

DIGI INTERNATIONAL INC

Form 10-Q

February 07, 2008

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

FORM 10-Q

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

For the quarterly period ended: December 31, 2007

OR

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

For the transition period from _____ to _____.

Commission file number: 0-17972

DIGI INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

Delaware

41-1532464

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification Number)

11001 Bren Road East

Minnetonka, Minnesota 55343

(Address of principal executive offices) (Zip Code)

(952) 912-3444

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months, 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, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No
On January 31, 2008, there were 25,691,024 shares of the registrant's \$.01 par value Common Stock outstanding.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three months ended December 31,	
	2007	2006
	(in thousands, except per common share data)	
Net sales	\$ 44,574	\$ 41,811
Cost of sales (exclusive of amortization of purchased and core technology shown separately below)	19,543	18,650
Amortization of purchased and core technology	1,136	1,148
 Gross profit	 23,895	 22,013
Operating expenses:		
Sales and marketing	8,686	8,158
Research and development	6,589	5,972
General and administrative	4,022	3,578
Total operating expenses	19,297	17,708
 Operating income	 4,598	 4,305
Interest income, net:		
Interest income	1,054	796
Interest expense	(14)	(25)
Total interest income, net	1,040	771
 Income before income taxes	 5,638	 5,076
Income tax provision	1,968	1,274
 Net income	 \$ 3,670	 \$ 3,802
 Net income per common share:		
Basic	\$ 0.14	\$ 0.15
 Diluted	 \$ 0.14	 \$ 0.15
 Weighted average common shares, basic	 25,619	 25,078

Weighted average common shares, diluted	26,593	25,983
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The accompanying notes are an integral part of the condensed consolidated financial statements.

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**DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)**

	December 31, 2007	September 30, 2007
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 17,778	\$ 18,375
Marketable securities	68,863	67,111
Accounts receivable, net	20,525	21,022
Inventories	26,647	26,130
Other	4,732	4,961
Total current assets	138,545	137,599
Marketable securities, long-term	4,246	2,081
Property, equipment and improvements, net	20,727	19,987
Identifiable intangible assets, net	22,416	24,214
Goodwill	66,995	66,817
Other	920	1,128
Total assets	\$ 253,849	\$ 251,826
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Capital lease obligations, current portion	\$ 381	\$ 379
Accounts payable	5,299	6,554
Income taxes payable	1,623	3,156
Accrued expenses:		
Compensation	4,133	7,080
Other	3,610	4,727
Total current liabilities	15,046	21,896
Capital lease obligations, net of current portion	263	358
Income taxes payable long-term	3,990	
Net deferred tax liabilities	5,280	6,667
Total liabilities	24,579	28,921
Commitments and contingencies		
Stockholders equity:		
Preferred stock, \$.01 par value; 2,000,000 shares authorized; none issued and outstanding		

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Common stock, \$.01 par value; 60,000,000 shares authorized; 28,267,761 and 28,153,763 shares issued	283	281
Additional paid-in capital	174,463	172,156
Retained earnings	69,944	66,782
Accumulated other comprehensive income	2,816	2,121
Treasury stock, at cost, 2,578,237 and 2,606,419 shares	(18,236)	(18,435)
Total stockholders' equity	229,270	222,905
Total liabilities and stockholders' equity	\$ 253,849	\$ 251,826

The accompanying notes are an integral part of the condensed consolidated financial statements.

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DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three months ended December 31,	
	2007	2006
	(in thousands)	
Operating activities:		
Net income	\$ 3,670	\$ 3,802
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of property, equipment and improvements	601	645
Amortization of identifiable intangible assets and other assets	1,896	1,947
Excess tax benefits from stock-based compensation	(129)	(60)
Stock-based compensation	872	765
Deferred income taxes (benefit) provision	(1,235)	78
Other	162	289
Changes in operating assets and liabilities:		
Accounts receivable	667	657
Inventories	(620)	(2,930)
Other assets	304	(776)
Accounts payable and accrued expenses	(4,149)	(2,444)
Income taxes payable	1,978	1,179
Net cash provided by operating activities	4,017	3,152
Investing activities:		
Purchase of held-to-maturity marketable securities	(23,836)	(16,941)
Proceeds from maturities of held-to-maturity marketable securities	19,919	20,143
Contingent purchase price payments related to business acquisitions	(1,315)	(781)
Purchase of property, equipment, improvements and certain other intangible assets	(1,177)	(688)
Net cash (used in) provided by investing activities	(6,409)	1,733
Financing activities:		
Payments on capital lease obligations	(102)	(103)
Excess tax benefits from stock-based compensation	129	60
Proceeds from stock option plan transactions	1,224	515
Proceeds from employee stock purchase plan transactions	348	191
Net cash provided by financing activities	1,599	663

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Effect of exchange rate changes on cash and cash equivalents	196	246
Net (decrease) increase in cash and cash equivalents	(597)	5,794
Cash and cash equivalents, beginning of period	18,375	15,674
Cash and cash equivalents, end of period	\$ 17,778	\$ 21,468

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**DIGI INTERNATIONAL INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)**

1. BASIS OF PRESENTATION OF UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The interim unaudited condensed consolidated financial statements included in this Form 10-Q have been prepared by Digi International Inc. (the Company, Digi, we, our, or us) pursuant to the rules and regulations of the Securities Exchange Commission (SEC). Certain information and footnote disclosures, normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted, pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto, including the summary of significant accounting policies, presented in our 2007 Annual Report on Form 10-K as filed with the SEC.

The condensed consolidated financial statements presented herein reflect, in the opinion of management, all adjustments which consist only of normal, recurring adjustments necessary for a fair statement of the condensed consolidated financial position and the condensed consolidated results of operations and cash flows for the periods presented. The condensed consolidated results of operations for any interim period are not necessarily indicative of results for the full year. The year-end condensed consolidated balance sheet data were derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Recently Issued Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 160,

Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160) to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 establishes accounting and reporting standards that require (i) the ownership interest in subsidiaries held by parties other than the parent to be clearly identified and presented in the consolidated balance sheet within equity, but separate from the parent s equity, (ii) the amount of consolidated net income attributable to the parent and the noncontrolling interest to be clearly identified and presented on the face of the consolidated statement of income, and (iii) changes in a parent s ownership interest while the parent retains its controlling financial interest in its subsidiary to be accounted for consistently. SFAS 160 will be effective for our fiscal year beginning October 1, 2009. Earlier adoption is prohibited. We do not expect SFAS 160 to have a material impact on our consolidated financial statements.

In December 2007, the FASB issued FASB Statement No. 141(R), Business Combinations (SFAS 141(R)). This Statement retained the fundamental requirements in the former Statement that the acquisition method of accounting (previously referred to as the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defined the acquirer as the entity that obtains control of one or more businesses in the business combination and established the acquisition date as the date that the acquirer achieves control. The new standard requires the acquiring entity in a business combination to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. This Statement also makes certain other modifications to the former Statement. SFAS 141(R) is effective for business combinations that are consummated for our fiscal year beginning October 1, 2009. Early adoption is not permitted. We are currently evaluating the potential impact of SFAS 141(R) on our consolidated financial statements.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****1. BASIS OF PRESENTATION OF UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

In February 2007, the FASB issued FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS 159). This Statement provides companies with an option to measure, at specified election dates, many financial instruments and certain other items at fair value that are not currently measured at fair value. A company that adopts SFAS 159 will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. This Statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This Statement is effective for fiscal years beginning after November 15, 2007, which for us is the fiscal year beginning October 1, 2008. We do not expect SFAS 159 to have a material impact on our consolidated financial statements, if we decide to adopt.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of FAS 157 are effective for our fiscal year beginning October 1, 2008 for financial assets and liabilities and for some, not all, non-financial assets and liabilities beginning October 1, 2009. We are currently evaluating the impact of the provisions of FAS 157 on our consolidated financial statements.

2. COMPREHENSIVE INCOME

Comprehensive income is comprised of net income and foreign currency translation adjustments. Foreign currency translation adjustments are charged or credited to accumulated other comprehensive income within stockholders equity. Comprehensive income was as follows (in thousands):

	Three months ended	
	December 31,	
	2007	2006
Net income	\$ 3,670	\$ 3,802
Foreign currency translation gain	695	379
Comprehensive income	\$ 4,365	\$ 4,181

3. NET INCOME PER COMMON SHARE

Basic net income per common share is calculated based on the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares of our stock result from dilutive common stock options and shares purchased through the employee stock purchase plan.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****3. NET INCOME PER COMMON SHARE (CONTINUED)**

The following table is a reconciliation of the numerators and denominators in the net income per common share calculations (in thousands, except per common share data):

	Three months ended December 31,	
	2007	2006
Numerator:		
Net income	\$ 3,670	\$ 3,802
Denominator:		
Denominator for basic net income per common share weighted average shares outstanding	25,619	25,078
Effect of dilutive securities:		
Employee stock options and employee stock purchase plan	974	905
Denominator for diluted net income per common share adjusted weighted average shares outstanding	26,593	25,983
Net income per common share, basic	\$ 0.14	\$ 0.15
Net income per common share, diluted	\$ 0.14	\$ 0.15

Potentially dilutive common shares related to stock options to purchase 219,250 and 562,613 common shares at December 31, 2007 and 2006, respectively were not included in the computation of diluted earnings per common share because the options exercise prices were greater than the average market price of common shares and, therefore, their effect would be anti-dilutive.

4. SELECTED BALANCE SHEET DATA

(in thousands)	December 31, 2007	September 30, 2007
Accounts receivable, net:		
Accounts receivable	\$ 21,017	\$ 21,501
Less allowance for doubtful accounts	492	479
	\$ 20,525	\$ 21,022
Inventories:		
Raw materials	\$ 23,511	\$ 20,097
Work in process	112	816
Finished goods	3,024	5,217
	\$ 26,647	\$ 26,130

Other accrued expenses:			
Product warranty accrual	\$	1,134	\$ 1,155
Accrued professional fees		639	522
Unearned revenue		323	190
Other accrued expenses		1,514	1,910
Contingent purchase price accrual			950
	\$	3,610	\$ 4,727

Inventories are stated at the lower of cost or market value, with cost determined using the first-in, first-out method.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****5. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS**

Amortized identifiable intangible assets were comprised of the following (in thousands):

	December 31, 2007			September 30, 2007		
	Gross carrying amount	Accum. amort.	Net	Gross carrying amount	Accum. amort.	Net
Purchased and core technology	\$ 38,735	\$ (27,853)	\$ 10,882	\$ 38,702	\$ (26,689)	\$ 12,013
License agreements	2,440	(2,390)	50	2,440	(2,290)	150
Patents and trademarks	8,011	(4,073)	3,938	7,925	(3,818)	4,107
Customer maintenance contracts	700	(411)	289	700	(394)	306
Customer relationships	11,671	(4,414)	7,257	11,613	(3,975)	7,638
Total	\$ 61,557	\$ (39,141)	\$ 22,416	\$ 61,380	\$ (37,166)	\$ 24,214

Amortization expense was \$1.9 million for both of the three month periods ended December 31, 2007 and 2006. Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2008 and the five succeeding fiscal years is as follows (in thousands):

2008 (nine months)	\$ 3,778
2009	4,202
2010	3,637
2011	3,076
2012	2,512
2013	1,765

The changes in the carrying amount of goodwill were as follows (in thousands):

	Three months ended December 31,	
	2007	2006
Beginning balance, October 1	\$ 66,817	\$ 65,841
Foreign currency translation adjustment	178	100
Ending balance, December 31	\$ 66,995	\$ 65,941

6. INCOME TAXES

For the first quarter of fiscal 2008 income taxes have been provided at an effective rate of 34.9% compared to 25.1% for the first quarter of fiscal 2007. On December 9, 2006, Congress passed H.R. 6111, the Tax Relief and Health Care Act of 2006, which included an extension of the research credit that previously expired on December 31, 2005. As a result of the extension, we recorded a discrete tax benefit of \$0.5 million in the first quarter of fiscal 2007 for research and development credits earned during the last three fiscal quarters of 2006, which reduced the effective tax rate by approximately 9 percentage points. The effective tax rate for the three months ended December 31, 2007 is approximately equal to the U.S. statutory rate of 35%. The effective tax rate for the three months ended December 31, 2006 is lower than the U.S. statutory rate of 35.0% primarily due to the aforementioned discrete item.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****6. INCOME TAXES (CONTINUED)**

Effective October 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (*FIN 48*). As a result of our adoption of *FIN 48*, we recognized an increase in our existing liabilities for unrecognized tax benefits of \$1.1 million and additional deferred tax assets of \$0.6 million, with an offsetting cumulative effect adjustment resulting in a decrease to the opening balance of retained earnings of \$0.5 million. At the adoption date, we had \$3.5 million of gross unrecognized tax benefits and accrued interest and penalties of \$0.5 million. If all of our unrecognized tax benefits were recognized, approximately \$3.5 million would impact our effective tax rate. All of our liabilities for unrecognized tax benefits are recorded as a long-term liability as we do not expect significant payments to occur over the next 12 months. In conjunction with our adoption of *FIN 48*, we reclassified \$4.0 million of unrecognized tax benefits that we do not expect to pay in cash over the next 12 months from a short-term liability to a long-term liability. We have elected to recognize interest and penalties related to income tax matters in income tax expense.

We file a consolidated U.S. federal income tax return, as well as income tax returns in various state and foreign jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by taxing authorities for years prior to fiscal 2004. Although the timing and resolution of potential tax audits is uncertain, we do not believe it is reasonably possible that the total amounts of unrecognized tax benefits will materially change in the next 12 months.

7. FINANCIAL GUARANTEES

In general, we warrant our products to be free from defects in material and workmanship under normal use and service for a period of up to five years from the date of receipt. We have the option to repair or replace products we deem defective with regard to material or workmanship. Estimated warranty costs are accrued in the period that the related revenue is recognized based upon an estimated average per unit repair or replacement cost applied to the estimated number of units under warranty. These estimates are based upon historical warranty incidence and are evaluated on an ongoing basis to ensure the adequacy of the warranty reserve. The following table summarizes the activity associated with the product warranty accrual (in thousands):

	Balance at October 1	Warranties issued	Settlements made	Balance at December 31
2007	\$ 1,155	\$ 165	\$ (186)	\$ 1,134
2006 (1)	\$ 1,104	\$ 85	\$ (225)	\$ 964

(1) Warranties issued includes a decrease in estimate adjustment of \$132,000 for the three months ended December 31, 2006.

We are not responsible and do not warrant that custom software versions created by original equipment manufacturer (OEM) customers based upon our software source code will function in a particular way, will conform to any specifications or are fit for any particular purpose and do not indemnify these customers from any third-party liability as it relates to or arises from any customization or modifications made by the OEM customer.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

8. CONTINGENCIES

Contingent obligations

Effective April 1, 2005, we acquired FS Forth-Systeme GmbH/Sistemas Embebidos S.A. (collectively referred to as FS Forth) from Embedded Solutions AG of Germany. The purchase price of \$6.5 million in cash included contingent consideration of \$0.8 million paid in October 2006 and the final payment of \$0.9 million, which was paid in October 2007, based on the achievement of milestones identified in the merger agreement.

Legal Proceedon prevailing compensation practices in technology companies with

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whom the Company competes for executive talent and by their evaluating such information in connection with the Company's corporate goals. To this end, the Committee attempts to compare the compensation of the Company's CEO and other executive officers with the compensation practices of comparable companies to determine base salary, target bonuses and target total cash compensation.

Compensation of Executive Officers

During the fiscal year that ended on December 31, 2002, the Company's executive compensation program was comprised of the following key components: base salary, annual bonus, and equity-based incentives.

Base Salary. The Company sets the base salaries of its executives at levels believed to be consistent with comparably sized companies engaged in similar industries.

Equity-Based Incentive Compensation. Stock options are an important component of the total compensation of executives. The Company believes that stock options align the interests of each executive with those of the stockholders. They also provide executives a significant, long-term interest in the Company's success and help retain key executives in a competitive market for executive talent. The Company's 1999 Equity Incentive Plan authorizes the Committee to grant stock options to executives. The number of shares owned by, or subject to options held by, each executive officer is periodically reviewed and additional awards are considered based upon past performance of the executive and the relative holdings of other executives in the Company. The option grants generally utilize four-year vesting periods to encourage executives to continue contributing to the Company, and they expire not later than ten years from the date of grant.

Compensation of the Chief Executive Officer

The Company's CEO's compensation plans include the same elements and performance measures as the plans of the Company's other executive officers. The Compensation Committee evaluates the performance of the Company's CEO, sets his base compensation and determines bonuses and awards stock or option grants, if any.

Mr. Pietri joined the Company in April of 2001 and the Company entered into a one-year employment agreement with him. In determining the terms of his agreement, the Compensation Committee considered a number of factors and criteria including, Mr. Pietri's depth of experience, his past accomplishments with other companies, his vision and leadership abilities, and the future needs of the Company. In making its compensation decisions with Mr. Pietri, the Compensation Committee also considered the need to retain Mr. Pietri and decided to award him a bonus at the end of one full year's service. Based on his successes to date, the Company decided to advance this bonus in January 2002. In April 2002, Mr. Pietri's employment agreement with the Company was amended and extended for an additional year. Under the terms of the extension, the guaranteed bonus was reduced to \$75,000, and a discretionary bonus of \$75,000 was added to the agreement. The guaranteed bonus of \$75,000 was paid in January 2003, and the discretionary bonus of \$75,000 was paid in April 2003. The Compensation Committee exercised its discretion and judgment based on the above factors, and no specific formula was applied to determine the weight of any factor.

Deductibility of Executive Compensation

The Compensation Committee has considered the impact of Section 162(m) of the Code, which disallows a deduction for any publicly held corporation for individual compensation exceeding \$1 million in any taxable year for the CEO and four other most highly compensated executive officers, unless such compensation meets the requirements for the performance-based exception to the general rule. Since the cash compensation paid by the Company to each of its executive officers is expected to be below \$1 million, the Compensation Committee believes that this section will not affect the tax deductions available to the

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Company. It will be the Compensation Committee's policy to qualify, to the extent reasonable, the executive officers' compensation for deductibility under applicable tax law.

COMPENSATION COMMITTEE

/s/ MATT FONG

/s/ HERBERT CHANG

**COMPENSATION COMMITTEE INTERLOCKS
AND INSIDER PARTICIPATION**

Fred Chan, who is the Chairman of the Company, participated in deliberations of the Company's Board of Directors concerning executive officer compensation. Matthew Fong, who was an employee of the Company through January 2003, and Didier Pietri, who remains an officer of the Company, also participated in deliberations of the Company's Board of Directors concerning executive officer compensation.

Vialta employs Fred S.L. Chan's brother as its Senior Director of IT and one of his sons as its Director of Product Marketing and Design. The salary and benefits provided to these individuals for fiscal 2002 was \$105,000 and \$88,000, respectively. Another of Mr. Chan's sons is employed as a Marketing Coordinator and received salary and benefits during the last fiscal year that did not exceed \$60,000.

No Compensation Committee interlocks existed during 2002.

CERTAIN RELATIONSHIPS AND CERTAIN TRANSACTIONS

Vialta employs Fred S.L. Chan's brother as its Senior Director of IT and one of his sons as its Director of Product Marketing and Design. The salary and benefits provided to these individuals for fiscal 2002 was \$105,000 and \$88,000, respectively, and they also received the Company's standard employee benefits package. Another of Mr. Chan's sons is employed as a Marketing Coordinator and received salary and benefits during the last fiscal year that did not exceed \$60,000.

Mr. Chan is Chairman of the Board of ESS Technology, Inc., and owns approximately 20.6% of the outstanding common stock of ESS. Prior to its spin-off in August 2001, Vialta was a subsidiary of ESS. Vialta leases its corporate headquarters and purchases component parts from ESS. The companies are also parties to an Administrative and Management Services Agreement. During 2002, Vialta made payments to ESS of \$1,852,000 under the lease, \$1,403,000 for component parts, \$201,000 for administrative and management services, \$27,000 for services received in fiscal 2001, and received payments from ESS of \$223,000 for administrative and management services, \$77,000 for product sales and \$124,000 for services rendered in fiscal 2001. Vialta believes it paid fair market value for the lease based on a review of lease rental rates in its area and believes the prices it was charged for parts is equivalent to those charged by ESS to other manufactures.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16 of the Securities Exchange Act of 1934, as amended, requires the Company's directors and officers, and persons who own more than 10% of the Company's Common Stock to file initial reports of ownership and reports of changes in ownership. Such persons are required by SEC regulation to furnish the Company with copies of all Section 16(a) forms that they file. Based solely on its review of the copies of such forms furnished to the Company and written representations from the executive officers and directors, the Company believes that all transactions required to be reported pursuant to Section 16(a) for the year ended December 31, 2002 were reported on a timely basis with the exception of Mr. Chan, who filed two reports in April 2003 for 223,816 shares acquired from ESS Technology's second distribution in November 2002; Mr. Pietri, who filed a report in February for 15,000 shares acquired open market transactions in December 2002 and a report filed in April 2003 for 17 shares acquired from ESS Technology's second distribution in

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November 2002; Mr. Chang, who filed a report in February 2003 for options granted in June 2002; Mr. Fong, who filed a form in February 2003 for options granted in November 2002, and Mr. Scharninghausen, who filed a form in November 2002 for options granted in November 2002.

HOUSEHOLDING INFORMATION

Some banks, brokers and other nominees are participating in the practice of householding proxy statements and annual reports. This means that only one Proxy Statement and set of accompanying materials is being delivered to multiple security holders sharing an address. We will deliver, promptly upon written or oral request, a separate copy of the Proxy Statement and accompanying materials to a security holder at a shared address to which a single copy of the documents was delivered. A security holder who wishes to receive a separate copy of the Proxy Statement and accompanying materials now or in the future, or security holders sharing an address who are receiving multiple copies of proxy materials and wish to receive a single copy of such materials, should submit a written request to Director of Finance, Vialta, Inc., 48461 Fremont Boulevard, Fremont, CA 94538 or call 510-870-3068.

OTHER BUSINESS

The Board does not presently intend to bring any other business before the Annual Meeting, and, so far as is known to the Board, no matters are to be brought before the Annual Meeting except as specified in the Notice of the Annual Meeting. As to any business that may properly come before the Annual Meeting, however, it is intended that proxies, in the form enclosed, will be voted in respect thereof in accordance with the judgment of the persons voting such proxies.

Whether or not you expect to attend the Meeting, please complete, date, sign and promptly return the accompanying Proxy in the enclosed postage paid envelope so that your shares may be represented at the meeting.

BY ORDER OF THE BOARD OF DIRECTORS

WILLIAM M. SCHARNINGHAUSEN
Chief Financial Officer

Dated: April 30, 2003

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Appendix A

VIALTA, INC.

AMENDED AND RESTATED

2000 DIRECTORS STOCK OPTION PLAN

1. *Purpose.* This Amended and Restated 2000 Directors Stock Option Plan (the *Plan*) is established to provide equity incentives for nonemployee members of the Board of Directors of Vialta, Inc. (the *Company*), who are described in Section 6.1 below, by granting such persons options to purchase shares of stock of the Company.

1. *Adoption and Stockholder Approval.* This Plan was adopted by the Board of Directors of the Company (the *Board*) effective as of February 17, 2000 and was amended and restated effective as of April 30, 2003 (the *Amendment Effective Date*). This Plan shall be approved by the stockholders of the Company, consistent with applicable laws, within twelve (12) months after the Amendment Effective Date. Options (*Options*) granted under this Plan before the Amendment Effective Date but after February 17, 2000 shall remain in full force and effect in accordance with the terms and provisions of the Plan as in effect prior to the Amendment Effective Date. In the event that stockholder approval is not obtained within the time period provided herein, this Plan and all Options granted hereunder shall be subject to the terms of the Plan as in effect prior to the Amendment Effective Date. No Option that is issued as a result of any increase in the number of shares authorized to be issued under this Plan shall be exercised prior to the time such increase has been approved by the stockholders of the Company and all such Options granted pursuant to such increase shall similarly terminate if such stockholder approval is not obtained.

2. *Types of Options and Shares.* Options granted under this Plan shall be nonqualified stock options (*NQSOs*). The shares of stock that may be purchased upon exercise of Options granted under this Plan (the *Shares*) are shares of the Common Stock of the Company.

3. *Number of Shares.* The maximum number of Shares that may be issued pursuant to Options granted under this Plan (the *Maximum Number*) is 600,000 Shares, subject to adjustment as provided in this Plan. If any Option is terminated for any reason without being exercised in whole or in part, the Shares thereby released from such Option shall be available for purchase under other Options subsequently granted under this Plan. At all times during the term of this Plan, the Company shall reserve and keep available such number of Shares as shall be required to satisfy the requirements of outstanding Options granted under this Plan; *provided, however*, that if the aggregate number of Shares subject to outstanding Options granted under this Plan plus the aggregate number of Shares previously issued by the Company pursuant to the exercise of Options granted under this Plan equals or exceeds the Maximum Number of Shares, then notwithstanding anything herein to the contrary, no further Options may be granted under this Plan until the Maximum Number is increased or the aggregate number of Shares subject to outstanding Options granted under this Plan plus the aggregate number of Shares previously issued by the Company pursuant to the exercise of Options granted under this Plan is less than the Maximum Number.

4. *Administration.* This Plan shall be administered by the Board or by a committee of not less than two members of the Board appointed to administer this Plan (the *Committee*). As used in this Plan, references to the Committee shall mean either such Committee or the Board if no Committee has been established. The interpretation by the Committee of any of the provisions of this Plan or any Option granted under this Plan shall be final and binding upon the Company and all persons having an interest in any Option or any Shares purchased pursuant to an Option.

5. *Eligibility and Award Formula.*

5.1 *Eligibility.* Options may be granted only to directors of the Company who are not employees of the Company or any Parent, Subsidiary or Affiliate of the Company, as those terms are defined in Section 17 below.

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5.2 *Initial Grant.* Each Optionee who on or after January 1, 2003 becomes a member of the Board or a non-employee member of the Board will automatically be granted an Option for 20,000 Shares (the *Initial Grant*). Initial Grants shall be made on the date such Optionee first becomes a member of the Board.

5.3 *Succeeding Grants.* On each anniversary of the Initial Grant, or, in the case of an Optionee who did not receive an Initial Grant, on each anniversary of the most recent prior grant date of an option to such Optionee, if the Optionee is still a member of the Board and has served continuously as a member of the Board since such date, the Optionee will automatically be granted an Option for 20,000 Shares (a *Succeeding Grant*); provided, however, that in no event shall any Optionee be granted Options to purchase more than 100,000 Shares under this Plan.

6. *Terms and Conditions of Options.* Subject to the following and to Section 6 above:

6.1 *Form of Option Grant.* Each Option granted under this Plan shall be evidenced by a written Stock Option Grant (*Grant*) in such form (which need not be the same for each Optionee) as the Committee shall from time to time approve, which Grant shall comply with and be subject to the terms and conditions of this Plan.

6.2 *Vesting.* Options granted under this Plan shall be exercisable as they vest. The date an Optionee receives an Initial Grant or a Succeeding Grant is referred to in this Plan as the *Start Date* for such Option.

(a) *Initial Grants.* Each Option that is an Initial Grant will vest as to twenty-five percent (25%) of the Shares upon each of the first four (4) successive anniversaries of the Start Date for such Initial Grant, so long as the Optionee continuously remains a director of the Company.

(b) *Succeeding Grants.* Each Succeeding Grant will vest as to twenty-five percent (25%) of the Shares upon each of the first four (4) successive anniversaries of the Start Date for such Succeeding Grant, so long as the Optionee continuously remains a director of the Company.

6.3 *Exercise Price.* The exercise price of an Option shall be the Fair Market Value (as defined in Section 17) of the Shares, at the time that the Option is granted.

6.4 *Termination of Option.* Except as provided below in this Section, each Option shall expire ten (10) years after its Start Date (the *Expiration Date*). The Option shall cease to vest if the Optionee ceases to be a member of the Board. The date on which the Optionee ceases to be a member of the Board shall be referred to as the *Termination Date*. An Option may be exercised after the Termination Date only as set forth below:

(a) *Termination Generally.* If the Optionee ceases to be a member of the Board for any reason except death or disability, then each Option then held by such Optionee, to the extent (and only to the extent) that it would have been exercisable by the Optionee on the Termination Date, may be exercised by the Optionee within seven (7) months after the Termination Date, but in no event later than the Expiration Date.

(b) *Death or Disability.* If the Optionee ceases to be a member of the Board because of the death of the Optionee or the disability of the Optionee within the meaning of Section 22(c)(3) of the Internal Revenue Code of 1986, as amended (the *Code*), then each Option then held by such Optionee, to the extent (and only to the extent) that it would have been exercisable by the Optionee on the Termination Date, may be exercised by the Optionee (or the Optionee's legal representative) within twelve (12) months after the Termination Date, but in no event later than the Expiration Date.

7. *Exercise of Options.*

7.1 *Notice.* Options may be exercised only by delivery to the Company of an exercise agreement in a form approved by the Committee stating the number of Shares being purchased, the restrictions imposed on the Shares and such representations and agreements regarding the Optionee's investment

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intent and access to information as may be required by the Company to comply with applicable securities laws, together with payment in full of the exercise price for the number of Shares being purchased.

7.2 *Payment.* Payment for Shares purchased upon exercise of an Option may be made (a) in cash or by check; (b) by surrender of shares of Common Stock of the Company that have been owned by the Optionee for more than six (6) months (and which have been paid for within the meaning of Rule 144 promulgated under the Securities Act of 1933, as amended (the *Securities Act*) and, if such shares were purchased from the Company by use of a promissory note, such note has been fully paid with respect to such shares) or were obtained by the Optionee in the open public market, having a Fair Market Value equal to the exercise price of the Option; (c) by waiver of compensation due or accrued to the Optionee for services rendered; (d) provided that a public market for the Company's stock exists, through a same day sale commitment from the Optionee and a broker-dealer that is a member of the National Association of Securities Dealers (an *NASD Dealer*) whereby the Optionee irrevocably elects to exercise the Option and to sell a portion of the Shares so purchased to pay for the exercise price and whereby the NASD Dealer irrevocably commits upon receipt of such Shares to forward the exercise price directly to the Company; (e) provided that a public market for the Company's stock exists, through a same day sale commitment from the Optionee and a NASD Dealer whereby the Optionee irrevocably elects to exercise the Option and to pledge the Shares so purchased to the NASD Dealer in a margin account as security for a loan from the NASD Dealer in the amount of the exercise price, and whereby the NASD Dealer irrevocably commits upon receipt of such Shares to forward the exercise price directly to the Company; or (f) by any combination of the foregoing.

7.3 *Withholding Taxes.* Prior to issuance of the Shares upon exercise of an Option, the Optionee shall pay or make adequate provision for any federal or state withholding obligations of the Company, if applicable.

7.4 *Limitations on Exercise.* Notwithstanding the exercise periods set forth in the Grant, exercise of an Option shall always be subject to the following limitations:

(a) An Option shall not be exercisable until such time as this Plan (or, in the case of Options granted pursuant to an amendment increasing the number of shares that may be issued pursuant to this Plan, such amendment) has been approved by the stockholders of the Company in accordance with Section 15 hereof.

(b) An Option shall not be exercisable unless such exercise is in compliance with the Securities Act and all applicable state securities laws, as they are in effect on the date of exercise.

(c) The Committee may specify a reasonable minimum number of Shares that may be purchased upon any exercise of an Option, provided that such minimum number will not prevent the Optionee from exercising the full number of Shares as to which the Option is then exercisable.

8. *Nontransferability of Options.* During the lifetime of the Optionee, an Option shall be exercisable only by the Optionee or by the Optionee's guardian or legal representative, unless otherwise permitted by the Committee. No Option may be sold, pledged, assigned, hypothecated, transferred or disposed of in any manner other than by will or by the laws of descent and distribution.

9. *Privileges of Stock Ownership.* No Optionee shall have any of the rights of a stockholder with respect to any Shares subject to an Option until the Option has been validly exercised. No adjustment shall be made for dividends or distributions or other rights for which the record date is prior to the date of exercise, except as provided in this Plan. The Company shall provide to each Optionee a copy of the annual financial statements of the Company, at such time after the close of each fiscal year of the Company as they are released by the Company to its stockholders.

10. *Adjustment of Option Shares.* In the event that the number of outstanding shares of Common Stock of the Company is changed by a stock dividend, stock split, reverse stock split, combination, reclassification or similar change in the capital structure of the Company without consideration, the number of Shares available under this Plan, the size of the Initial Grant and Succeeding Grant described in Section 6,

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and the number of Shares subject to outstanding Options and the exercise price per share of such outstanding Options shall be proportionately adjusted, subject to any required action by the Board or stockholders of the Company and compliance with applicable securities laws; *provided, however*, that no fractional shares shall be issued upon exercise of any Option and any resulting fractions of a Share shall be rounded up to the nearest whole Share.

11. *No Obligation to Continue as Director.* Nothing in this Plan or any Option granted under this Plan shall confer on any Optionee any right to continue as a director of the Company.

12. *Compliance With Laws.* The grant of Options and the issuance of Shares upon exercise of any Option shall be subject to and conditioned upon compliance with all applicable requirements of law, including without limitation compliance with the Securities Act, compliance with all other applicable state securities laws and compliance with the requirements of any stock exchange or national market system on which the Shares may be listed. The Company shall be under no obligation to register the Shares with the SEC or to effect compliance with the registration or qualification requirement of any state securities laws, stock exchange or national market system.

13. *Acceleration of Options.* In the event of (a) a dissolution or liquidation of the Company, (b) a merger or consolidation in which the Company is not the surviving corporation (other than a merger or consolidation with a wholly-owned subsidiary, a reincorporation of the Company in a different jurisdiction, or other transaction in which there is no substantial change in the stockholders of the Company or their relative stock holdings and the Options granted under this Plan are assumed or replaced by the successor corporation, which assumption will be binding on all Optionees), (c) a merger in which the Company is the surviving corporation but after which the stockholders of the Company (other than any stockholder which merges (or which owns or controls another corporation which merge) with the Company in such merger) cease to own their shares or other equity interests in the Company, (d) the sale of substantially all of the assets of the Company, or (e) any other transaction which qualifies as a corporate transaction under Section 424 of the Code wherein the stockholders of the Company give up all of their equity interests in the Company (*except* for the acquisition, sale or transfer of all or substantially all of the outstanding shares of the Company from or by the stockholders of the Company), the vesting of all options granted pursuant to this Plan will accelerate and the options will become exercisable in full as of the date 10 days prior to the consummation of such event and if such options are not exercised prior to the consummation of the corporate transaction, they shall terminate in accordance with the provisions of this Plan, unless the acquiring or successor corporation (or parent corporation thereof) assumes the Company's rights and obligations under the outstanding Options or substitutes for outstanding Options substantially equivalent options for such corporation's stock.

14. *Amendment or Termination of Plan.* The Committee may at any time terminate or amend this Plan (but may not terminate or amend the terms of any outstanding option without the consent of the Optionee); *provided, however*, that the Committee shall not, without the approval of the stockholders of the Company, increase the total number of Shares available under this Plan (except by operation of the provisions of Sections 4 and 11 above) or adopt any other amendment that would require stockholder approval under any applicable law, regulation or rule. In any case, no amendment of this Plan may adversely affect any then outstanding Options or any unexercised portions thereof without the written consent of the Optionee.

15. *Term of Plan.* Options may be granted pursuant to this Plan from time to time within a period of ten (10) years from the date this Plan is adopted by the Board.

16. *Certain Definitions.* As used in this Plan, the following terms shall have the following meanings:

16.1 *Affiliate* means any corporation that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, another corporation, where control (including the terms controlled by and under common control with) means the possession, direct or indirect, of the power to cause the direction of the management and policies of the corporation, whether through the ownership of voting securities, by contract or otherwise.

16.2 *Fair Market Value* shall mean as of any date, the value of a share of the Company's Common Stock determined by the Board in its sole discretion, exercised in good faith; *provided, however*,

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that where there is a public market for the Common Stock, the Fair Market Value per share shall be the average of the closing bid and asked prices of the Common Stock on the last trading day prior to the date of determination as reported in *The Wall Street Journal* (or, if not so reported, as otherwise reported by the Nasdaq Stock Market) or, in the event the Common Stock is listed on a stock exchange or on the Nasdaq National Market, the Fair Market Value per share shall be the closing price on the exchange or on the Nasdaq National Market on the last trading date prior to the date of determination as reported in *The Wall Street Journal*; *provided, however*, that notwithstanding the foregoing, with respect to the Initial Grants that are granted on the Expiration Date, the Fair Market Value shall mean the price per share at which shares of the Company's Common Stock are initially offered for sale to the public by the Company's underwriters in the initial public offering of the Company's Common Stock pursuant to a registration statement filed with the SEC under the Securities Act.

16.3 *Parent* means any corporation (other than the Company) in an unbroken chain of corporations ending with the Company if, at the time of the granting of the Option, each of such corporations other than the Company owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

16.4 *Subsidiary* means any corporation (other than the Company) in an unbroken chain of corporations beginning with the Company if, at the time of granting of the Option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

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PROXY

**THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS OF
VIALTA, INC.**

2003 ANNUAL MEETING OF STOCKHOLDERS

The undersigned stockholder of Vialta, Inc., a Delaware corporation, hereby acknowledges receipt of the Notice of Annual Meeting of Stockholders and Proxy Statement, each dated April 30, 2003, and hereby appoints Didier Pietri and William M. Scharninghausen, and each of them, with full power to each of substitution, as proxies and attorneys-in-fact, on behalf and in the name of the undersigned, to represent the undersigned at the Annual Meeting of Stockholders of Vialta, Inc. to be held on June 17, 2003 at 2:00 p.m. local time, at the Fremont Marriott, 46100 Landing Parkway, Fremont, CA 94538, and at any adjournment or postponement thereof, to vote all shares of Common Stock which the undersigned would be entitled to vote if then and there personally present, on the matters set forth on the reverse side.

The Proxy will be voted as directed or, if no contrary direction is indicated, will be voted as follows: (1) **FOR** the Election of Directors in the manner described in the Proxy Statement, (2) **FOR** the approval of the Amended and Restated 2000 Directors Stock Options Plan (3) **FOR** the proposal to ratify the selection of PricewaterhouseCoopers LLP as the Company's independent accountants for the fiscal year ending December 31, 2003.

(Continued and to be signed on reverse side)

Address Change/Comments (Mark the corresponding box on the reverse side)

Fold and detach here.

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THIS PROXY, WHEN PROPERLY EXECUTED, WILL BE VOTED IN THE MANNER DIRECTED HEREIN BY THE UNDERSIGNED STOCKHOLDER(S)

Mark Here
for Address
Change or
Comments
**PLEASE SEE
REVERSE SIDE**

The Board of Directors unanimously recommends a vote FOR all nominees for directors and Proposals 2 and 3.

		FOR all nominees listed below (except as indicated)	WITHHOLD AUTHORITY			
		<input type="radio"/>	<input type="radio"/>	FOR	AGAINST	ABSTAIN
1.	Election of the six directors nominated by the Board of Directors.	<input type="radio"/>	<input type="radio"/>	ITEM 2-	To approve the Amended and Restated 2000 Directors Stock Options Plan.	<input type="radio"/> <input type="radio"/> <input type="radio"/>
01	Fred S.L.	04	Herbert Chang	ITEM 3-	To ratify the appointment of PricewaterhouseCoopers LLP as independent accountants of the Company for the fiscal year ending December 31, 2003.	<input type="radio"/> <input type="radio"/> <input type="radio"/>
02	Chan	05	Michael S. Dubester			
03	Didier Pietri George M. Cain	06	Matthew K. Fong			

(To withhold authority to vote for any individual nominee or nominees write such nominee's or nominees' name in the space provided below)

and, in their discretion, the proxies are authorized to vote on such other business as may properly come before the meeting or any adjournment thereof.

PLEASE MARK, SIGN, DATE AND RETURN THE PROXY CARD USING THE ENCLOSED ENVELOPE.

Signature _____ Signature _____ Date _____

Please sign exactly as name appears hereon. Where shares are held by joint tenants, both should sign. When signing as attorney, executor, administrator, trustee, or guardian, please give full title as such. If a corporation, please sign in full corporate name by President or other authorized officer. If a partnership, please sign in partnership by authorized person.

Fold and detach here.