1,523)
Net income, (loss) per share:					
Basic	$ 0.72	$ 0.44	$ 0.22	$ 0.09	$ (0.64)
Diluted	$ 0.66	$ 0.42	$ 0.22	$ 0.09	$ (0.64)
Weighted average shares outstanding:					
Basic	4,316	4,403	4,427	3,261	2,383
Diluted	4,740	4,677	4,435	3,261	2,383
Balance Sheet Data (at period end):					
Working capital	$ 12,533	$ 9,536	$ 8,689	$ 7,969	$ 1,472
Total assets	27,728	22,897	14,471	11,931	4,946
Stockholders' equity	13,322	10,037	8,966	8,174	1,675

consolidated balance sheets

assets

	September 30, 1999	September 30, 1998
Current Assets:		
Current Assets:		
Cash and cash equivalents	$ 6,122,922	$ 6,281,852
Accounts receivable, net of allowance for doubtful accounts of $135,000 and $100,000	6,973,452	6,497,163
Inventories	12,957,439	8,552,097
Prepaid expenses and other current assets	407,916	468,763
Deferred tax assets	477,074	597,131
Total current assets	26,938,803	22,397,006
Property, plant and equipment, net	718,562	443,610
Security deposits and other non current assets	70,219	56,838
	$ 27,727,584	$ 22,897,454

liabilities&stockholders' equity:

	1999	1998
Current Liabilities:		
Accounts payable	$ 11,208,777	$ 9,497,003
Accrued expenses	2,698,161	2,342,380
Income taxes payable	498,555	1,021,173
Total current liabilities	14,405,493	12,860,556
Commitments and Contingencies (Notes 5, 8 and 9)		
Stockholders' Equity		
Common stock $.01 par value; 10,000,000 shares authorized, 4,560,302 and 4,501,402 issued, respectively	45,603	45,014
Additional paid-in capital	10,696,208	10,465,707
Retained earnings	3,847,409	729,781
Treasury stock, at cost, 214,300 and 207,200 shares, respectively	(1,267,129)	(1,203,604)
Total stockholders' equity	13,322,091	10,036,898
	$ 27,727,584	$ 22,897,454

See accompanying notes to consolidated financial statements

consolidated statements of income

	Years ended September 30,		
	1999	1998	1997
Net sales	$ 58,601,611	$ 38,757,443	$ 25,613,252
Cost of sales	42,434,612	28,643,843	19,962,035
Gross profit	16,166,999	10,113,600	5,651,217
Selling, general and administrative expenses	10,457,713	7,243,818	4,283,330
Research & development expenses	1,256,536	808,088	560,367
Income from operations	4,452,750	2,061,694	807,520
Other income (expense):			
Interest income	201,392	236,441	243,235
Other, net	(61,514)	184,355	(8,944)
Income before taxes on income	4,592,628	2,482,490	1,041,811
Taxes on income	1,475,000	523,937	56,003
Net income	$ 3,117,628	$ 1,958,553	$ 985,808
Net income per share-basic	$ 0.72	$ 0.44	$ 0.22
Net income per share-diluted	$ 0.66	$ 0.42	$ 0.22

See accompanying notes to consolidated financial statements

consolidated statements of shareholders equity

for the years ended September 30, 1999, 1998 and 1997

	Common Stock Number Of shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Treasury Stock	Total
Balance at October 1, 1996	4,465,302	$ 44,653	$ 10,344,844	$ (2,214,580)	$ –	$ 8,174,917
Net income				985,808	–	985,808
Purchase of treasury stock					(193,953)	(193,953)
Balance at September 30, 1997	4,465,302	$ 44,653	$ 10,344,844	$ (1,228,772)	$ (193,953)	$ 8,966,772
Net income				1,958,553		1,958,553
Purchase of treasury stock					(1,009,651)	(1,009,651)
Exercise of stock options	29,600	296	91,272			91,568
Stock issued to pay bonuses	6,500	65	29,591			29,656
Balance at September 30, 1998	4,501,402	$ 45,014	$ 10,465,707	$ 729,781	$ (1,203,604)	$ 10,036,898
Net income				3,117,628		3,117,628
Purchase of treasury stock					(63,525)	(63,525)
Exercise of stock options	58,600	586	192,105			192,691
Compensation in options for consulting services			36,000			36,000
Stock issued to pay bonuses	300	3	2,396			2,399
Balance at September 30, 1999	4,560,302	$ 45,603	$ 10,696,208	$ 3,847,409	$ (1,267,129)	$ 13,322,091

See accompanying notes to consolidated financial statements

consolidated statements of cash flows

	Years ended September 30, 1999	1998	1997
Cash flows from operating activities:			
Net income	$ 3,117,628	$ 1,958,553	$ 985,808
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	158,967	88,138	50,783
Provision for doubtful accounts	35,000	50,000	24,367
Compensation paid in stock and options	38,399	29,656	–
Deferred income taxes	120,057	(503,131)	(94,000)
Changes in current assets and liabilities:			
Accounts receivable	(511,289)	(3,353,030)	(1,382,610)
Inventories	(4,405,342)	(3,707,731)	(1,705,405)
Prepaid expenses and other current assets	60,847	(9,223)	(268,379)
Accounts payable	1,711,774	5,093,216	1,584,954
Accrued expenses	(166,837)	2,262,808	163,894
	(2,958, 424)	(49,297)	(1,626,396)
Net cash provided by (used in) operating activities	159,204	1,909,256	(640,588)
Cash flows from investing activities:			
Purchases of property, plant and equipment	(431,288)	(311,733)	(120,002)
Security deposits and other	(16,012)	–	(2,220)
Net cash used in investing activities	(447,300)	(311,733)	(122,222)
Cash flows from financing activities:			
Purchase of treasury stock	(63,525)	(1,009,651)	(193,953)
Proceeds from the exercise of stock options	192,691	91,568	–
Net cash provided by (used in) financing activities	129,166	(918,083)	(193,953)
Net (decrease) increase in cash and cash equivalents	(158,930)	679,440	(956,763)
Cash and cash equivalents, beginning of period	6,281,852	5,602,412	6,559,175
Cash and cash equivalents, end of period	$ 6,122,922	$ 6,281,852	$5,602,412
Supplemental disclosure:			
Income taxes paid	$ 1,971,561	$ 148,522	$ 66,895

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., Hauppauge Digital Asia, PTE, and Hauppauge Digital SARL, as well as Hauppauge Computer Works, GMBH and Hauppauge Computer Works, Ltd., both wholly owned subsidiaries of Hauppauge Computer Works, Inc. (collectively, the "Company"). All inter company accounts and transactions have been eliminated.

nature of business

The Company is primarily engaged in the design, manufacture and marketing of WinTV® video computer boards and video conferencing boards. Win/TV boards convert moving video images from cable TV, video cameras or a VCR to a digital format which is displayed in a sizable window on a PC monitor. These video images can be viewed simultaneously with normal PC operations such as word processing programs and spreadsheet applications. The WinTV® board is marketed worldwide through retailers, distributors, original equipment manufacturers and manufacturers' representatives. Net sales to international and domestic customers were approximately 73% and 27%, 72% and 28%, and 66% and 34% of total sales for the years ended September 30, 1999, 1998 and 1997, respectively. The Company operates in only one segment. The Company maintains sales offices in both Europe and Asia. Long lived assets of the foreign operations are immaterial and therefore not separately disclosed.

Net sales to customers by geographic location consist of:

	Years ended September 30,		
Sales to:	1999	1998	1997
United States	27%	28%	34%
Germany	43%	38%	28%
United Kingdom	13%	19%	20%
France	6%	2%	–
Netherlands	2%	3%	5%
Other Countries	9%	10%	13%
Total	100%	100%	100%

use of estimates

In preparing financial statements in conformity with generally accepted accounting principles, 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 7). 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.

revenue recognition

The Company records revenue when its products are shipped. Provisions for estimated sales allowances and returns are accrued at the time revenues are recognized.

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 an 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.

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 & equipment

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

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

income taxes

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

long-lived assets

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

foreign currency transactions & operations

The Company sells products and services to foreign customers through local sales offices. Revenues and expenses are recorded in U.S. dollars at the current exchange rate at the time of the transaction. Gains due to the changes in exchange rate totaling approximately $184,000 for fiscal 1998 and losses totaling approximately $62,000 and $16,000 for fiscal 1999 and 1997 were included as a component of Other, net, in the statement of income.

financial instruments

The Company uses forward exchange contracts to hedge certain firm commitments denominated in foreign currencies. Gains and losses on these positions are deferred and included in the Statement of Income as part of Other, net, when the transaction is completed.

fair value of financial instruments

The carrying amounts of certain financial instruments, including cash, accounts receivable and accounts payable, approximate fair value as of September 30, 1999 because of the relatively short term maturity of these instruments.

net income per share

Basic earnings per share includes no dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings 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 per share follows:

	Years ended September 30.		
	1999	1998	1997
Weighted average shares outstanding-basic	4,316,216	4,403,357	4,427,440
Common stock equivalents-stock options	423,658	273,390	7,158
Weighted average shares outstanding-diluted	4,739,874	4,676,747	4,434,598

Options to purchase approximately 47,500 shares of common stock at exercise prices of $17.50 to $20.00 per share were outstanding during a portion of 1999, but were not included in the computation of diluted earnings per share because they are anti-dilutive. These options expire through 2004.

The Company repurchased 7,100, 148,000 and 59,200 shares in fiscal 1999, 1998 and 1997, respectively, for treasury purposes (see note 6a). These shares, on a weighted average basis, have been excluded in calculating weighted average shares outstanding.

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" (see note 6c).

prospective accounting changes

Investment Derivatives and Hedging Activities Income

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133 ("SFAS 133"), Accounting for Derivative Investments and Hedging Activities Income. SFAS 133 is effective for transactions entered into after June 15, 2000. SFAS 133 requires that all derivative instruments be recorded on the balance sheet at fair value. Changes in the fair value of the derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designed as part of the hedge transaction and the type of hedge transaction. The ineffective portion of all hedges will be recognized in earnings. The Company is in the process of determining the impact that the adoption of SFAS 133 will have on its results of operations and financial position.

2. inventories

Inventories consist of the following:

	September 30, 1999	September 30, 1998
Component Parts	$ 4,875,940	$ 1,445,811
Work in Process	494,285	511,640
Finished Goods	7,587,214	6,594,646
	$ 12,957,439	$ 8,552,097

3. property, plant & equipment

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

	September 30, 1999	September 30, 1998
Office Equipment and Machinery	$ 1,178,805	$ 773,384
Leasehold Improvements	58,436	32,569
	1,237,241	805,953
Less: Accumulated depreciation and amortization	518,679	362,343
	$ 718,562	$ 443,610

4. income taxes

The income tax provision consists of the following:

	Years ended September 30, 1999	1998	1997
Current tax expense:			
Federal income taxes	$ 1,125,234	$ 932,653	$ 120,284
State income taxes	129,709	94,415	29,719
Foreign income taxes	100,000	–	–
Total current	$ 1,354,943	$1,027,068	$ 150,003
Deferred tax expense (benefit)			
Federal	107,417	(450,170)	(84,105)
State	12,640	(52,961)	(9,895)
Total deferred	120,057	(503,131)	(94,000)
Total taxes on income	$ 1,475,000	$ 523,937	$ 56,003

Components of deferred taxes are as follows:

	Years ended September 30, 1999	1998
Deferred tax assets:		
Net operating loss carry forwards	$ 47,612	$ 152,259
Inventory obsolescence reserve	125,400	101,853
Warranty reserve	27,550	27,550
Allowance for doubtful accounts	66,107	33,807
Deferred rent payments	39,632	41,632
Capitalized inventory costs	92,109	74,129
Sales return reserve	65,189	272,141
Other reserves	13,475	20,760
Total deferred assets	477,074	724,131
Valuation allowance	–	(127,000)
Net deferred tax assets	$ 477,074	$ 597,131

Prior to 1997, due to new products, the relative volatility of the industry the Company operates in and the limited track record of profitability, the Company had recorded a full valuation allowance against the deferred tax assets. In recognition of market acceptance of the Company's product as evidenced by the expansion of sales, along with consecutive years of profitability, the Company reduced the valuation allowance by $127,000, $292,798 and $282,408, primarily in the fourth quarter of fiscal 1999, 1998 and 1997, respectively, which resulted in the recognition of deferred tax benefits of $127,000, $503,131 and $94,000, respectively.

As of September 30, 1999, the Company had net operating losses, (which expire in the years through 2010), of $125,295 available to offset future taxable income. Due to the change in control which resulted from the Company's January 10, 1995 initial public offering of stock, all of the remaining unused net operating losses are subject to limitations per Internal Revenue code section 382. The Company's carry forward utilization of these restricted net operating losses is limited to $275,386 per year. In 1999 and 1998, the Company utilized $275,386 in restricted tax loss carry forwards.

The difference between the actual income tax provision and the tax provision 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,		
	1999	1998	1997
Income tax at federal statutory rate	$1,561,494	$ 844,047	$ 354,816
Reduction in deferred income tax			
Valuation allowance (see above)	(127,000)	(292,798)	(282,408)
Permanent differences	48,356	21,250	–
Income taxed at lower than statutory rates	(159,219)	(104,995)	(36,020)
State income taxes, net of federal benefit	85,608	62,040	19,615
Foreign income taxes	100,000	–	–
Research and Development credit	(100,000)	(75,000)	–
Other	65,761	69,393	–
Taxes on income	$1,475,000	$ 523,937	$ 56,003

5. line of credit

On March 28, 1996, Hauppauge Computer Works, Inc, a wholly owned subsidiary of Hauppauge Digital, Inc., entered into a Credit Agreement with a bank which expired on February 28, 1998. The Credit Agreement provided for, among other things, a two year asset based line of credit, whereby the Company may borrow up to $1,600,000. The loan required the Company to maintain certain financial covenants and the Company was prohibited from paying cash dividends during the term of the Credit Agreement. The line expired on February 28, 1998, and the Company chose not to renew the line. The Company is now seeking to replace this loan facility and believes it can replace this credit facility at more favorable rates.

6. shareholders' equity

a. treasury stock

On November 8, 1996, the Company approved a stock repurchase program for the repurchase of up to 300,000 shares of its own Common Stock. The repurchased shares will be used by the Company for certain employee benefit programs. The total shares purchased as of September 30, 1999 were 214,300 for $1,267,129, at an average price of $5.91. As of September 30, 1998 the Company had repurchased 207,200 shares for $1,203,604, at an average price of $5.81. As of September 30, 1997, the Company had repurchased 59,200 for $193,953, at an average price of $3.28.

b. exercise of stock options

During fiscal 1999 and 1998, 58,600 and 29,600 options from the Company's incentive stock option plans were exercised at an average prices of $3.29 and $3.09. The Company realized $ 192,691 and $91,568 in proceeds for the exercise of options for fiscal 1999 and 1998, respectively.

c. 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, 200,000 options may be granted for up to ten years with exercise prices during the first two years subsequent to the IPO being the greater of the IPO offering price per unit ($3.15) or the fair market value of the common stock at the date of the grant. After the initial two year period, the option price shall be no less than the fair market value of the stock on the date the options are granted. As of September 30, 1999, 1998 and 1997, 110,800, 167,200 and 160,000 options were outstanding, respectively, ranging in prices from $2.69 to $5.09.

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 Non-Qualified Plan authorizes the grant of 250,000 shares. 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, 1999, 1998 and 1997, 159,000. 110,000 and 40,000 options ranging in prices from $2.69 to $20 have been granted to employees 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 ("ISO") pursuant to section 422A of the Internal Revenue Code. This plan was approved by the Company's shareholders at the Company's March 12, 1998 annual shareholder meeting. The plan as adopted authorizes the grant of 350,000 shares of common stock, subject to adjustment as provided in the plan. The plan terminates on December 16, 2007. The options terms may not exceed ten years. Options can not be granted at less than 100% of the market value at the time of grant. Options granted top employees who own more the 10% of the Company's outstanding common stock will be granted options at not less than 100% of the market value of the stock at the date of grant. As of September 30, 1999 and 1998, 334,950 and 148,150 were outstanding with exercise prices from $4.50 to $ 17.50.

On September 30, 1999, 1998 and 1997, in connection with employment contracts the Company had with the Chief Executive Officer and President, 60,000 non qualified stock options for each year became exercisable.

The Company accounts for its stock option awards under the intrinsic value based method, as prescribed by APB Opinion 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations. Under APB 25, because the exercise price of the employees stock options equals the market price of the underlying stock at the date of the grant, no compensation is cost is recognized.

SFAS Statement 123, "Accounting for Stock Based Compensation," ("SFAS 123") requires the Company to provide pro forma information regarding net income and earnings 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 1999, 1998 and 1997: risk free interest rates of 4.25%, 4.25% and 5.92% for 1999, 1998 and 1997, volatility factor of the expected market price of the Company's stock 35%, 37% and 35% for 1999, 1998 and 1997, and expected lives of either five or ten years. The weighted average fair value of options granted in 1999, 1998 and 1997 were $1.71 to $6.66, $1.63 to $2.58 and $1.15 to $1.75, 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,		
	1999	1998	1997
Net income:			
As reported	$ 3,117,628	$ 1,958,553	$ 985,808
Pro forma	2,749,697	1,724,754	843,123
Net income, per share:			
As reported			
Basic	$ 0.72	$ 0.44	$ 0.22
Diluted	$ 0.66	$ 0.42	0.22
Pro Forma			
Basic	$ 0.64	$ 0.39	0.19
Diluted	$ 0.58	$ 0.37	0.19

A summary of the status of the Company's fixed options plans as of September 30, 1999, 1998 and 1997 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, 1996	87,000	$ 3.68	30,000	$ 3.00
Granted	91,100	2.78	70,000	3.08
Exercised	–	–	–	–
Forfeited	(20,600)	3.70	–	–
Balance at September 30, 1997	157,500	$ 2.95	100,000	$ 3.06
Granted	190,650	4.74	130,000	4.10
Exercised	(29,600)	3.10	–	–
Forfeited	(3,200)	3.10	–	–
Balance at September 30, 1998	315,350	$ 4.10	230,000	$ 3.64
Granted	197,000	8.63	109,000	8.02
Exercised	(58,600)	3.29	–	–
Forfeited	(8,000)	3.96	–	–
Balance at September 30, 1999	445,750	$ 6.24	339,000	$ 5.05
Options exercisable at year end	52,350	$ 4.65	267,000	$ 3.70

The following table summarizes information about stock options outstanding at September 30, 1999:

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise
$2.69	40,900	3.4 years	$ 2.69	10,800	$2.69
3.00	30,000	6.4	3.00	24,000	3.00
3.15	180,000	5.3	3.15	180,000	3.15
2.93	800	3.8	2.93	–	2.93
3.37	4,500	3.9	3.37	–	3.37
3.75	34,600	2.6	3.75	10,600	3.75
4.13	7,500	4.0	4.13	1,500	4.13
5.09	90,000	3.3	5.09	30,000	5.09
4.63	60,000	8.3	4.63	24,000	4.63
4.50	80,450	3.4	4.50	9,450	4.50
6.44	10,000	3.5	6.44	10,000	6.44
7.50	4,000	1.0	7.50	4,000	7.50
7.75	15,000	4.3	7.75	15,000	7.75
20.00	25,000	4.8	20.00	–	20.00
7.88	149,500	4.5	7.88	–	7.88
5.63	30,000	4.0	5.63	–	5.63
17.50	22,500	4.7	17.50	–	17.50
	784,750			319,350	

7. significant customer information

For the years ended September 30, 1999 and 1998 the Company had no single customer who accounted for more that 10% of net sales. As of September 30, 1999 and 1998 the Company had five and four customers who accounted for 66% and 51%, respectively of the net accounts receivable. For the year ended September 30, 1997, the Company had two customers who accounted for 12% and 11% of net sales, respectively.

8. related party transactions

The Company rents its principal office and warehouse space in Hauppauge, New York from a real estate partnership owned by the two principal shareholders of the Company. 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. On December 17, 1997 in connection with a re-negotiation of the lease term, the Company granted 60,000 options to a real estate partnership owned by the principal shareholders at an exercise price of $3.81 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 indebtedness incurred by the two principal shareholders to purchase the building is also guaranteed by the Company and totaled $978,655 at September 30, 1999.

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

Year ended September 30,	
2000	505,507
2001	493,474
2002	514,413
2003	489,372
2004	503,000
Thereafter	745,702
	$ 3,251,468

Rent expense totaled approximately $432,196, $399,166 and $373,704 for the years ended September 30, 1999, 1998 and 1997, respectively. The Company pays the real estate taxes and is responsible for normal building maintenance.

9. commitment & contingencies

a. litigation

In the normal course of business, the Company is a party to various claims and/or litigation. Management and the Company's 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.

In January 1998, Advanced Interactive Incorporated ("AII") contacted the Company and attempted to induce the Company to enter into a patent license or joint venture agreement with AII relative to certain of the Company's products. AII alleged that such products infringe U.S. Patent No. 4, 426, 698 (the "AII Patent"). At such time, the Company's engineering staff analyzed the AII Patent and determined that the Company's products did not infringe any such patent. Accordingly, the Company rejected AII's offer.

On October 6, 1998, the Company received notice that AII had commenced an action against it and multiple other defendants in the United States District Court for the Northern District of Illinois, alleging that the certain of the Company's products infringe on certain patent rights allegedly owned by the plaintiff. The complaint seeks unspecified compensatory and statutory damages with interest. The Company denies such allegations and intends to vigorously defend this action. On December 22, 1998, the Company filed its Answer (the "Answer").

Among other things, pursuant to the answer, the Company denies that its products infringe AII's patent rights and asserts certain affirmative defenses. In addition, the Answer contains a counterclaim challenging the validity of AII's alleged patent rights.

Notwithstanding the foregoing, because of the uncertainties of litigation, no assurances can be given as to the outcome of the AII litigation. In the event that the Company were not to prevail in this litigation, the Company could be required to pay significant damages to AII and could be enjoined from further use of such technology as it presently exists. Although a negative outcome in the AII litigation would have a material adverse affect on the Company, including, but not limited to, its operations and financial condition, the Company believes that, if it is held that the Company's products infringe AII's patent rights, the Company would attempt to design components to replace the infringing components or would attempt to negotiate with AII to utilize its system, although no assurances can be given that the Company would be successful in these attempts. At the present time, the Company can not assess the possible cost of designing and implementing a new system or obtaining rights from AII

b. employment contracts

On January 10, 1998, upon the expiration of prior employment agreements, the Company's chief executive officer and president entered into new employment agreements with the Company. The term of the employment agreements is for three years which is automatically renewed each year unless otherwise not authorized by the Board of Directors. The agreements provide each executive with an annual base salary of $125,000, $150,000 and $180,000 for the first, second and third year of the contract. For each annual year thereafter, compensation shall be mutually determined, but can not be less that the preceding year.

The contract also provides for a bonus of 2% of operating income (income from operations but before interest and other income) to be paid if the operating income exceeds the prior year's operating earnings by 120%. A 1% bonus on operating income will be paid if the operating income exceed the prior year's operating by less than 120%. The agreement also obligates the Company to provide certain disability, medical and life insurance, and other benefits. In the event of a change of control as defined in the employment agreement, a one time bonus shall be paid equal to the executive's average annual compensation, including base compensation, bonus and benefits, received by him during the thirty six month period preceding the change in control.

Pursuant to the January 10, 1998 employment agreements, on January 21, 1998, incentive stock options to acquire 45,000 shares each, exercisable in increments of 33 1/3 % per year at $5.0875 for a period of five years from the date the options first become exercisable, were granted to the chief executive officer and the president. In addition, options to purchase 30,000 non qualified options were issued to the chief executive officer and president, exercisable for a period of ten years at $4.625.

c. forward exchange contracts

The Company, in an effort to manage the volatility that exchange rates have upon foreign sales, maintains a program of selling forward foreign currencies based on future estimated revenue. The amount of window contracts open, at September 30, 1999, was approximately $4 million Euros, ranging in prices from 1.066 to 1.0717, which expire through January 2000. As of September 30, 1999, the Company has deferred foreign gains of approximately $2,000, based on the September 30, 1999 Euro exchange rate of 1.066 dollars to 1 Euro. The Company will continue this strategy of hedging projected future revenues invoices in foreign currency in an effort to control the impact of foreign currency fluctuations.

report of the independent certified public accountants

BDO

To the Board of Directors and Shareholders 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, 1999 and 1998 and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years ended September 30, 1999. 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 generally accepted auditing standards. 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, 1999 and 1998 and the results of their operations and their cash flows for each of the three years in the period ended September 30, 1999 in conformity with generally accepted accounting principles.

BDO Seidman, LLP

BDO Seidman, LLP

Melville, New York
December 10, 1999

report of the independent certified public accountants

BDO

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

The audits referred to in our report dated December 10, 1999 relating to the consolidated financial statements of Hauppauge Digital, Inc. included the audits of the financial statement Schedule II-Valuation and Qualifying Accounts for each of the three years in the period ended September 30, 1999. This financial statement schedule is the responsibility of management. Our responsibility is to express an opinion on this schedule based on our audits.

In our opinion, such financial statement Schedule-Valuation and Qualifying Accounts, presents fairly, in all material respects, the information set forth therein.

BDO Seidman, LLP

BDO Seidman, LLP

Melville, New York
December 10, 1999

schedule II-valuation and qualifying accounts

Description	Balance at Beginning of Period	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions (1)	Balance at End of Period
YEAR ENDED SEPTEMBER 30, 1999					
Reserve and allowances deducted from asset accounts................	100,000	585,000		550,000	135,000
Allowance for doubtful accounts					
YEAR ENDED SEPTEMBER 30, 1998					
Reserve and allowances deducted from asset accounts					
Allowance for doubtful accounts	100,000	50,000		50,000	100,000
YEAR ENDED SEPTEMBER 30, 1997					
Reserve and allowances deducted from asset accounts					
Allowance for doubtful accounts	75,000	25,000		–	100,000

(1) Doubtful accounts written off net of collections

corporate information

executive offices

91 Cabot Court
Hauppauge, New York 11788

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.
Hauppauge Computer Works, Ltd. (Virgin Islands)
Hauppauge Computer Works, GmbH
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
90 Merrick Rd.
East Meadow, NY 11554

auditors

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

common stock and warrants

NASDAQ National Market

symbols

NASDAQ
HAUP (Common Stock)

officers and directors

Kenneth R. Aupperle
President, Chief Operating Officer and a Director

Kenneth Plotkin
Chairman of the Board, Chief Executive Officer, Secretary and Vice-President of Marketing

Gerald Tucciarone
Chief Financial Officer and Treasurer

John Casey
Vice-President of Technology

Bernard Herman
Director

Steven Kuperschmid
Director. Partner, Certilman, Balin, Adler & Hyman

annual report on form 10-ksb available

A copy of the Company's Annual Report on Form 10-KSB as filed with the Securities and Exchange Commission for September 30, 1999 can be obtained from the Company without charge by writing to:

Hauppauge Digital, Inc.
91 Cabot Court
Hauppauge, New York 11788
Attention: Kenneth Plotkin, Secretary

Hauppauge!®

91 cabot court, hauppauge, new york, usa 11788

tel: 631 434 1600 • fax: 631 434 3198

Visit our world wide web site on the internet:

http://www.hauppauge.com