

SBE INC  
Form 10-Q  
March 06, 2006

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

**FORM 10-Q**

(Mark one)

Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934

**For the quarterly period ended January 31, 2006**

Transition report pursuant to section 13 or 15(d) of the Securities and Exchange Act of 1934

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

Commission file number 0-8419

**SBE, INC.**

\_\_\_\_\_  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

94-1517641  
(I.R.S. Employer Identification No.)

4000 Executive Parkway, Suite 200, San Ramon, California 94583  
(Address of principal executive offices and zip code)

(925) 355-2000  
(Registrant's telephone number, including area code)

Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares of registrant's common stock outstanding as of January 31, 2006 was 9,955,158.

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**SBE, INC.**

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**PART I. Financial Information****Item 1. Financial Statements**

**SBE, INC.**  
**CONDENSED BALANCE SHEETS**  
(In thousands)

	January 31, 2006 (unaudited)	October 31, 2005 (A)
Current assets:		
Cash and cash equivalents	\$ 2,764	\$ 3,632
Trade accounts receivable, net	1,059	1,555
Inventories	1,633	1,283
Other	240	293
Total current assets	5,696	6,763
Property, plant and equipment, net	648	563
Capitalized software costs, net	10,422	11,424
Other	53	82
Total assets	\$ 16,819	\$ 18,832
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Trade accounts payable	\$ 933	\$ 743
Accrued payroll and employee benefits	116	155
Capital lease obligations - current portion	50	29
Deferred software revenue	178	138
Other accrued expenses	169	178
Total current liabilities	1,446	1,243
Capital lease obligations and deferred rent, net of current portion	322	241
Total liabilities	1,768	1,484
Commitments (note 7)		
Stockholders' equity:		
Common stock	33,460	35,431
Deferred compensation	—	(2,401)
Accumulated deficit	(18,409)	(15,682)
Total stockholders' equity	15,051	17,348
Total liabilities and stockholders' equity	\$ 16,819	\$ 18,832

(A) Derived from audited financial statements

See notes to condensed consolidated financial statements.



**SBE, INC.**  
**CONDENSED STATEMENTS OF OPERATIONS**  
(In thousands, except per share amounts)  
(Unaudited)

	Three months ended January 31,	
	2006	2005
Net sales	\$ 1,400	\$ 2,815
Cost of sales	1,825	1,230
Gross profit (loss)	(425)	1,585
Product research and development	946	473
Sales and marketing	598	559
General and administrative	771	369
Total operating expenses	2,315	1,401
Operating income (loss)	(2,740)	184
Interest and other income (expense)	18	(2)
Income (loss) before income taxes	(2,722)	182
Provision for income taxes	5	5
Net income (loss)	\$ (2,727)	\$ 177
Basic earnings (loss) per share	\$ (0.28)	\$ 0.03
Diluted earnings (loss) per share	\$ (0.28)	\$ 0.03
Shares used in per share computations:		
Basic	9,895	5,136
Diluted	9,895	5,869

See notes to condensed consolidated financial statements.

**SBE, INC.**  
**CONDENSED STATEMENTS OF CASH FLOWS**

(In thousands)  
(Unaudited)

	Three months ended January 31,	
	2006	2005
Cash flows from operating activities:		
Net income (loss)	\$ (2,727)	\$ 177
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Stock based compensation	445	—
Depreciation and amortization	1,086	72
Changes in operating assets and liabilities:		
Trade accounts receivable	496	(380)
Inventories	(350)	288
Other assets	82	(53)
Trade accounts payable	190	(330)
Other current liabilities	(6)	(98)
Other non-current liabilities	81	7
Net cash used in operating activities	(703)	(317)
Cash flows from investing activities:		
Purchases of property and equipment	(148)	(38)
Purchased software	(20)	(9)
Net cash used in investing activities	(168)	(47)
Cash flows from financing activities:		
Stock offering expense	(2)	—
Proceeds from stock plans	5	79
Net cash provided by financing activities	3	79
Net decrease in cash and cash equivalents	(868)	(285)
Cash and cash equivalents at beginning of period	3,632	1,849
Cash and cash equivalents at end of period	\$ 2,764	\$ 1,564
SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING ACTIVITIES:		
Non-cash stock portion of Antares purchase price	\$ —	\$ 114

See notes to condensed consolidated financial statements.

**SBE, INC.**  
**NOTES TO CONDENSED FINANCIAL STATEMENTS**  
(UNAUDITED)

**1. Interim Period Reporting:**

These condensed financial statements of SBE, Inc. are unaudited, and include all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations and cash flows for the interim periods presented. The results of operations for the three month period ended January 31, 2006 are not necessarily indicative of expected results for the full 2006 fiscal year.

Certain information and footnote disclosures normally contained in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes contained in our Annual Report on Form 10-K for the year ended October 31, 2005.

**Management Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles in the U.S. requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, as well as certain disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of net sales and expenses during the reporting period. Actual results could differ from these estimates. Significant estimates and judgments made by us include matters such as warranty obligations, indemnification obligations, collectibility of accounts receivable, realizability of inventories and recoverability of capitalized software and deferred tax assets.

**Stock Based Compensation**

Effective November 1, 2005, we adopted the provisions of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, (SFAS 123R) using the modified prospective method. See Note 4 for additional information regarding stock based compensation.

**Segment Information**

After we acquired PyX on July 26, 2005 we organized our operations into two business segments: Embedded and Storage Products. In the quarter ended January 31, 2006 we reorganized the company to one industry segment by combining the previously segmented engineering, sales, marketing groups to focus on delivering IP-based hardware and software products that are embedded in both communications and storage servers. We now have only one chief operating decision maker and analyze financial information on a single segment basis.



**2. Inventories:**

Inventories comprise the following (in thousands):

	January 31, 2006	October 31, 2005
Finished goods	\$ 1,166	\$ 815
Parts and materials	467	468
	\$ 1,633	\$ 1,283

The total reserve for slow moving and obsolete inventory is \$2,310,000 and \$2,313,000 at January 31, 2006 and October 31, 2005, respectively.

**3. Capitalized Software:**

Capitalized software costs comprise the following (in thousands):

	January 31, 2006	October 31, 2005
Purchased software	\$ 14,197	\$ 14,177
Less accumulated amortization	(3,775)	(2,753)
	\$ 10,422	\$ 11,424

We capitalized \$20,000, \$9,000 and \$12,424,000 of purchased software costs in the three months ended January 31, 2006 and 2005 and for the fiscal year ended October, 31, 2005, respectively. Amortization of capitalized software costs totaled \$1,022,000 and \$16,000 for the three months ended January 31, 2006 and 2005, respectively. Capitalized software costs consist of the allocation of the software relating to current products and the design of future iSCSI software products acquired in connection with our acquisition of PyX on July 26, 2005. We amortize capitalized software to cost of sales expense on a straight line basis over thirty-six months, beginning August 1, 2005, which is the expected useful life and which does not materially differ from the expected cash inflow from the sale of products related to the acquired PyX product line. It is our belief that no impairment to the software asset exists as of January 31, 2006.

**4. Net Income (Loss) Per Share:**

Basic income (loss) per common share for the three months ended January 31, 2006 and 2005 was computed by dividing the net income (loss) for such period by the weighted average number of shares of common stock outstanding for such period. Common stock equivalents for the three months ended January 31, 2006 were anti-dilutive and as such are not included in the calculation of diluted net loss per share. Common stock equivalents for the three months ended January 31, 2005 have been included in the calculation of diluted net income per share (in thousands).

**Common Stock Equivalents**

	Three months ended January 31,	
	2006	2005
Employee stock options	504	635
Common Stock issued relating to purchase of Antares	—	28
Warrants to purchase common stock	—	70
Common stock equivalents	504	733

	Three months ended January 31,	
	2006	2005
<b>Basic</b>	(in thousands, except per share amounts)	
Weighted average number of common shares outstanding	9,895	5,136
Number of shares for computation of net income (loss) per share	9,895	5,136
Net income (loss)	\$ (2,727)	\$ 177
Net income (loss) per share	\$ (0.28)	\$ 0.03

**Diluted**

Weighted average number of common shares outstanding	9,895	5,136
Shares issuable pursuant to options granted under stock option plans and warrants granted, less assumed repurchase at the average fair market value for the period	(a)	733
Number of shares for computation of net income (loss) per share	9,895	5,869
Net income (loss)	\$ (2,727)	\$ 177
Net income (loss) per share	\$ (0.28)	\$ 0.03

(a) In loss periods, all common share equivalents would have an anti-dilutive effect on net loss per share and therefore have been excluded.

## 5. Stock Based Compensation:

Effective November 1, 2005, we adopted SFAS 123R using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on the grant date and recognition of compensation expense over the requisite service period for awards expected to vest. The fair value of stock option grants is determined using the Black-Scholes valuation model, which is consistent with our valuation techniques previously utilized for options in footnote disclosures required under SFAS No. 123, *Accounting for Stock Based Compensation*, (SFAS 123) as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure* (SFAS 148). The fair value of restricted stock awards is determined based on the number of shares granted and the quoted price of our common stock. Such fair values will be recognized as compensation expense over the requisite service period, net of estimated forfeitures, using the accelerated method under SFAS 123R.

The fair value method under SFAS 123R is similar to the fair value method under SFAS 123 as amended by SFAS 148 with respect to measurement and recognition of stock-based compensation. However, SFAS 123 permitted us to recognize forfeitures as they occur, while SFAS 123R requires us to estimate future forfeitures and adjust our estimate on a quarterly basis. SFAS 123R also requires a classification change in the statement of cash flows; whereby, the income tax benefit from stock option exercises is reported as a financing cash flow rather than an operating cash flow as previously reported.

We have several Board and shareholder approved stock option plans for which stock options and restricted stock awards are available to grant to employees and directors. All employee and director stock options granted under our stock option plans have an exercise price equal to the market value of the underlying common stock on the grant date. There are no vesting provisions tied to performance conditions for any options as vesting for all outstanding option grants was based only on continued service as an employee of the Company. All of our outstanding stock options and restricted stock awards are classified as equity instruments.

### *Stock Options*

We sponsor three employee stock option plans, the 1996 Stock Option Plan (the 1996 Plan), the 1998 Non-Officer Stock Option Plan (the 1998 Plan) and the PyX 2005 Stock Option Plan (the PyX Plan). A total of 2,730,000 shares of common stock were reserved under the 1996 Plan at October 31, 2005. The 1996 Plan terminated effective January 31, 2006 and although we can no longer issue stock options out of the plan, the outstanding options at the date of termination will continue to vest. A total of 650,000 shares of common stock are reserved under the 1998 Plan and a total of 2,038,950 shares of our common stock will be issuable upon exercise of the assumed PyX Plan stock options at January 31, 2006, respectively. Stock options granted under the 1996, 1998 and PyX Plans are exercisable over a maximum term of ten years from the date of grant, vest in various installments over a one to four-year period and have exercise prices reflecting the market value of the shares of common stock on the date of grant.

Additionally, in 2001, stockholders approved a Non-Employee Director Stock Option Plan (the Director Plan). A total of 340,000 shares of Common Stock are reserved for issuance under the Director Plan. Options granted under the Director Plan vest over a one to four-year period, expire five to seven years after the date of grant and have exercise prices reflecting market value at the date of grant.

On the date of adoption of SFAS 123R, there were 4,213,704 outstanding stock options, of which 1,400,397 were fully vested. We granted 265,000 stock options to employees during the three month period ended January 31, 2006. Included in the outstanding stock options are 2,038,950 stock options related to the PyX 2005 Stock Option Plan that was assumed by us in our acquisition of PyX Technologies, Inc. (PyX) on July 27, 2005. The fair value related to the unvested portion of the PyX stock options assumed by us totaled \$2,484,000 and was recorded as deferred compensation in the fourth quarter of fiscal 2005. On the date of adoption of SFAS 123R, we reduced deferred compensation and common stock by \$2,311,000, which was the value of the unamortized balance of the deferred compensation recorded when we purchased PyX. We will record compensation expense at the rate of \$173,000 per quarter over the remaining 13 quarterly vesting periods and record an increase to our common stock as required by SFAS 123R. The \$173,000 per quarter compensation expense is included in General and Administrative expense.

We awarded stock option grants to certain non-employee strategic business advisors as a part of their fee structure. The fair value of these option grants is estimated on the date of grant using the Black-Scholes option-pricing model and is recalculated on a quarterly basis based on market price. For the three month period ended January 31, 2006, \$35,000, of compensation expense is included in General and Administrative expense.

For the three months ended January 31, 2006, we recorded approximately \$146,000 of stock-based compensation expense associated with outstanding unvested employee stock options in the accompanying statements of operations. The fair value of the unearned portion of stock-based compensation related to the unvested employee stock options is calculated using the Black-Scholes option pricing model as of the grant date of the underlying stock options. We recognized no net deferred tax impact on the adoption of SFAS 123R. As of January 31, 2006, there was approximately \$1.5 million of remaining unamortized stock-based compensation expense associated with unvested employee stock options which will be expensed over the remaining service period through September 2009. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during the three months ended January 31, 2005.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Unvested Options On November 1, 2005	Options Granted During Three Months Ended January 31, 2006
Expected life (in years)	4.19	4.00
Risk-free interest rate	2.65% - 4.36%	4.375%
Volatility	53.76% -151.22%	97.46%
Dividend yield	0.00%	0.00%
Forfeiture rate	6.71%	5.47%

The fair value of stock-based awards to employees is calculated using the Black-Scholes option pricing model, even though this model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the Company's stock options. The Black-Scholes model also requires subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The expected term and forfeiture rate of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The risk-free rate is based on the U.S Treasury rates in effect during the corresponding period of grant. The expected volatility is based on the historical volatility of our stock price. These factors could change in the future, which would affect the stock-based compensation expense in future periods.

The following table summarizes our stock option and restricted stock activity in fiscal 2006:

	Weighted Number of options	Average Exercise Price
Outstanding at October 31, 2005	4,213,704	\$ 2.66
Granted	523,483	1.94
Exercised	60,658	1.50
Cancelled	119,436	7.19
Outstanding at January 31, 2006	4,557,093	\$ 2.48
As of January 31, 2006:		
Options exercisable	1,368,394	\$ 2.73
Shares available for grant	151,868	

The weighted average grant-date fair value of options granted during the three months ended January 31, 2006 and 2005 was \$1.94 and \$3.88, respectively. The total intrinsic value of options exercised during the quarter ended January 31, 2006 and 2005 was \$3,400 and \$76,834 respectively.

The following table summarizes information with respect to all options to purchase shares of common stock outstanding under the 1996 Stock Option Plan (the 1996 Plan), the 1998 Non-Officer Stock Option Plan (the 1998 Plan) and the PyX 2005 Stock Option Plan (the PyX Plan) and the Non-Employee Director Stock Option Plan (the Director Plan) at January 31, 2006:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding at 1/31/06	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number Exercisable at 1/31/06	Weighted Average Exercise Price
\$ 0.00 - \$ 1.00	583,566	3.4	\$ 0.91	581,232	\$ 0.91
\$ 1.01 - \$ 2.50	2,459,651	6.0	\$ 2.07	104,625	\$ 1.55
\$ 2.51 - \$ 3.50	839,500	5.5	\$ 2.80	184,308	\$ 2.67
\$ 3.51 - \$ 4.50	376,000	5.5	\$ 4.20	209,940	\$ 4.22
\$ 4.51 - \$ 6.50	219,376	1.9	\$ 5.06	219,376	\$ 5.06
\$ 6.51 - \$ 8.50	38,000	4.7	\$ 7.01	27,913	\$ 7.03
\$ 8.51 - \$10.50	40,000	1.0	\$ 8.63	40,000	\$ 8.63
\$10.51 - \$18.50	1,000	1.2	\$ 17.28	1,000	\$ 17.28
	4,557,093	5.3	\$ 2.48	1,368,394	\$ 2.73

#### *Restricted Stock Awards*

On January 12, 2006, our Board of Directors (Board) approved a company-wide 30% reduction in employee base salaries, effective January 16, 2006. In order to continue to motivate and retain our employees despite such salary reductions, the Board also approved restricted stock grants to all of our employees pursuant to the 1996 Stock Option Plan. A total of 227,301 shares of our common stock will be issued pursuant to such restricted stock grants. Such stock grants will vest in five ratable semi-monthly installments, for so long as the employees continue to act as employees, with the first installment vested on January 31, 2006. In addition, the Board also approved the suspension of all cash Board and Board committee fees, indefinitely. In place of such cash payments, the Board made a restricted stock grant of 30,681 shares to non-employee members of the Board. Such stock grants will vest in three equal monthly installments, for so long as the directors continue to act as directors, with the first installment vested on January 31, 2006. For the three months ended January 31, 2006, we recorded approximately \$91,000, of stock-based compensation and director expense associated with these restricted stock awards.

A summary of the status of the Company's restricted stock units as of January 31, 2006 and changed during the three months ended January 31, 2006 is as follows:

Nonvested Restricted Stock Units	Number of Shares (in Thousands)	Weighted Average Grant-Date Fair Value
Nonvested at November 1, 2005	—	—
Granted	264	\$ 1.55
Vested	(66)	1.38
Cancelled	—	—
Nonvested at January 31, 2006	198	\$ 1.34



Prior to November 1, 2005, we accounted for stock-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Under this method, compensation expense was recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. Our practice is to award employee stock options with an exercise price equal to the market price on the date of the award. Accordingly, no stock-based employee compensation cost has previously been recognized in net income for the stock option plans. Had compensation cost for our stock option plans been determined based on the fair value recognition provisions of SFAS 123, our net income and income per share would have been as follows:

	Three Months Ended January 31, 2005 (in thousands, except per share amounts)
Net income, as reported	\$ 177
Add: Total stock-based compensation expense (benefit) included in the net income determined under the recognition and measurement principles of APB Opinion 25	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(640)
Pro forma net loss	\$ (463)
Net income (loss) per share:	
Basic - as reported	\$ 0.03
Basic - pro forma	\$ (0.09)
Diluted - as reported	\$ 0.03
Diluted - pro forma	\$ (0.09)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

Options granted in three months ended January 31	2005
Expected life (in years)	5.00
Risk-free interest rate	3.00%
Volatility	76.29%
Dividend yield	0.00%



The following table summarizes stock-based compensation expense related to employee stock options - under SFAS 123(R), restricted stock awards and non-employee consultant and PyX stock based compensation expense for the three months ended January 31, 2006 which was allocated to product costs and operating expense as follows (in thousands):

	Three Months Ended January 31, 2006
Cost of goods sold	\$ 5
Product research and development	37
Sales and Marketing	56
General and administrative	347
Total	\$ 445

## 6. Revenue Recognition and Concentration of Risk:

Our policy is to recognize revenue for hardware product sales when title transfers and risk of loss has passed to the customer, which is generally upon shipment of our hardware products to our customers. We defer and recognize service revenue over the contractual period or as services are rendered. Our policy complies with the guidance provided by Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements*, issued by the Securities and Exchange Commission.

We account for the licensing of software in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition*. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. We will defer all revenue related to the sale of our software products until such time that we are able to establish VSOE for the undelivered elements related to our iSCSI software products or when we fulfill the undelivered elements.

Deferred revenue represents post-delivery engineering support and the right to receive specified upgrades/enhancements of our iSCSI software on a when-and-if-available basis.

In the first three months of fiscal 2006 and 2005, most of our sales were attributable to sales of wireless communications products and were derived from a limited number of Original Equipment Manufacturer (OEM) customers. Sales to The Hewlett-Packard Company (HP) accounted for 0% and 36% of our net sales in the first three months of fiscal 2006 and 2005, respectively, and sales to Data Connection Limited (DCL), Nortel Networks (Nortel) and True Position, Inc. accounted for 41%, 12% and 10% of our net sales for the quarter ended January 31, 2006, respectively as compared to DCL and Nortel accounting for 15% and 14% of our net sales for the same quarter ended January 31, 2005, respectively. No other customer accounted for more than 10% of our net sales in either quarter. DCL and Nortel combined accounted for 65% of our accounts receivable at January 31, 2006. A significant reduction in orders from any of our OEM customers, or a failure to collect outstanding accounts receivable from any of our OEM customers, could have a material adverse effect on our business, operating results, financial condition and cash flows.

International sales constituted 58% and 20% of net sales for the three month periods ended January 31, 2006 and 2005, respectively. International sales are primarily executed in Europe with 44% to customers in the United Kingdom. All international sales are executed in U.S. dollars.

## 7. Warranty Obligations and Other Guarantees:

The following is a summary of our agreements that we have determined are within the scope of FASB Interpretation (FIN) No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others* -- an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FIN 34.

We accrue the estimated costs to be incurred in performing warranty services at the time of revenue recognition and shipment of the products to our customers. Our estimate of costs to service our warranty obligations is based on historical experience and expectation of future conditions. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, the warranty accrual will increase, resulting in decreased gross margin.

The following table sets forth an analysis of our warranty reserve (in thousands):

	January 31, 2006	January 31, 2005
Warranty reserve at beginning of period	\$ 22	\$ 20
Less: Cost to service warranty obligations	(1)	(4)
Plus: Increases to reserves	1	4
Total warranty reserve included in other accrued expenses	\$ 22	\$ 20

We have agreed to indemnify each of our executive officers and directors for certain events or occurrences arising as a result of the officer or director serving in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. However, we have a directors' and officers' liability insurance policy that should enable us to recover a portion of future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal and have no liabilities recorded for these agreements as of January 31, 2006 and October 31, 2005, respectively.

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with business partners, contractors, customers and-landlords. Under these provisions we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities or, in some cases, as a result of the indemnified party's activities under the agreement. These indemnification provisions often include indemnifications relating to representations made by us with regard to intellectual property rights. These indemnification provisions generally survive termination of the underlying agreement. The maximum potential amount of future payments we could be required to make under these indemnification provisions is unlimited. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of January 31, 2006 and October 31, 2005, respectively.

As discussed below, we are the secondary guarantor on the sublease of our previous headquarters. We believe we will have no liabilities on this guarantee and have not recorded a liability at January 31, 2006.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### ***Forward Looking Statements***

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve risks and uncertainties. Words such as "believes," "anticipates," "expects," "intends" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Readers are cautioned that the forward-looking statements reflect our analysis only as of the date hereof, and we assume no obligation to update these statements. Actual events or results may differ materially from the results discussed in or implied by the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those risks and uncertainties set forth under the caption "Risk Factors" below.

The following discussion should be read in conjunction with the Financial Statements and the Notes thereto included in Item 1 of this Quarterly Report on Form 10-Q and in our Form 10-K for the fiscal year ended October 31, 2005.

### **Risk Factors**

In addition to the other information in this Quarterly Report on Form 10-Q, stockholders or prospective investors should carefully consider the following risk factors:

#### **Risks Related to Our Business**

##### ***We may not realize any anticipated benefits from the acquisition of PyX.***

We acquired PyX on July 26, 2005. While we believe that our opportunities are greater than our opportunities prior to the acquisition and that we will be able to create substantially more stockholder value, there is substantial risk that the synergies and benefits sought in the acquisition might not be fully achieved. There is no assurance that PyX's technology can be successfully integrated into our existing product platforms or that our financial results will meet or exceed the financial results that would have been achieved absent the acquisition. As a result, our operations and financial results may suffer and the market price of our common stock may decline.

***If PyX's products contain undetected errors, we could incur significant unexpected expenses and experience product returns and lost sales.***

The iSCSI software products developed by PyX are highly technical and complex. While PyX's products have been tested, because of their nature, we can not be certain of their performance either as stand-alone products or when integrated with our existing product line. Because of PyX's short operating history, we have little information on the performance of its products. There can be no assurance that defects or errors may not arise or be discovered in the future. Any defects or errors in PyX's products discovered in the future could result in a loss of customers or decrease in net revenue and market share.

***We depend upon a small number of Original Equipment Manufacturer (OEM) customers. The loss of any of these customers, or their failure to sell their products, could limit our ability to generate revenues. In particular, the Hewlett Packard Company (HP) ceased to be a significant customer of ours in the first quarter of fiscal 2005, and our success depends on being able to replace net sales previously attributable to HP with sales to other customers.***

In the first quarter of fiscal 2005, sales of VME products to HP accounted for 36% of our net sales. We made our final shipment for \$1.0 million of our VME products to HP in the first quarter of fiscal 2005. Our future success depends on being able to replace net sales previously attributable to HP with sales to other customers. We can provide no assurance that we will succeed in obtaining new orders from existing or new customers sufficient to replace or exceed the net sales previously attributable to HP or that we will become a qualified supplier with new OEM customers or remain a qualified supplier with existing OEM customers.

Orders by our OEM customers are affected by factors such as new product introductions, product life cycles, inventory levels, manufacturing strategies, contract awards, competitive conditions and general economic conditions. Our sales to any single OEM customer are also subject to significant variability from quarter to quarter. Such fluctuations may have a material adverse effect on our operating results. A significant reduction in orders from any of our OEM customers, could have a material adverse effect on our operating results, financial condition and cash flows.

A failure to collect outstanding accounts receivable from any of our OEM customers could have a material adverse effect on our business, operating results, financial condition and cash flows.

***Our future capital needs may exceed our ability to raise capital.***

The development and marketing of our products is capital-intensive. We believe that our existing cash balances and our anticipated cash flow from operations will satisfy our working capital needs for the foreseeable future. Declines in our sales or a failure to keep expenses in line with revenues could require us to seek additional financing in fiscal 2006. In addition, should we experience a significant growth in customer orders or wish to make strategic acquisitions of a business or assets, we may be required to seek additional capital to meet our working capital needs. There can be no assurance that additional financing, if required, will be available on reasonable terms or at all. To the extent that additional capital is raised through the sale of additional equity or convertible debt securities, the issuance of such securities could result in additional dilution to our stockholders.

***Because of our dependence on single suppliers for some components, we may be unable to obtain an adequate supply of such components, or we may be required to pay higher prices or to purchase components of lesser quality.***

The chip sets used in some of our products are currently available only from a single supplier. If these suppliers discontinue or upgrade some of the components used in our products, we could be required to redesign a product to incorporate newer or alternative technology. The inability to obtain sufficient key components as required, or to develop alternative sources if and as required in the future, could result in delays or reductions in product shipments or margins that, in turn, would have a material adverse effect on our business, operating results, financial condition and cash flows. If enough components are unavailable, we may have to pay a premium in order to meet customer demand. Paying premiums for parts, building inventories of scarce parts and obsolescence of existing inventories could lower or eliminate our profit margin, reduce our cash flow and otherwise harm our business. To offset potential component shortages, we have in the past, and may in the future, carry an inventory of these components. As a result, our inventory of components parts may become obsolete and may result in write-downs.

***If we fail to develop and produce new products, we may lose sales and our reputation may be harmed.***

The markets for our products are characterized by rapidly changing technologies, evolving industry standards and frequent new product introductions. Our future success will depend on our ability to enhance our existing products and to introduce new products and features to meet and adapt to changing customer requirements and emerging technologies such as VoIP, third generation wireless services (3G Wireless), SATA, iSCSI, SAS, Gigabit Ethernet, 10G and TOE. There can be no assurance that we will be successful in identifying, developing, manufacturing and marketing new products or enhancing our existing products. In addition, there can be no assurance that services, products or technologies developed by others will not render our products obsolete.

We have focused a significant portion of our research and development, marketing and sales efforts on VoIP, HighWire, WAN and LAN adapters, iSCSI and TOE products. The success of these products is dependent on several factors, including timely completion of new product designs, achievement of acceptable manufacturing quality and yields, introduction of competitive products by other companies, market acceptance of our products and our ability to sell our products. If the VoIP, iSCSI, HighWire, TOE and adapter products or other new products developed by us do not gain market acceptance, our business, operating results, financial condition and cash flows would be materially adversely affected.

***Our iSCSI and VoIP products will require a substantial product development investment by us and we may not realize any return on our investment.***

The development of new or enhanced products is a complex and uncertain process. As we integrate the PyX iSCSI products into our product line, our customers may experience design, manufacturing, marketing and other difficulties that could delay or prevent the development, introduction or marketing of new products and enhancements, both to our existing product line as well as to the PyX and VoIP products. Development costs and expenses are incurred before we generate any net revenue from sales of the products resulting from these efforts. We expect to incur substantial research and development expenses relating to the iSCSI and VoIP product lines, which could have a negative impact on our earnings in future periods.

***The storage and embedded products market is intensely competitive, and our failure to compete effectively could reduce our revenues and margins.***

We compete directly with traditional vendors of storage software and hardware devices, including Fibre Channel SAN products, open source “free” software, TOE and application-specific storage solutions. We compete with communications suppliers of routers, switches, gateways, network interface cards and other products that connect to the Public Switched Telephone Network (PSTN) and the Internet. In the future, we expect competition from companies offering client/server access solutions based on emerging technologies such as Fibre Channel, switched digital telephone services, iSCSI, SAS, TOE, VoIP and other technologies. In addition, we may encounter increased competition from operating system and network operating system vendors to the extent that such vendors include full communications and storage capabilities in their products. We may also encounter future competition from telephony service providers (such as AT&T or the regional Bell operating companies) and storage product providers (such as EMC Corporation, Network Appliance, Inc. and Qlogic Corporation).

Increased competition with respect to any of our products could result in price reductions and loss of market share, which would adversely affect our business, operating results, financial condition and cash flows. Many of our current and potential competitors have greater financial, marketing, technical and other resources than we do. There can be no assurance that we will be able to compete successfully with our existing competitors or will be able to compete successfully with new competitors.

***We depend on our key personnel. If we are unable to retain our current personnel and hire additional qualified personnel as needed, our business will be harmed.***

We are highly dependent on the technical, management, marketing and sales skills of a limited number of key employees. We do not have employment agreements with, or life insurance on the lives of, any of our key employees. The loss of the services of any key employees could adversely affect our business and operating results. Our future success will depend on our ability to continue to attract and retain highly talented personnel to the extent our business grows. Competition for qualified personnel in the networking and software industries, and in the San Francisco Bay Area, is intense. There can be no assurance that we will be successful in retaining our key employees or that we can attract or retain additional skilled personnel as required. None of our employees are covered by life insurance that names the Company as beneficiary.

***We may be unable to protect our software, which could reduce any competitive advantage we have.***

Although we believe that our future success will depend primarily on continuing innovation, sales, marketing and technical expertise and the quality of product support and customer relations, we must also protect the proprietary technology contained in our products. We do not currently hold any patents and rely on a combination of copyright, trademark, trade secret laws and contractual provisions to establish and protect proprietary rights in our products. There can be no assurance that steps taken by us in this regard will be adequate to deter misappropriation or independent third-party development of our technology. Although we believe that our products and technology do not infringe on the proprietary rights of others, there can be no assurance that third parties will not assert infringement claims against us.

### **Risks Associated with Ownership of Our Common Stock**

***The market price of our common stock is likely to continue to be volatile. You may not be able to resell your shares at or above the price at which you purchased such shares.***

The trading price of our common stock is subject to wide fluctuations in response to quarter-to-quarter fluctuations in operating results, the failure to meet analyst estimates, announcements of technological innovations or new products by us or our competitors, general conditions in the computer and communications industries and other events or factors. In addition, stock markets have experienced extreme price and trading volume volatility in recent years. This volatility has had a substantial effect on the market price of the securities of many high technology companies for reasons frequently unrelated to the operating performance of the specific companies. These broad market fluctuations may adversely affect the market price of our common stock. Our common stock has historically had relatively small trading volumes. As a result, small transactions in our common stock can have a disproportionately large impact on the quoted price of our common stock.

***If we continue to experience losses we could experience difficulty meeting our business plan, and our stock price could be negatively affected.***

We may experience operating losses and negative cash flow from operations as we develop and market the iSCSI software solution acquired in the PyX acquisition. Any failure to achieve or maintain profitability could negatively impact the market price of our common stock. Historically, PyX has not been profitable on a quarterly or annual basis, and we expect that the combined company will incur net losses for the foreseeable future. We anticipate that we will continue to incur significant product development, sales and marketing and administrative expenses. As a result, we will need to generate significant quarterly revenues if we are to achieve and maintain profitability. A substantial failure to achieve profitability could make it difficult or impossible for us to grow our business. Our business strategy may not be successful, and we may not generate significant revenues or achieve profitability. Any failure to significantly increase revenues would also harm our ability to achieve and maintain profitability. If we do achieve profitability in the future, we may not be able to sustain or increase profitability on a quarterly or annual basis.

***Future sales of our common stock, including shares issued in the PyX acquisition and the private placement could cause the market price for our common stock to significantly decline.***

Sales of substantial amounts of our common stock in the public market could cause the market price of our common stock to fall, and could make it more difficult for us to raise capital through public offerings or other sales of our capital stock. In addition, the public perception that these sales might occur could have the same undesirable effects. The PyX shareholders who received shares of our common stock in the PyX acquisition entered into agreements that provide, in part, that, with respect to 95% of the shares of our common stock that the shareholder received in connection with the acquisition, the shareholder will not sell these shares until one year after the acquisition is completed. We registered for the resale all of the shares that we issued in the merger and private placement effective November 14, 2005. The purchasers in the private placement are not subject to any lockup with respect to the shares they purchased in the private placement. As a result, sales under the registration statement will include a very substantial number of shares and percentage of our common stock. Holders of approximately 46.7% of the outstanding shares of our common stock will have the right to sell their shares pursuant to these registration rights and holders of an additional approximately 5.7% of the outstanding shares of our common stock, assuming no further issuances of shares of our common stock, will have the right to sell their shares after the one year period has passed. Such free transferability could materially and adversely affect the market price of our common stock.

***Our common stock has been at risk for delisting from the Nasdaq SmallCap Market. If it is delisted, our stock price and your liquidity may be impacted.***

Our common stock is currently listed on the Nasdaq SmallCap Market. Nasdaq has requirements that a company must meet in order to remain listed on the Nasdaq SmallCap Market. These requirements include maintaining a minimum closing bid price of \$1.00 and minimum stockholders' equity of \$2.5 million. Our stockholders' equity as of January 31, 2006 was approximately \$15.1 million and our closing bid price on January 31, 2006 was \$1.33. Although we currently meet all of the minimum continued listing requirements for the Nasdaq SmallCap Market, should our stock price decline, our common stock could be subject to potential delisting from the Nasdaq SmallCap Market.

If we fail to maintain the standards necessary to be quoted on the Nasdaq SmallCap Market and our common stock is delisted, trading in our common stock would be conducted on the OTC Bulletin Board as long as we continue to file reports required by the Securities and Exchange Commission. The OTC Bulletin Board is generally considered to be a less efficient market than the Nasdaq SmallCap Market, and our stock price, as well as the liquidity of our common stock, may be adversely impacted as a result.



*Our certificate of incorporation and bylaws and the Delaware General Corporation Law contain provisions that could delay or prevent a change in control.*

Our board of directors has the authority to issue up to 2,000,000 shares of preferred stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by the stockholders. The rights of the holders of common stock will be subject to, and may be materially adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. Furthermore, certain other provisions of our certificate of incorporation and bylaws may have the effect of delaying or preventing changes in control or management, which could adversely affect the market price of our common stock. In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, an anti-takeover law.

## **Management's Discussion and Analysis**

### *Overview*

We engineer and provide standards-based hardware and software products to OEMs who embed our products into their systems to provide data storage and network connectivity solutions for the enterprise storage and telecommunications markets. Our products include iSCSI storage software, WAN and LAN adapters, intelligent carrier cards and TOE NICs. These products perform critical IP-based transport, computing, processing offload, I/O and storage tasks across both the enterprise server and embedded markets such as high-end enterprise level servers, Linux super-computing clusters, workstations, media gateways, routers, Internet access devices, communications network applications, NAS, SAN and remote storage devices and networks. Our products are distributed worldwide through a direct sales force, distributors, independent manufacturers' representatives and value-added resellers.

After we acquired PyX on July 26, 2005 we organized our operations into two business segments: Embedded and Storage Products. In the quarter ended January 31, 2006 we reorganized the company to one industry segment by combining the previously segmented engineering, sales, marketing groups to focus on delivering IP-based hardware and software products that are embedded in both communications and storage servers. We now have only one chief operating decision maker and analyze financial information on a single segment basis.

Our business is characterized by a concentration of sales to a small number of OEMs and distributors who provide products and services to the communications and data storage markets. Consequently, the timing of significant orders from major customers and their product cycles cause fluctuation in our operating results. DCL was the largest of our customers representing 41% of our sales in the first quarter of fiscal 2006. HP has historically been one of our largest customer and represented 36% of net sales in the quarter ended January 31, 2005. We shipped the last \$1.0 million of VME products to HP in that quarter and have not received and do not expect to receive any future purchase orders from HP for our VME products.

During the quarter ended January 31, 2006 and 2005, \$78,000, or 5% of sales and \$173,000 or 6% of our sales, respectively were sold to distributors. Our reserves for distributor programs totaled approximately \$22,000 as of January 31, 2006 and 2005, respectively.

On January 31, 2006, we had a sales backlog of product orders of approximately \$1.0 million compared to a sales backlog of product orders of approximately \$1.2 million at October 31, 2005.

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

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include levels of reserves for doubtful accounts, obsolete inventory, warranty costs and deferred tax assets. Actual results could differ from those estimates.

Our critical accounting policies and estimates include the following:

#### ***Revenue Recognition:***

#### ***Hardware Products***

Our policy is to recognize revenue for hardware product sales when title transfers and risk of loss has passed to the customer, which is generally upon shipment of our hardware products to our customers. We defer and recognize service revenue over the contractual period or as services are rendered. We estimate expected sales returns and record the amount as a reduction of revenue and cost of goods sold (COGS) at the time of shipment. Our policy complies with the guidance provided by the Securities and Exchange Commission's Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements*, issued by the Securities and Exchange Commission. Judgments are required in evaluating the credit worthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectibility is reasonably assured. Our sales transactions are denominated in U.S. dollars. The software component of our hardware products is considered incidental. Therefore, we do not recognize software revenue related to our hardware products separately from the hardware product sale.

When selling hardware, our agreements with OEMs, such as DCL and Nortel, typically incorporate clauses reflecting the following understandings:

- all prices are fixed and determinable at the time of sale;
- title and risk of loss pass at the time of shipment (FOB shipping point);
- collectibility of the sales price is probable (the OEM is creditworthy, the OEM is obligated to pay and such obligation is not contingent on the ultimate sale of the OEM's integrated solution);
- the OEM's obligation to us will not be changed in the event of theft or physical destruction or damage of the product;
- we do not have significant obligations for future performance to directly assist in the resale of the product by the OEMs; and
- there is no contractual right of return other than for defective products.

Our agreements with our distributors include certain product rotation and price protection rights. All distributors have the right to rotate slow moving products once each fiscal quarter. The maximum dollar value of inventory eligible for rotation is equal to 25% of our products purchased by the distributor during the previous quarter. In order to take advantage of their product rotation rights, the distributors must order and take delivery of additional products of ours equal to at least the dollar value of the products that they want to rotate.

Each distributor is also allowed certain price protection rights. If and when we reduce or plan to reduce the price of any of our products and the distributor is holding any of the affected products in inventory, we will credit the distributor the difference in price when they place their next order with us. We record an allowance for price protection at the time of the price reduction, thereby reducing our net sales and accounts receivable. The allowance is based on the price difference of the inventory held by our stocking distributors at the time we expect to reduce selling prices. We believe we are able to fully evaluate potential returns and adjustments and continue to recognize the sale based on shipment to our distributors. Reserves for the right of return and restocking are established based on the requirements of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (SFAS) 48, *Revenue Recognition when Right of Return Exists*.

#### *Software Products*

With the acquisition of PyX, we will also derive future revenues from the following sources: (1) software, which includes new iSCSI target and initiator software licenses and (2) services, which include consulting. We account for the licensing of software in accordance with SOP 97-2, *Software Revenue Recognition*. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. Customers receive certain elements of our products over a period of time. These elements include free post-delivery telephone support and the right to receive unspecified upgrades/enhancements of our iSCSI software on a when-and-if-available basis, the fair value of which is recognized over the product's estimated life cycle. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products. We will defer all revenue related to the bundled sale of our software products for which we do not have VSOE and amortize the deferred revenue over its estimated life.

For software license arrangements that do not require significant modification or customization of the underlying software, we will recognize new software license revenue when: (1) we enter into a legally binding arrangement with a customer for the license of software; (2) we deliver the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured. Substantially, all of our new software license revenue will be recognized in this manner. No software license revenue has been recognized to date.

As of January 31, 2006, we have deferred all license revenue related to software arrangements until the specified upgrade is delivered. Once the specified upgrade is delivered, revenues for the license will be recognized over the term of the contract or over the economic life of the product, whichever is shorter. If there is significant uncertainty about the project completion or receipt of payment for the services, revenue is deferred until the uncertainty is sufficiently resolved.

Certain software arrangements include consulting implementation services sold separately under consulting engagement contracts. Consulting revenues from these arrangements are generally accounted for separately from new software license revenues because the arrangements qualify as service transactions as defined in SOP 97-2. The more significant factors considered in determining whether the revenue should be accounted for separately include the nature of services (i.e., consideration of whether the services are essential to the functionality of the licensed product), degree of risk, availability of services from other vendors, timing of payments and impact of milestones or acceptance criteria on the realizability of the software license fee. For the three months ended January 31, 2006, we recognized \$10,000 of software consulting revenue.

*Allowance for Doubtful Accounts:*

Our policy is to maintain allowances for estimated losses resulting from the inability of our customers to make required payments. Credit limits are established through a process of reviewing the financial history and stability of each customer. Where appropriate, we obtain credit rating reports and financial statements of the customer when determining or modifying their credit limits. We regularly evaluate the collectibility of our trade receivable balances based on a combination of factors. When a customer's account balance becomes past due, we initiate dialogue with the customer to determine the cause. If it is determined that the customer will be unable to meet its financial obligation to us, such as in the case of a bankruptcy filing, deterioration in the customer's operating results or financial position or other material events impacting their business, we record a specific allowance to reduce the related receivable to the amount we expect to recover. Should all efforts fail to recover the related receivable, we will write-off the account.

We also record an allowance for all customers based on certain other factors including the length of time the receivables are past due and historical collection experience with customers. We believe our reported allowances are adequate. If the financial conditions of those customers were to deteriorate, however, resulting in their inability to make payments, we may need to record additional allowances which would result in additional general and administrative expenses being recorded for the period in which such determination was made.

*Inventories:*

Inventories are stated at the lower of cost, using the first-in, first-out method, or market value. We utilize standard cost, which approximates actual costs for certain indirect costs.

We are exposed to a number of economic and industry factors that could result in portions of our inventory becoming either obsolete or in excess of anticipated usage, or subject to lower of cost or market issues. These factors include, but are not limited to, technological changes in our markets, our ability to meet changing customer requirements, competitive pressures in products and prices, and the availability of key components from our suppliers. Our policy is to establish inventory reserves when conditions exist that suggest that our inventory may be in excess of anticipated demand or is obsolete based upon our assumptions about future demand for our products and market conditions. We regularly evaluate our ability to realize the value of our inventory based on a combination of factors including the following: historical usage rates, forecasted sales or usage, product end-of-life dates, estimated current and future market values and new product introductions. Purchasing practices and alternative usage avenues are explored within these processes to mitigate inventory exposure. When recorded, our reserves are intended to reduce the carrying value of our inventory to its net realizable value. If actual demand for our products deteriorates, or market conditions are less favorable than those that we project, additional inventory reserves may be required.

*Stock-Based Compensation:*

Effective November 1, 2005, we adopted the provisions of SFAS 123R, Share-Based Payment, using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on the grant date and recognition of compensation expense over the requisite service period for awards expected to vest.

The fair value method under SFAS 123R is similar to the fair value method under SFAS 123, Accounting for Stock Based Compensation, as amended by SFAS 148, Accounting for Stock-Based Compensation - Transition and Disclosure with respect to measurement and recognition of stock-based compensation. However, SFAS 123 permitted us to recognize forfeitures as they occur, while SFAS 123R requires us to estimate future forfeitures and adjust our estimate on a quarterly basis. SFAS 123R also requires a classification change in the statement of cash flows; whereby, the income tax benefit from stock option exercises is reported as a financing cash flow rather than an operating cash flow as previously reported.

We have several Board and shareholder approved stock option plans for which stock options and restricted stock awards are available to grant to employees and directors. All employee and director stock options granted under our stock option plans have an exercise price equal to the market value of the underlying common stock on the grant date. There are no vesting provisions tied to performance conditions for any option as vesting for all outstanding option grants was based only on continued service as an employee of SBE. All of our outstanding stock options and restricted stock awards are classified as equity instruments.

*Stock Options*

On the date of adoption of SFAS 123R, there were 4,213,704 outstanding stock options, of which 1,400,397 were fully vested. We granted 265,000 stock options to employees during the three month period ended January 31, 2006. Included in the outstanding stock options are 2,038,950 stock options related to the PyX 2005 Stock Option Plan that was assumed by us in our acquisition of PyX Technologies, Inc. (PyX) on July 27, 2005.

For the three months ended January 31, 2006, we recorded approximately \$354,000 of stock-based compensation expense associated with outstanding unvested employee stock options, employee stock options granted during the three months ended January 31, 2006 and stock options issued to non-employee advisors. As of January 31, 2006, there was approximately \$3.9 million of remaining unamortized stock-based compensation expense associated with unvested employee stock options, employee stock options granted during the three months ended January 31, 2006 and stock options issued to non-employee advisors which will be expensed over the remaining service period through September 2009. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during the three months ended January 31, 2005.

*Restricted Stock Awards*

On January 12, 2006, our Board of Directors (Board) approved a company-wide reduction in employee base salaries, effective January 16, 2006. In order to continue to motivate and retain our employees despite such salary reductions, the Board also approved restricted stock grants to all of our employees pursuant to the 1996 Stock Option Plan. A total of 233,381 shares of our common stock will be issued pursuant to such restricted stock grants. Such stock grants will vest in five ratable semi-monthly installments, for so long as the employees continue to act as employees, with the first installment vested on January 31, 2006. In addition, the Board also approved the suspension of all cash Board and Board committee fees, indefinitely. In place of such cash payments, the Board made a restricted stock grant of 30,681 shares to non-employee members of the Board. Such stock grants will vest in three equal monthly installments, for so long as the directors continue to act as directors, with the first installment vested on January 31, 2006. For the three months ended January 31, 2006, we recorded approximately \$91,000 of stock-based compensation and director expense associated with these restricted stock awards.

*Income Taxes:*

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). SFAS 109 requires recognition of deferred tax liabilities and assets for the expected future tax consequences of items that have been included in the financial statements or tax returns. Deferred income taxes represent the future net tax effects resulting from temporary differences between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are recorded against net deferred tax assets where, in our opinion, realization is uncertain. Based on the uncertainty of future pre-tax income, we fully reserved our deferred tax assets as of January 31, 2006 and October 31, 2005, respectively. In the event we were to determine that we would be able to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would increase income in the period such determination was made. The provision for income taxes represents the net change in deferred tax amounts, plus income taxes payable for the current period.

*Long-lived Asset Impairment:*

Capitalized software costs consist of costs to purchase software and costs to internally develop software. Capitalization of software costs begins upon the establishment of technological feasibility. All capitalized software costs are amortized as related sales are recorded on a per-unit basis with a minimum amortization to cost of goods sold based on a straight-line method over a three-year estimated useful life. We amortize capitalized software acquired from PyX to cost of sales on a straight line basis over thirty-six months, beginning August 1, 2005, which is the expected useful life and does not materially differ from the expected cash inflow from the sale of products related to the acquired PyX product line. We assess any impairment anytime events may indicate we have impairment and at least annually by estimating the future cash flow from the associated asset in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. If the estimated undiscounted cash flow related to these assets decreases in the future or the useful life is shorter than originally estimated, we may incur charges for impairment of these assets. The impairment is based on the estimated discounted cash flow associated with the asset. It is our belief that no impairment to the software asset exists as of January 31, 2006.

New Accounting Pronouncements:

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154). This new standard replaces APB Opinion 20, *Accounting Changes*, and FASB No. 3, *Reporting Accounting Changes in Interim Financial Statements*. Among other changes, SFAS 154 requires that a voluntary change in accounting principle to be applied retrospectively with all prior period financial statements presented using the new accounting principle, unless it is impracticable to do so. SFAS 154 also provides that (1) a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a "restatement." The new standard is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. We believe the adoption of the provisions of SFAS 154 will not have a material impact on our results of operations, financial positions or liquidity.

***Results of Operations***

The following table sets forth, as a percentage of net sales, consolidated statements of operations data for the three month period ended January 31, 2006 and 2005. These operating results are not necessarily indicative of our operating results for any future period.

	<b>Three Months Ended</b>	
	<b>January 31,</b>	
	<b>2006</b>	<b>2005</b>
Net sales	100%	100%
Cost of sales	130	44
Gross profit (loss)	(30)	56
Product research and development	68	17
Sales and marketing	43	20
General and administrative	55	13
Total operating expenses	166	50
Operating income (loss)	(196)	6
Interest income and provision for income taxes	1	—
Net income (loss)	(195)%	6%

### *Net Sales*

Net sales for the first quarter of fiscal 2006 was \$1.4 million, a 50% decrease from \$2.8 million in the first quarter of fiscal 2005. This decrease was primarily attributable to a decrease in shipments to HP and our adapter products. There were no sales to HP in the first quarter of fiscal 2006, compared to \$1.0 million for the first quarter of fiscal 2005. Sales to HP, primarily of VME products, represented 36% of total sales for the first quarter of fiscal 2005 after we shipped our final order of VME products to HP. Data Connection Limited (DCL), Nortel Networks (Nortel) and True Position, Inc. accounted for 41%, 12% and 10% of our net sales for the quarter ended January 31, 2006, respectively. For the quarter ended January 31, 2005, our top three customers accounted for 65% of our total sales including the aforementioned 36% related to HP in addition to 15% and 14% attributed to Nortel and DCL, respectively.

Sales of our adapter products were \$737,000 for the first quarter of fiscal 2006, as compared to \$965,000 for the same quarter in fiscal 2005. Sales of our HighWire products were \$592,000 in the quarter ended January 31, 2006, as compared to \$585,000 in the same quarter in fiscal 2005. Our adapter products are used primarily in edge-of-the-network applications such as Virtual Private Network (VPN) and other routers, Voice over Internet Protocol (VoIP) gateways and security devices, whereas our HighWire products are primarily targeted at core-of-the-network applications used primarily by telecommunications central offices. During the quarter we shipped a small number of TOE adapters to customers who will use the TOE to facilitate CPU acceleration for use in iSCSI storage applications. We continue to test our TOE and iSCSI products at customer sites and expect customer adoption of these new technologies to begin during fiscal 2006.

In the short term, our net sales will continue to be generated by sales of our adapter and HighWire products as we transition from our legacy embedded products to software and hardware products directed at the IP SAN storage market. Over the next few quarters, we do expect to see an increase in our software sales as the storage OEMs who have selected our iSCSI software begin to complete their product design phase and begin to roll-out their storage products to end-users. Over the next few years, we expect our net sales will be generated primarily by sales of our iSCSI storage software products, followed by sales of our VoIP/HighWire products. We have begun to see market acceptance of our iSCSI software products and as of January 31, 2006 have signed software contracts with nine storage OEMs. Although we expect to see sales growth in our iSCSI products as these OEMs products are completed and released to the marketplace, there can be no assurance that our OEM customers will be successful in selling their products incorporating our iSCSI software to end-user customers. In addition, we will continue to sell and support our legacy VME products, but expect sales for them to decline significantly as the OEM products in which they are embedded are phased out.

International sales constituted 58% and 20% of net sales for the three month periods ended January 31, 2006 and 2005, respectively. International sales are primarily executed in Europe with 44% to customers in the United



Kingdom. All international sales are executed in U.S. dollars.

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Our sales backlog at January 31, 2006 was \$1.0 million, compared to \$1.4 million at January 31, 2005 and \$1.2 million at October 31, 2005. Because our sales are generally concentrated with a small group of OEM customers, we could experience significant fluctuations in our quarterly sales volumes due to fluctuating demand from any major customer or delay in the rollout of any significant new product by a major customer.

### ***Gross Margin***

Gross margin as a percentage of sales in the first quarter of fiscal 2006 was negative 30% compared to 56% during the first quarter of fiscal 2005. The decrease in our gross profit margin for the quarter ended January 31, 2006 as compared to the same quarter in 2005 is related to the reduction in sales of 70% gross margin products to HP and the inclusion of non-cash amortization expense in 2006 combined with a lower sales volume that did not efficiently absorb the overhead costs of our production department. In the first quarter of fiscal 2005 we sold \$1.0 million of product to HP compared to none in the quarter 2006 just ended.

For the fiscal quarter ended January 31, 2006 cost of goods sold (COGS) includes, amortization expense of intangible and long-lived assets related to the PyX acquisition of \$1.0 million, compared to none for the same quarter of fiscal 2005. The \$12.3 million software long-lived asset recorded when we acquired PyX is scheduled to be amortized to COGS expense over 13 quarters beginning with the fourth quarter of fiscal 2005 at the rate of \$1.0 million per quarter.

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

Product research and development (R&D) expense representing engineering salaries and benefits, contract services and other costs to develop and enhance our products were \$946,000 in the first quarter of fiscal 2006, an increase of 100% from \$473,000 in the first quarter of fiscal 2005. The increase is related to a combination of new employees and an increase in our spending on new product development projects. When we acquired PyX we hired six new employees in our engineering group. We remain committed to the development and enhancement of new and existing products, particularly, iSCSI and VoIP products and as result saw a \$264,000 or 713% increase in our funding for new product development projects, primarily iSCSI software and a VoIP gateway products. Included in R&D expense is \$37,000 of non-cash stock based compensation expense related to the adoption of SFAS 123R and the issuance of restricted stock to employees in-lieu of cash compensation in the first quarter of fiscal 2006 compared to none in 2005. We did not capitalize any internal software development costs in the first quarter of fiscal 2005.

### ***Sales and Marketing***

Sales and marketing expenses for the first quarter of fiscal 2006 were \$598,000, an increase of 7% from \$559,000 in the first quarter of fiscal 2005. The increase is primarily due to the addition of one salesperson and increased marketing program spending for our new iSCSI products. Sales and Marketing expense includes \$56,000 of non-cash stock based compensation expense related to the adoption of SFAS 123R and the issuance of restricted stock to employees in-lieu of cash compensation in the first quarter of fiscal 2006 compared to none in 2005. Our iSCSI software is at the early stages of storage market acceptance and we will continue to increase our spending on marketing activities to capture market share in the emerging market space.

### ***General and Administrative***

General and administrative expenses were \$771,000 for the first quarter of fiscal 2006, an increase of 109% from \$369,000 in the first quarter of 2005. This increase is primarily due to the \$333,000 of non-cash stock based compensation expense related to the adoption of SFAS 123R in the first quarter of fiscal 2006 compared to none in 2005. The 2006 quarter also includes \$14,000 of non-cash compensation expense related the issuance of restricted stock to employees in-lieu of cash compensation.

### ***Net Income (Loss)***

As a result of the factors discussed above, we recorded a net loss of \$2.7 million in the first quarter of fiscal 2006, as compared to net income of \$177,000 in the first quarter of fiscal 2005.

### **Off-Balance Sheet Arrangements**

We do not have any transactions, arrangements or other relationships with unconsolidated entities that are reasonably likely to affect our liquidity or capital resources. We have no special purpose or limited purpose entities that provide off-balance sheet financing, liquidity, or market or credit risk support. We also do not engage in leasing, hedging, research and development services, or other relationships that could expose us to liability that is not reflected on the face of the financial statements.

### **Liquidity and Capital Resources**

Our liquidity is dependent on many factors, including sales volume, operating profit and the efficiency of asset use and turnover. Our future liquidity will be affected by, among other things:

- the actual versus anticipated increase in sales of our products;
- ongoing cost control actions and expenses, including for example, research and development and capital expenditures;
  - timing of product shipments which occur primarily during the last month of the quarter;
    - the gross profit margin;
    - the ability to raise additional capital, if necessary
    - the ability to secure credit facilities, if necessary, and
- the ability to successfully negotiate merger and partnership agreements to acquire certain intellectual property rights related to the storage and VoIP markets.

At January 31, 2006, we had cash and cash equivalents of \$2.8 million, as compared to \$3.6 million at October 31, 2005. In the first three months of fiscal 2006, \$703,000 of cash was used in operating activities primarily as a result of cash related net operating losses and an increase in our inventory. These decreases in cash were partially offset by a decrease in accounts receivable and increases in our current and long-term liabilities. Working capital, comprised of our current assets less our current liabilities, at January 31, 2006 was \$4.2 million, as compared to \$5.5 million at October 31, 2005.

In the first three months of fiscal 2006, we purchased \$148,000 of fixed assets, consisting primarily of computer and engineering equipment. We also purchased \$20,000 of capitalized software during the quarter. Capital expenditures for each of the remaining quarters of fiscal 2006 are expected to range from \$25,000 to \$100,000 per quarter.

In mid-January 2006 we took steps to reduce our cash flow break-even point. We changed the formula for paying all officers and employees and our Board of Directors for their services. Beginning with our January 31, 2006 payroll, officer and employee compensation will be paid 70% in cash and 30% in restricted shares of SBE common stock. Our Board of Directors fees will be paid 100% in restricted SBE common stock. Concurrent with our stock-for-pay program, we are controlling or eliminating other cash operating expenses. These cost cutting measures will reduce our quarterly operating cash expenses by approximately \$550,000 and reduced our projected cash break-even point to approximately \$8.5 to \$9.5 million from approximately \$11.5 million to \$12.5 million in net sales at a gross margin of 75% to 77%. Although our current gross margin is significantly lower than the mid-70% range, we expect our gross margin to increase significantly as software sales become the dominant product in our product sales mix. We do expect to continue to increase our expenditures on engineering and sales and marketing activities to develop and market new and existing products, especially in the IP storage and communications markets. We will have significant non-cash expenses in the coming quarters and years related to the amortization of the software and deferred compensation recorded as a result of the PyX acquisition and the adoption of SFAS 123R on November 1, 2005. Because of the non-cash expenses related to the PyX acquisition, expensing of employee stock options and anticipated increases in our expenditure levels, we expect to generate net losses for the foreseeable future. Our projected sales are to a limited number of new and existing OEM customers and are based on internal and customer-provided estimates of future demand, not firm customer orders. In addition, the markets for IP storage, particularly iSCSI NAS and SAN storage appliances, is a new market and may not gain acceptance as quickly as we predict. If our projected sales do not materialize, we may need to reduce expenses and raise additional capital through customer prepayments or the issuance of debt or equity securities. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of common stock, and debt covenants could impose restrictions on our operations. The sale of equity or debt could result in additional dilution to current stockholders, and such financing may not be available to us on acceptable terms, if at all.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Our cash and cash equivalents are subject to interest rate risk. We invest primarily on a short-term basis, principally money market instruments with maturities of less than three months. We have no other investments with significant interest rate risks. If interest rates increased by 10%, the expected effect on net income related to our financial instruments would be immaterial. We hold no assets or liabilities denominated in a foreign currency. Since October 31, 2005, there has been no change in our exposure to market risk.

### **Item 4. Controls and Procedures**

#### *Evaluation of Disclosure Controls and Procedures*

An evaluation as of January 31, 2006 was carried out under the supervision of and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's "disclosure controls and procedures," which are defined under SEC rules as controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Securities Exchange Act of 1934 (the "Exchange Act") is recorded, processed, summarized and reported within required time periods. In the Company's financial reporting process, the Company's Chief Financial Officer in discussions with its independent registered public accounting firm identified a certain "material weakness" (as such term is defined under Public Company Accounting Oversight Board Auditing Standard No. 2) in our internal controls. As a result of this material weakness, the Company's Chief Executive Officer and Chief Financial Officer has determined that the Company's internal controls are ineffective.

The material weakness identified is related to management's inadequate technical expertise with respect to income tax accounting and income tax disclosure in the 2005 financial statements. The lack of technical expertise is related to the Company's accounting and disclosure of deferred income tax liability for long-lived assets capitalized in the PyX acquisition. Although the lack of technical expertise did not result in any net changes to the balance sheets, statements of operations or cash flows, during 2005 it did result in an adjustment to the disclosures related to deferred income tax assets and liability in the notes to the financial statements. The Company will utilize the assistance of income tax reporting specialists in future periods.

***Limitations on the Effectiveness of Controls***

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the controls are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Accordingly, the Company's disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met and, as set forth above, the Company's Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by this quarterly report on Form 10-Q, that the Company's disclosure controls and procedures were sufficiently effective to provide reasonable assurance that the objectives of the Company's disclosure control system were met.

**PART II. Other Information****Item 6. Exhibits and Reports on Form 8-K**

## (a)(3) List of Exhibits

Exhibit Number Description

- |          |                                                                                                                                                              |
|----------|--------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1(1)   | Certificate of Incorporation, as amended through December 15, 1997.                                                                                          |
| 3.2(2)   | Bylaws, as amended through December 8, 1998.                                                                                                                 |
| 10.1(3)* | 1996 Stock Option Plan, as amended.                                                                                                                          |
| 10.2(4)* | 1991 Non-Employee Directors' Stock Option Plan, as amended.                                                                                                  |
| 10.3(5)  | 1992 Employee Stock Purchase Plan, as amended.                                                                                                               |
| 10.4(5)  | 1998 Non-Officer Stock Option Plan as amended.                                                                                                               |
| 10.5(6)  | 2005 PyX Technologies Stock Option Plan.                                                                                                                     |
| 10.6     | Lease for 4000 Executive Parkway, Suite 200 dated July 27, 2005 between the Company and Alexander Properties Company.                                        |
| 10.7(5)* | Full Recourse Promissory Note executed by William B. Heye, Jr. in favor of the Company dated November 6, 1998, as amended and restated on December 14, 2001. |

- 10.8(5)+ Letter Agreement, dated October 30, 2001, amending (i) Amendment No. S/M018-4 dated April 3, 2001, and (ii) Purchase Agreement dated May 6, 1991, each between SBE, Inc. and Compaq Computer Corporation
- 10.9(7) Stock subscription agreement and warrant to purchase 111,111 of SBE, Inc. Common Stock dated April 30, 2002 between SBE, Inc. and Stonestreet Limited Partnership.
- 10.10(8) Amendment dated August 22, 2002 to stock subscription agreement dated April 20, 2002 between SBE, Inc. and Stonestreet LP.
- 10.11(9) Securities Purchase Agreement, dated July 27, 2003, between SBE, Inc. and purchasers of SBE's common stock thereunder, including form of warrant issued thereunder
- 10.12(9) Form of warrant issued to associates of Puglisi & Co. (\$1.50 exercise price)
- 10.13(9) Form of warrant issued to associates of Puglisi & Co. (\$1.75 and \$2.00 exercise price)
- 10.14(10) Unit Subscription Agreement, dated May 4, 2005, by and between SBE, Inc. and the other parties thereto.
- 10.15(10) Agreement and Plan of Merger and Reorganization, dated March 28, 2005, by and among SBE, Inc., PyX Acquisition Sub, LLC, PyX Technologies, Inc. and the parties identified on Exhibit A thereto.
- 10.16(10) Investor Rights Agreement, dated July 26, 2005, between SBE, Inc. and the investors listed on Exhibit A thereto.
- 10.17(10) Form of warrant issued on July 26, 2005.
- 31.1 Certification of Chief Executive Officer
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- \* Indicates management contract or compensation plans or arrangements filed pursuant to Item 601(b)(10) of Regulation SK.
- + Certain confidential information has been deleted from this exhibit pursuant to a confidential treatment order that has been granted.

- (1) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 1997 and incorporated herein by reference.
- (2) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 1998 and incorporated herein by reference.
- (3) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 2002 and incorporated herein by reference.
- (4) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 1993 and incorporated herein by reference.
- (5) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 1995 and incorporated herein by reference.
- (6) Filed as an exhibit to Registration Statement on Form S-8 dated September 20, 2005 and incorporated herein by reference.
- (7) Filed as an exhibit to Registration Statement on Form S-3 dated May 23, 2002 and incorporated herein by reference.
- (8) Filed as an exhibit to Quarterly Report on Form 10-Q for the quarter ended July 31, 2002 and incorporated herein by reference.
- (9) Filed as an exhibit to Registration Statement on Form S-3 dated July 11, 2003 and incorporated herein by reference.
- (10) Filed as an exhibit to Proxy Statement on Form 14A dated June 24, 2005 and incorporated herein by reference.

**(b) Reports on Form 8-K**

A report on Form 8-K was filed with the Securities and Exchange Commission on January 13, 2006. The report provided information regarding the granting of restricted common stock to certain officers and directors on January 16, 2006.



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, on March 6, 2006.

**SBE, Inc.**

Registrant

Date: March 6, 2006

By: /s/ Kenneth Yamamoto  
Kenneth Yamamoto  
Chief Executive Officer and President  
*(Principal Executive Officer)*

Date: March 6, 2006

By: /s/ David W. Brunton  
David W. Brunton  
Chief Financial Officer, Vice President, Finance and  
Secretary  
*(Principal Financial and Accounting Officer)*