NETWORK ENGINES INC

FORM 10-Q
(Quarterly Report)

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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 March 31, 2010

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: 000-30863

NETWORK ENGINES, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation)	**04-3064173** (I.R.S. Employer Identification No.)
25 Dan Road, Canton, MA (Address of principal executive offices)	**02021** (Zip Code)

(781) 332-1000
(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 (or for such shorter period that the 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 ☐ (Do not check if a smaller reporting company)	Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of May 6, 2010, there were 42,631,017 shares of the registrant's Common Stock, par value $.01 per share, outstanding.

NETWORK ENGINES, INC.

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PART I. FINANCIAL INFORMATION

ITEM I. FINANCIAL STATEMENTS

NETWORK ENGINES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)
(unaudited)

	March 31, 2010	September 30, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 16,138	$ 21,039
Accounts receivable, net of allowances of $80 and $117 at March 31, 2010 and September 30, 2009, respectively	34,304	27,479
Refundable acquisition consideration	—	3,629
Inventories	23,897	13,078
Prepaid expenses and other current assets	1,467	1,521
Total current assets	75,806	66,746
Property and equipment, net	1,557	1,622
Intangible asset, net	7,351	8,128
Other assets	230	174
Total assets	$ 84,944	$ 76,670
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 21,029	$ 14,200
Accrued compensation and other related benefits	1,729	1,466
Accrued warranty	593	641
Other accrued expenses	1,695	2,043
Deferred revenue	4,393	4,233
Total current liabilities	29,439	22,583
Deferred revenue, net of current portion	2,951	2,517
Total liabilities	32,390	25,100
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, $0.01 par value, 5,000,000 authorized, and no shares issued and outstanding	—	—
Common stock, $0.01 par value, 100,000,000 shares authorized; 47,280,097 and 47,132,540 shares issued; 42,136,693 and 42,147,336 shares outstanding at March 31, 2010 and September 30, 2009, respectively	473	471
Additional paid-in capital	197,436	196,711
Accumulated deficit	(140,336)	(140,770)
Treasury stock, at cost, 5,143,404 and 4,985,204 shares at March 31, 2010 and September 30, 2009, respectively	(5,019)	(4,842)
Total stockholders' equity	52,554	51,570
Total liabilities and stockholders' equity	$ 84,944	$ 76,670

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

NETWORK ENGINES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three months ended March 31,		Six months ended March 31,	
	2010	2009	2010	2009
Net revenues	$ 55,030	$ 37,461	$ 99,082	$ 74,696
Cost of revenues	48,527	31,693	86,524	63,320
Gross profit	6,503	5,768	12,558	11,376
Operating expenses:				
Research and development	1,584	1,653	3,267	3,095
Selling and marketing	2,060	2,024	3,818	4,201
General and administrative	2,199	2,275	4,220	4,350
Amortization of intangible asset	389	439	778	878
Total operating expenses	6,232	6,391	12,083	12,524
Income (loss) from operations	271	(623)	475	(1,148)
Interest and other (expense) income, net	(26)	(47)	(8)	12
Income (loss) before income taxes	245	(670)	467	(1,136)
Provision for income taxes	9	—	33	—
Net income (loss)	$ 236	$ (670)	$ 434	$ (1,136)
Net income (loss) per share — basic	$ 0.01	$ (0.02)	$ 0.01	$ (0.03)
Net income (loss) per share — diluted	$ 0.01	$ (0.02)	$ 0.01	$ (0.03)
Shares used in computing basic net income (loss) per share	42,050	43,177	42,039	43,156
Shares used in computing diluted net income (loss) per share	43,566	43,177	43,199	43,156

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

NETWORK ENGINES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six months ended March 31, 2010	Six months ended March 31, 2009
Cash flows from operating activities:		
Net income (loss)	$ 434	$ (1,136)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,241	1,334
(Gain) loss on disposal of property and equipment	(9)	7
Provision for doubtful accounts	(31)	25
Stock-based compensation	594	680
Changes in operating assets and liabilities:		
Accounts receivable	(6,794)	3,614
Income tax receivable	—	1,856
Inventories	(10,817)	6,275
Prepaid expenses and other assets	37	536
Accounts payable	6,829	(2,898)
Accrued expenses	(104)	(726)
Deferred revenue	593	(548)
Net cash (used in) provided by operating activities	(8,027)	9,019
Cash flows from investing activities:		
Receipt of refundable acquisition consideration	3,629	—
Purchases of property and equipment	(408)	(544)
Net cash provided by (used in) investing activities	3,221	(544)
Cash flows from financing activities:		
Purchase of treasury stock	(177)	(218)
Proceeds from issuance of common stock	130	89
Payment of bank line of credit fees	(38)	—
Payments on capital lease obligation	(10)	(14)
Net cash used in financing activities	(95)	(143)
Net (decrease) increase in cash and cash equivalents	(4,901)	8,332
Cash and cash equivalents, beginning of period	21,039	10,003
Cash and cash equivalents, end of period	$ 16,138	$ 18,335

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

NETWORK ENGINES, INC.
NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared by Network Engines, Inc. ("Network Engines" or the "Company") in accordance with accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all year-end disclosures required by accounting principles generally accepted in the United States of America. These financial statements should be read in conjunction with the audited financial statements and the accompanying notes included in the Company's 2009 Annual Report on Form 10-K (the "2009 Form 10-K") filed by the Company with the SEC.

The information furnished reflects all adjustments, which, in the opinion of management, are of a normal recurring nature and are considered necessary for a fair statement of results for the interim periods. It should also be noted that results for the interim periods are not necessarily indicative of the results expected for the full year or any future period.

The preparation of these condensed consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates reflected in these financial statements include allowance for doubtful accounts, inventory valuation, valuation of deferred tax assets, valuation of intangible assets, warranty reserves and stock-based compensation. Actual results could differ from those estimates.

2. Significant Accounting Policies

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued authoritative guidance which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. This guidance was effective for fiscal years beginning after November 15, 2007; however, the FASB delayed the effective date to fiscal years beginning after November 15, 2008 for nonfinancial assets and nonfinancial liabilities, except those items recognized or disclosed at fair value on an annual or more frequent basis. The Company adopted this guidance, as it applies to its financial assets and liabilities which are recognized or disclosed at fair value on a recurring basis (at least annually), as of October 1, 2008. The Company adopted this guidance, as it applies to its nonfinancial assets and liabilities, as of October 1, 2009. The adoption of this guidance did not have an impact on the Company's financial position, results of operations, or cash flows.

In December 2007, the FASB issued authoritative guidance related to business combinations. This guidance establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This guidance is effective for business combinations on a prospective basis for which the acquisition date is on or after the beginning of the Company's first annual reporting period beginning on or after December 15, 2008. The Company adopted this guidance as of October 1, 2009 and the adoption did not have an impact on its financial position, results of operations, or cash flows.

In April 2008, the FASB issued authoritative guidance used to determine the useful life of intangible assets. This guidance amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. This change is intended to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. The requirement for determining useful lives must be applied prospectively to intangible assets acquired after the effective date and the disclosure requirements must be applied prospectively to all

intangible assets recognized as of, and subsequent to, the effective date. The Company adopted this guidance as of October 1, 2009 and the adoption did not have an impact on its financial position, results of operations, or cash flows.

In October 2009, the FASB issued authoritative guidance for multiple-deliverable revenue arrangements, which amends previously issued guidance to require an entity to use its best estimate of selling price when vendor-specific objective evidence or acceptable third party evidence of selling price does not exist for any products or services included in a multiple element arrangement. The arrangement consideration should be allocated among the products and services based upon their relative selling prices, thus eliminating the use of the residual method of allocation. This guidance also requires expanded qualitative and quantitative disclosures regarding significant judgments made and changes in applying this guidance. This guidance is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption and retrospective application are also permitted. The Company adopted this guidance as of January 1, 2010 and the adoption did not have a material impact on its financial position, results of operations, or cash flows, and does not change the units of accounting for our revenue transactions.

In October 2009, the FASB issued authoritative guidance for certain revenue arrangements that include software elements. Under this guidance, tangible products containing software elements that function together to deliver the product's essential functionality are no longer within the scope of software revenue guidance. Entities that sell joint hardware and software products that meet this scope exception will be required to follow the guidance for multiple-deliverable revenue arrangements outside of the scope of software revenue guidance. This guidance is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption and retrospective application are also permitted. The Company adopted this guidance as of January 1, 2010 and the adoption did not have a material impact on its financial position, results of operations, or cash flows.

In January 2010, the FASB issued authoritative guidance requiring additional disclosure related to fair value measurements that are made on a recurring and non-recurring basis. This guidance updates the guidance previously issued by the FASB related to fair value measurement disclosures. Under this guidance, entities will be required to provide disclosures for transfers in and out of Level 1 and Level 2 fair value inputs. In addition, entities will be required to provide disclosures for activity within the Level 3 fair value input tier, including purchases, sales, issuances, and settlements during the reporting period. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for the Level 3 disclosure requirements, which will be effective for fiscal years beginning after December 15, 2010. The Company adopted the guidance as it relates to Level 1 and Level 2 fair value inputs as of January 1, 2010 and the adoption did not have a material impact on its financial position, results of operations, or cash flows. The Company does not expect the adoption of this guidance as it relates to Level 3 inputs to have a material impact on its financial position, results of operations, or cash flows.

Adoption of New Authoritative Guidance

In October 2009, the FASB amended the authoritative guidance related to revenue recognition for arrangements with multiple deliverables and arrangements that include software elements. The Company elected to early adopt this guidance on a prospective basis for applicable transactions originating or materially modified on or after January 1, 2010, the start of the second fiscal quarter of the Company's fiscal year 2010.

Under previous authoritative guidance, for revenue arrangements that contained multiple elements, such as the sale of both the product and post-sales support and/or extended warranty and related services element, in which software was not incidental to the product as a whole, the Company was required to determine the fair value of the undelivered elements based upon vendor-specific objective evidence ("VSOE") of fair value. VSOE was established through contractual post-sales support renewal rates. The Company used the residual fair value method to allocate the arrangement consideration to the product. For revenue arrangements that contained software elements that were not incidental to the product as a whole, and VSOE was not available for the undelivered elements, the Company deferred all revenue associated with the arrangement and recognized the revenue over the related service period.

Under the amended authoritative guidance for arrangements with multiple deliverables and arrangements that include software elements, the Company is required to determine if the software elements function together with the tangible product to deliver the tangible product's essential functionality. The Company determined that its software elements provide additional functionality but are not necessary to deliver the tangible product's essential

NETWORK ENGINES, INC.
NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

functionality; as such, the Company is required to allocate the arrangement consideration to the hardware and software elements based upon the relative selling price of the hardware and software deliverables.

The Company’s software elements consist of software and software maintenance. Revenue associated with the software is recognized upon delivery, when VSOE is available for the undelivered software maintenance. Revenue associated with the software maintenance is recognized over the term of the maintenance period, which is generally one year. When VSOE is not available for the undelivered software maintenance, revenue associated with the software elements is deferred and recognized over the software maintenance period.

The Company’s hardware elements generally consist of an application platform and post-sales support and/or an extended warranty. Revenue associated with the application platform is recognized upon delivery. The Company allocates revenue associated with the post-sales support and/or extended warranty based upon separately priced contractual rates for these elements. Revenue associated with the post-sales support and/or extended warranty is deferred and recognized over the support period, generally one to three years.

The following table presents the effect that the adoption of the authoritative guidance would have had on the Company’s Condensed Consolidated Statement of Operations for the three months ended December 31, 2009, assuming the Company had adopted the authoritative guidance on October 1, 2009:

	Three months ended December 31, 2009		
	As Reported	Adjustments	As Amended
Net revenues	$ 43,878	$ 175	$ 44,053
Cost of revenues	37,882	116	37,998
Gross profit	5,996	59	6,055
Operating expenses:			
Research and development	1,683	—	1,683
Selling and marketing	1,758	—	1,758
General and administrative	2,021	—	2,021
Amortization of intangible asset	389	—	389
Total operating expenses	5,851	—	5,581
Income from operations	145	59	204
Interest and other income, net	18	—	18
Income before income taxes	163	59	222
Provision for income taxes	24	—	24
Net income	$ 139	$ 59	$ 198
Net income per share – basic and diluted	$ 0.00	$ 0.00	$ 0.00
Shares used in computing basic net income per share	42,027	42,027	42,027
Shares used in computing diluted net income per share	42,833	42,833	42,833

The Company’s Condensed Consolidated Statement of Operations for the six months ended March 31, 2010 includes the impact of the adjustments above.

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Cash and Cash Equivalents

The Company held $16.1 million in cash as of March 31, 2010. The Company held cash and cash equivalents totaling $21.0 million as of September 30, 2009. Cash equivalents consisted of a money market fund purchased with an original maturity of three months or less. The following table presents balances of cash and cash equivalents held as of March 31, 2010 and September 30, 2009 (in thousands):

	March 31, 2010	September 30, 2009
Cash	$ 16,138	$ 4,009
Cash equivalents:		
Money market funds	—	17,030
Total cash and cash equivalents	$ 16,138	$ 21,039

Comprehensive Income (Loss)

During each period presented, comprehensive income (loss) was equal to net income (loss).

Significant Customers

The following table summarizes those customers which accounted for greater than 10% of the Company's net revenues or accounts receivable:

	Net Revenues				Accounts Receivable at	
	Three months ended March 31,		Six months ended March 31,			
	2010	2009	2010	2009	March 31, 2010	September 30, 2009
EMC Corporation	44%	38%	42%	36%	29%	30%
Tektronix, Inc.	25%	9%	23%	12%	35%	17%

3. Business Combination

On October 11, 2007, the Company acquired all of the equity of Alliance Systems, Inc. ("Alliance Systems"), a privately held corporation located in Plano, Texas, which provided application platforms and related equipment supporting carrier communications and enterprise communications solutions. For further information on the acquisition, refer to the Company's Annual Report on Form 10-K for the year ended September 30, 2009.

The acquisition of Alliance Systems was structured to include an adjustment to decrease the purchase price based on the net working capital of Alliance Systems as of October 11, 2007, as defined in the merger agreement, and therefore approximately $4.0 million of the cash paid was contingently returnable to the Company and was previously recorded as contingently returnable acquisition consideration. The former Alliance Systems shareholders disputed the amounts claimed by the Company under this provision of the merger agreement. In September 2009, the Company engaged in arbitration with the former Alliance Systems shareholders to resolve the disputed claims as provided for in the merger agreement. In October 2009, the arbitrator's decision was rendered. As a result, approximately $3.6 million of the contingently returnable consideration was returned to the Company from escrow funds on November 3, 2009. This amount was recorded as refundable acquisition consideration in the Company's consolidated balance sheet as of September 30, 2009. The $393,000 not returned to the Company was recorded as settlement of acquisition dispute in the statement of operations for the year ended September 30, 2009.

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4. Stock-Based Compensation

Stock-based compensation expense is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity award).

The following table presents stock-based employee compensation expense included in the Company's unaudited condensed consolidated statements of operations (in thousands):

	Three months ended March 31,		Six months ended March 31,	
	2010	2009	2010	2009
Cost of revenues	$ 39	$ 40	$ 77	$ 75
Research and development	43	58	89	142
Selling and marketing	92	77	169	138
General and administrative	108	166	259	325
Total stock-based compensation expense	$ 282	$ 341	$ 594	$ 680

The Company estimates the fair value of stock options using the Black-Scholes valuation model. This valuation model takes into account the exercise price of the award, as well as a variety of significant assumptions. These assumptions include the expected term, the expected volatility of the Company's common stock over the expected term, the risk-free interest rate over the expected term, and the Company's expected annual dividend yield. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the Company's stock options granted during the three and six month periods ended March 31, 2010 and 2009. Estimates of fair value are not intended to predict the value ultimately realized by persons who receive equity awards. In determining the amount of expense to be recorded, judgment is also required to estimate forfeitures of the awards based on the probability of employees completing the required service period. Historical forfeitures are used as a starting point for developing the estimate of future forfeitures.

Assumptions used to determine the fair value of options granted during the three and six months ended March 31, 2010 and 2009, using the Black-Scholes valuation model, were:

	Three months ended March 31,		Six months ended March 31,	
	2010	2009	2010	2009
Expected term (1)	3.75 to 6.50 years	3.50 to 6.00 years	3.75 to 6.50 years	3.50 to 6.00 years
Expected volatility factor (2)	71.56% to 72.09%	73.36% to 80.11%	71.56% to 74.03%	66.82% to 80.11%
Risk-free interest rate (3)	1.71% to 2.97%	1.28% to 2.21%	1.45% to 2.97%	1.28% to 2.21%
Expected annual dividend yield	—	—	—	—

(1) The expected term for each grant was determined based on analysis of the Company's historical exercise and post-vesting cancellation activity.

(2) The expected volatility for each grant was estimated based on a weighted average of the historical volatility of the Company's common stock.

(3) The risk-free interest rate for each grant was based on the U.S. Treasury yield curve in effect at the time of grant for a period equal to the expected term of the stock option.

Stock-based compensation expense incurred related to the Company's Employee Stock Purchase Plan (the "Purchase Plan") is determined based on the discount of 15% from the per share market price on the close of the purchase period. No expense related to the Purchase Plan was incurred during the three and six months ended March 31, 2010 as there have been no new offerings under the Purchase Plan since the most recent purchase in May 2009.

A summary of the Company's stock option activity for the six months ended March 31, 2010 is as follows:

NETWORK ENGINES, INC.
NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Six months ended March 31, 2010			
	Number of Options		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)
Outstanding at September 30, 2009	7,959,408	$	2.08	
Granted	518,500	$	1.50	
Exercised	(147,557)	$	0.88	
Forfeited	(36,458)	$	1.49	
Expired	(141,671)	$	2.72	
Outstanding at March 31, 2010	8,152,222	$	2.06	6.27
Exercisable at March 31, 2010	5,993,123	$	2.33	5.50

All stock options granted during the six months ended March 31, 2010 were granted with exercise prices equal to the fair market value of the Company’s common stock on the grant date and had a weighted average grant date fair value of $0.93.

At March 31 , 2010, unrecognized compensation expense related to non-vested stock options was $1,511,000, which is expected to be recognized over a weighted average vesting period of 2.25 years.

5. Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of shares of common stock outstanding during the period. Diluted net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of shares of common stock and potential common stock, if dilutive, outstanding during the period. Potential common stock includes incremental shares of common stock issuable upon the exercise of stock options, calculated using the treasury stock method. For periods in which the Company incurs a net loss, diluted net loss per share is the same as basic net loss per share because the inclusion of these common stock equivalents would be anti-dilutive.

The following table sets forth the computation of basic and diluted net income (loss) per share as well as the weighted average potential common stock excluded from the calculation of net income (loss) per share because their inclusion would be anti-dilutive (in thousands, except per share data):

	Three months ended March 31,				Six months ended March 31,			
	2010		2009		2010		2009	
Numerator:								
Net income (loss)	$	236	$	(670)	$	434	$	(1,136)
Denominator:								
Shares used in computing basic net income (loss) per share		42,050		43,177		42,039		43,156
Common stock equivalents from employee stock options		1,516		—		1,160		—
Shares used in computing diluted net income (loss) per share		43,566		43,177		43,199		43,156
Net income (loss) per share:								
Basic	$	0.01	$	(0.02)	$	0.01	$	(0.03)
Diluted	$	0.01	$	(0.02)	$	0.01	$	(0.03)
Anti-dilutive potential common stock equivalents excluded from the calculation of diluted net income (loss) per share:								
Options to purchase common stock		4,313		8,020		5,247		7,763

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NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

6. Intangible Asset

The Company recorded an intangible asset as the result of its acquisition of Alliance Systems (see Note 3 above). The acquired intangible asset is customer relationships, which is being amortized over 17 years, which is the estimated period of economic benefit expected to be received, resulting in a weighted average amortization period of 4.97 years. The following table presents the intangible asset balances as of March 31, 2010 and September 30, 2009 (in thousands):

	March 31, 2010			September 30, 2009		
	Gross Carrying Amount	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Customer relationships	$ 11,775	$ 4,424	$ 7,351	$ 11,775	$ 3,647	$ 8,128

Amortization expense for the three and six months ended March 31, 2010 was $389,000 and $778,000, respectively. The estimated future amortization expense for the intangible asset as of March 31, 2010 by fiscal year is $778,000 for the remainder of 2010, $1,330,000 for 2011, $1,119,000 for 2012, $868,000 for 2013, $678,000 for 2014 and $2,578,000 thereafter.

The Company reviews long-lived assets, including definite-lived intangible assets, to determine if any adverse conditions exist that would indicate impairment. Factors that could lead to an impairment of acquired customer relationships include a worsening in customer attrition rates compared to historical attrition rates, or lower than initially anticipated cash flows associated with customer relationships. The Company assesses the recoverability of long-lived assets based on the projected undiscounted future cash flows estimated to be generated over the asset's remaining life. The amount of impairment, if any, is measured based on the excess of the carrying value over fair value. Fair value is generally calculated as the present value of estimated future cash flows using a risk-adjusted discount rate, which requires significant management judgment with respect to revenue and expense growth rates, and the selection and use of an appropriate discount rate.

7. Inventories

Inventories consisted of the following (in thousands):

	March 31, 2010	September 30, 2009
Raw materials	$ 11,685	$ 8,246
Work in process	2,357	1,063
Finished goods	9,855	3,769
Total	$ 23,897	$ 13,078

8. Equity

On June 12, 2008, the Board of Directors of the Company authorized the repurchase of up to $5 million of its common stock through a share repurchase program. As authorized by the program, shares may be purchased in the open market or through privately negotiated transactions, in a manner consistent with applicable securities laws and regulations. This stock repurchase program does not obligate the Company to acquire any specific number of shares, does not have an expiration date, and may be terminated at any time by the Company's Board of Directors. All repurchases are expected to be funded from the Company's current cash balances or from cash generated from operations. To facilitate repurchases of shares under this program, the Company has established Rule 10b5-1 plans intended to comply with the requirements of Rule 10b5-1 and Rule 10b-18 under the Securities Exchange Act of 1934. A Rule 10b5-1 plan permits the repurchase of shares by a company at times when it otherwise might be prevented from doing so under insider trading laws or because of company blackout periods, provided that the plan is adopted when the company is not aware of material non-public information. Pursuant to the plan, a broker designated by the Company has the authority to repurchase shares, in accordance with the terms of the plan, without

further direction from the Company. The amount and timing of specific repurchases are subject to the terms of the plan and market conditions. Upon the expiration of the first 10b5-1 plan on November 7, 2008, the Company suspended repurchases of its common stock. The Company resumed the stock repurchase program on March 16, 2009 under a new 10b5-1 plan, as authorized by the Board of Directors. During the three months ended March 31, 2010, the Company did not repurchase any shares of its common stock. During the six months ended March 31, 2010, the Company repurchased 158,200 shares of its common stock at an average cost of $1.12 per share. From the inception of the share repurchase program through March 31, 2010, the Company had repurchased 2,581,546 shares of its common stock at an average cost of $0.84 per share. As of March 31, 2010, the maximum dollar value that may yet be used for purchases under the program was $2,820,000.

9. Commitments and Contingencies

Guarantees and Indemnifications

Acquisition-related indemnifications — When, as part of an acquisition, the Company acquires all the stock of a company, the Company assumes liabilities for certain events or circumstances that took place prior to the date of acquisition. The maximum potential amount of future payments the Company could be required to make for such obligations is undeterminable. Although certain provisions of the agreements remain in effect indefinitely, the Company believes that the probability of receiving a claim related to acquisitions other than Alliance Systems is unlikely. As a result, the Company had not recorded any liabilities for such indemnification clauses as of March 31, 2010. As of March 31, 2010, the Company had received two claims related to the Alliance Systems acquisition. For one of the claims, the Company paid a settlement of $88,000 during the fiscal year ended September 30, 2008. The second claim was brought in January 2009 by Cordsen Engineering GmbH (“Cordsen”), a former customer of Alliance Systems, alleging that certain products that Cordsen purchased from Alliance Systems (prior to the Company’s acquisition of Alliance Systems) were defective and did not meet Cordsen’s desired specifications. Cordsen alleges that by virtue of the Company’s acquisition of Alliance Systems in October 2007, the Company became the assignee of Alliance Systems’ agreement with Cordsen. In April 2010, a settlement was reached with Cordsen, whereby the former Alliance Systems shareholders have agreed to pay a settlement of $100,000 and the Company’s insurer has agreed to pay a settlement of $300,000 to Cordsen. Payment of the settlement is due on May 12, 2010.

The Company enters into standard indemnification agreements in the ordinary course of its business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally its business partners or customers, in connection with any patent, copyright, trademark, trade secret or other intellectual property infringement claim by any third party with respect to its products. The term of these indemnification agreements is generally perpetual. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these indemnifications as of March 31, 2010.

Product warranties — The Company offers and fulfills standard warranty services on its application platform solutions. Warranty terms vary in duration depending upon the product sold, but generally provide for the repair or replacement of any defective products for periods of up to 36 months after shipment. Based upon historical experience and expectation of future conditions, the Company reserves for the estimated costs to fulfill customer warranty obligations upon the recognition of the related revenue. The following table presents changes in the Company’s product warranty liability for the three and six months ended March 31, 2010 and 2009 (in thousands):

	Three months ended March 31,		Six months ended March 31,	
	2010	2009	2010	2009
Beginning balance	$ 602	$ 876	$ 641	$ 931
Accruals for warranties issued	463	249	787	582
Fulfillment of warranties during the period	(472)	(329)	(835)	(717)
Ending balance	$ 593	$ 796	$ 593	$ 796

NETWORK ENGINES, INC.
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Contingencies

Initial Public Offering Lawsuit

On or about December 3, 2001, a putative class action lawsuit was filed in the United States District Court for the Southern District of New York against the Company, Lawrence A. Genovesi (the Company's former Chairman and Chief Executive Officer), Douglas G. Bryant (the Company's Chief Financial Officer), and several underwriters of the Company's initial public offering. The suit alleges, *inter alia* , that the defendants violated the federal securities laws by issuing and selling securities pursuant to the Company's initial public offering in July 2000 ("IPO") without disclosing to investors that the underwriter defendants had solicited and received excessive and undisclosed commissions from certain investors. The suit seeks damages and certification of a plaintiff class consisting of all persons who acquired shares of the Company's common stock between July 13, 2000 and December 6, 2000.

In October 2002, Lawrence A. Genovesi and Douglas G. Bryant were dismissed from this case without prejudice. On December 5, 2006, the United States Court of Appeals for the Second Circuit overturned the District Court's certification of a plaintiff class. On April 6, 2007, the Second Circuit denied plaintiffs' petition for rehearing, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. On September 27, 2007, plaintiffs filed a motion for class certification in certain designated "focus cases" in the District Court. That motion has since been withdrawn. On November 13, 2007, the issuer defendants in certain designated "focus cases" filed a motion to dismiss the second consolidated amended class action complaints that were filed in those cases. On March 26, 2008, the District Court issued an Opinion and Order denying, in large part, the motions to dismiss the amended complaints in the "focus cases." On April 2, 2009, the plaintiffs filed a motion for preliminary approval of a new proposed settlement between plaintiffs, the underwriter defendants, the issuer defendants and the insurers for the issuer defendants. On June 10, 2009, the Court issued an opinion preliminarily approving the proposed settlement, and scheduling a settlement fairness hearing for September 10, 2009. On October 5, 2009, the Court issued an opinion granting plaintiffs' motion for final approval of the settlement, approval of the plan of distribution of the settlement fund, and certification of the settlement classes. An Order and Final Judgment was entered on December 30, 2009. Various notices of appeal of the District Court's October 5, 2009 order have been filed. The Company is unable to predict the outcome of this suit and as a result, no amounts have been accrued as of March 31, 2010.

10. Line of Credit

On October 11, 2007, the Company entered into a Loan and Security Agreement (the "Loan Agreement") with Silicon Valley Bank (the "Bank"). On August 5, 2008, the Company and the Bank entered into the First Loan Modification Agreement (the "First Modification "). The First Modification amended the Loan Agreement to extend its term to August 5, 2010, and to change the amount of the revolving loan facility to $10 million.

On February 5, 2010, the Company and the Bank entered into an Amended and Restated Loan and Security Agreement. This agreement amended the Loan Agreement to extend its term to February 4, 2012, and to change the interest rate on the line to one half of a point (0.50%) above the Prime Rate with interest payable monthly. The Prime Rate is the rate announced from time to time by the Bank. The Company is also required to comply with certain financial covenants relating to liquidity and minimum operating cash flows per quarter. As of May 10, 2010, the Company had not drawn on this line of credit.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Special Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, that involve risks and uncertainties. All statements other than statements of historical information provided herein are forward-looking statements and may contain projections related to financial results, economic conditions, trends and known uncertainties. Our actual results could differ materially from those discussed in the forward-looking statements as a result of a number of factors, which include those discussed in this section and in Part II, Item 1A, Risk Factors, of this report and the risks discussed in our other filings with the Securities and Exchange Commission (the "SEC"). Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis, judgment, belief or expectation only as of the date hereof. We undertake no obligation to publicly reissue these forward-looking statements to reflect events or circumstances that arise after the date hereof.

The following discussion and analysis should be read in conjunction with the condensed consolidated financial statements and the notes thereto included in Item 1 in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended September 30, 2009 filed by us with the SEC.

Overview

We design and manufacture application platform solutions that enable original equipment manufacturers, or OEMs, and independent software vendors, or ISVs, that then deliver their software applications in the form of a network-ready device. Application platforms are pre-configured server-based network infrastructure devices, engineered to deliver specific software application functionality, ease deployment challenges, improve integration and manageability, accelerate time-to-market and increase the security of that software application in an end user's network. We offer our customers an extensive suite of services including solution design, integration control, global logistics, Smart Services, and support and maintenance. We produce and fulfill devices branded for our customers, and derive our revenues primarily from the sale of value-added hardware platforms to these customers. Our customers subsequently resell and support these platforms under their own brands to their customer bases.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. In preparing these financial statements, we have made estimates and judgments in determining certain amounts included in the financial statements. We base our estimates and judgments on historical experience and other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

On January 1, 2010, we adopted the authoritative guidance issued by the Financial Accounting Standards Board ("FASB") related to revenue arrangements with multiple deliverables and revenue arrangements which include software elements. Under the amended authoritative guidance for arrangements with multiple deliverables and arrangements that include software elements, we are required to determine if the software elements function together with the tangible product to deliver the tangible product's essential functionality. We determined that our software elements provide additional functionality but are not necessary to deliver the tangible product's essential functionality; as such, we are required to allocate the arrangement consideration to the hardware and software elements based upon the relative selling price of the hardware and software deliverables. Our software elements consist of software and software maintenance. Revenue associated with the software is recognized upon delivery, when VSOE is available for the undelivered software maintenance. Revenue associated with the software maintenance is recognized over the term of the maintenance period, which is generally one year. When VSOE is not available for the undelivered software maintenance, revenue associated with the software elements is deferred and recognized over the software maintenance period. Our hardware elements generally consist of an application platform and post-sales support and/or an extended warranty. Revenue associated with the application platform is recognized upon delivery. We allocate revenue associated with the post-sales support and/or extended warranty based upon separately priced contractual rates for these elements. Revenue associated with the post-sales support and/or extended warranty is deferred and recognized over the support period, generally one to three years. With the exception of the adoption of the authoritative guidance related to revenue arrangements with multiple deliverables and revenue arrangements which include software elements, there have been no changes to our critical accounting policies since September 30, 2009.

Results of Operations

Three months ended March 31, 2010 compared to the three months ended March 31, 2009

The following table summarizes financial data for the periods indicated, in thousands and as a percentage of net revenues, and provides the changes in thousands and percentages:

	Three months ended March 31 ,					
	2010		2009			
		% of Net		% of Net	Increase (Decrease)	
	Dollars	Revenues	Dollars	Revenues	Dollars	Percentage
Net revenues	$ 55,030	100.0%	$ 37,461	100.0%	$ 17,569	46.9%
Gross profit	6,503	11.8%	5,768	15.4%	735	12.7%
Operating expenses	6,232	11.3%	6,391	17.1%	(159)	(2.5)%
Income (loss) from operations	271	0.5%	(623)	(1.7)%	894	—
Net income (loss)	$ 236	0.4%	$ (670)	(1.8)%	$ 906	—

Net Revenues

Our revenues are derived primarily from sales of application platform solutions to our OEM and ISV customers. The increase in net revenues during the three months ended March 31, 2010 as compared to the three months ended March 31, 2009 was primarily the result of increased sales volume to some of our larger customers, in particular a design win achieved in the fourth quarter of fiscal year 2009 with our largest customer, combined with lower overall sales volumes in the three months ended March 31, 2009 due to the global economic downturn. The increases in revenues were partially offset by a decrease in net revenues related to our transition away from some of our non-strategic, transactional revenues to projects that are more in line with our business model.

Gross Profit

Gross profit represents net revenues recognized less the cost of revenues. Cost of revenues includes cost of materials, manufacturing costs, warranty costs, inventory write-downs, shipping and handling costs and customer support costs. Manufacturing costs are primarily comprised of compensation, contract labor costs and, when applicable, contract manufacturing costs.

Gross profit increased in the three months ended March 31, 2010 as compared to the three months ended March 31, 2009, primarily due to increased sales volumes with our largest customer. Gross profit as a percentage of net revenues decreased for the three months ended March 31, 2010, as compared to the three months ended March 31, 2009. The decrease from the prior year was primarily due to the high volume design win achieved in the fourth quarter of fiscal year 2009 with our largest customer, which has gross margins that are lower than historical levels. The first shipments of product related to some of this business occurred (and the related revenues were recognized) during the three months ended December 31, 2009 and continued to ramp up in the three months ended March 31, 2010. We have pursued such opportunities in order to increase revenues and leverage those revenues over our existing infrastructure to improve operating margins. In addition, certain planned price decreases were in effect during the three months ended March 31, 2010 in connection with the design win achieved in the fourth quarter of fiscal year 2009 with our largest customer.

Gross profit as a percentage of net revenues is affected by customer and product mix, component material costs, pricing and the volume of orders as well as by the mix of product manufactured internally compared to product manufactured by a contract manufacturer, which carries higher manufacturing costs. There could be variability with regard to our gross profit percentage in future periods as it will be highly dependent on how much of our revenue is derived from our high volume, lower gross margin business. We may also continue to seek higher volume revenue opportunities which have gross profit percentages that are lower than historical levels.

Operating Expenses

The following table presents operating expenses during the periods indicated, in thousands and as a percentage of net revenues, and provides the changes in thousands and percentages:

	Three months ended March 31 ,					
	2010		2009		Increase (Decrease)	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	Percentage
Operating expenses:						
Research and development	$ 1,584	2.9%	$ 1,653	4.4%	$ (69)	(4.2)%
Selling and marketing	2,060	3.7%	2,024	5.4%	36	1.8%
General and administrative	2,199	4.0%	2,275	6.1%	(76)	(3.3)%
Amortization of intangible asset	389	0.7%	439	1.2%	(50)	(11.4)%
Total operating expenses	$ 6,232	11.3%	$ 6,391	17.1%	$ (159)	(2.5)%

Research and Development

Research and development expenses consist primarily of salaries and related expenses for personnel engaged in research and development, material costs for prototype and test units, fees paid to consultants and outside service providers, and other expenses related to the design, development, testing and enhancements of our application platform solutions. We expense all of our research and development costs as they are incurred. The following table summarizes the most significant components of research and development expense for the periods indicated, in thousands and as a percentage of total research and development expense, and provides the changes in thousands and percentages:

	Three months ended March 31 ,					
	2010		2009		Increase (Decrease)	
	Dollars	% of Expense Category	Dollars	% of Expense Category	Dollars	Percentage
Research and development:						
Compensation and related expenses	$ 1,227	77.5%	$ 1,035	62.6%	$ 192	18.6%
Stock-based compensation	43	2.7%	58	3.5%	(15)	(25.9)%
Prototype	188	11.9%	244	14.8%	(56)	(23.0)%
Consulting and professional services	72	4.5%	197	11.9%	(125)	(63.5)%
Other	54	3.4%	119	7.2%	(65)	(54.6)%
Total research and development	$ 1,584	100%	$ 1,653	100%	$ (69)	(4.2)%

Research and development expenses decreased in the three months ended March 31, 2010, as compared to the three months ended March 31, 2009, primarily due to decreases in prototype and consulting and professional services. These costs often tend to fluctuate based on the status of our development projects which are in process at any given time. Although our application platform development strategy emphasizes the utilization of standard component technologies, which utilize off-the-shelf components, some of our designs require customized platforms which require additional prototype and consulting and professional services. As such, we expect that prototype and consulting and professional services costs will continue to be variable and could fluctuate depending on the timing and magnitude of our development projects.

These decreases in prototype and consulting and professional services were partially offset by an increase in compensation and related expenses. Compensation and related expenses increased primarily due to an increase in headcount from 37 at March 31, 2009 to 40 at March 31, 2010 and an increase in variable compensation, which was directly related to the results of operations.

Selling and Marketing

Selling and marketing expenses consist primarily of salaries and commissions for personnel engaged in sales and marketing, and costs associated with our marketing programs, which include costs associated with our attendance at trade shows, public relations, product literature costs, web site enhancements, and travel. The following table summarizes the most significant components of selling and marketing expense for the periods indicated, in thousands and as a percentage of total selling and marketing expense, and provides the changes in thousands and percentages:

	Three months ended March 31,					
	2010		2009			
	Dollars	% of Expense Category	Dollars	% of Expense Category	Increase (Decrease) Dollars	Increase (Decrease) Percentage
Selling and marketing:						
Compensation and related expenses	$ 1,567	76.0%	$ 1,570	77.6%	$ (3)	(0.2)%
Stock-based compensation	92	4.5%	77	3.8%	15	19.5%
Marketing programs	150	7.3%	116	5.7%	34	29.3%
Travel	70	3.4%	76	3.8%	(6)	(7.9)%
Other	181	8.8%	185	9.1%	(4)	(2.2)%
Total selling and marketing	$ 2,060	100%	$ 2,024	100%	$ 36	1.8%

Selling and marketing expenses increased in the three months ended March 31, 2010, as compared to the three months ended March 31, 2010, primarily due to increased marketing program costs. The increase in marketing programs was primarily attributed to increased expenses associated with industry trade shows during the three months ended March 31, 2010. Historically, we have attended a major trade show during the third quarter of our fiscal year; however, that trade show occurred during the three months ended March 31, 2010 instead of the third quarter of fiscal year 2010. Compensation and related expenses decreased primarily as a result of a decrease in headcount from 43 at March 31, 2009 to 38 at March 31, 2010, partially offset by an increase in variable compensation which was directly related to the results of operations.

General and Administrative

General and administrative expenses consist primarily of salaries and other related costs for executive, finance, information technology and human resources personnel; consulting and professional services, which include legal, accounting, audit and tax fees; and director and officer insurance. The following table summarizes the most significant components of general and administrative expense for the periods indicated, in thousands and as a percentage of total general and administrative expense, and provides the changes in thousands and percentages:

	Three months ended March 31,					
	2010		2009			
	Dollars	% of Expense Category	Dollars	% of Expense Category	Increase (Decrease) Dollars	Increase (Decrease) Percentage
General and administrative:						
Compensation and related expenses	$ 1,303	59.3%	$ 1,096	48.2%	$ 207	18.9%
Stock-based compensation	108	4.9%	166	7.3%	(58)	(34.9)%
Consulting and professional services	490	22.3%	660	29.0%	(170)	(25.8)%
Director and officer insurance	38	1.7%	56	2.5%	(18)	(32.1)%
Other	260	11.8%	297	13.0%	(37)	(12.5)%
Total general and administrative	$ 2,199	100%	$ 2,275	100%	$ (76)	(3.3)%

General and administrative expenses decreased in the three months ended March 31, 2010, as compared to the three months ended March 31, 2009, primarily due to decreases in consulting and professional services and stock-based compensation, partially offset by an increase in compensation and related expenses. Compensation and

related expenses increased primarily due to an increase in variable compensation, which was directly related to the results of operations. The decrease in consulting and professional services was primarily attributed to a decrease in legal and outside service expenses incurred during the three months ended March 31, 2010 as compared to the three months ended March 31, 2009. The decrease in stock-based compensation was primarily due to the fact that certain stock options granted in prior periods reached the end of their vesting periods during the three months ended March 31, 2010.

Amortization of Intangible Asset

Amortization of the intangible asset decreased by $50,000 in the three months ended March 31, 2010, as compared to the three months ended March 31, 2009. Amortization expense for the intangible asset decreases annually over its life of 17 years, to reflect the fact that the estimated economic benefit expected to be received from the intangible asset declines over time.

Interest and Other Income (Expense), net

Interest and other income (expense), net, totaled $(26,000) of expense for the three months ended March 31, 2010, compared to $(47,000) of expense for the three months ended March 31, 2009. This change was primarily due to foreign currency exchange losses of $13,000 recorded during the three months ended March 31, 2010 as compared to foreign currency exchange losses of $83,000 recorded during the three months ended March 31, 2009. These losses relate primarily to value-added tax (“VAT”) refunds receivable. The refundable VAT amounts, which we pay on products and services purchased from our contract manufacturer located in Ireland, are denominated in Euros. The decrease in the foreign currency exchange loss incurred during the three months ended March 31, 2010 was partially offset by a decrease of $48,000 in interest income, primarily attributable to lower interest rates on the cash balances held by us during the three months ended March 31, 2010 as compared to the three months ended March 31, 2009.

Provision for Income Taxes

The provision for income taxes for the three months ended March 31, 2010 was $9,000, based upon our estimated effective tax rate for fiscal year 2010. There was no provision for income taxes during the three months ended March 31, 2009. Although we have significant net operating loss carryforwards which can be used to offset taxable income, we are still subject to federal alternative minimum tax. In addition, we will be subject to state taxes in various jurisdictions where we do not have net operating loss carryforwards or where states have suspended the use of net operating loss carryforwards to offset taxable income.

Six months ended March 31, 2010 compared to the six months ended March 31, 2009

The following table summarizes financial data for the periods indicated, in thousands and as a percentage of net revenues, and provides the changes in thousands and percentages:

	Six Months ended March 31 ,					
	2010		2009		Increase (Decrease)	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	Percentage
Net revenues	$ 99,082	100.0%	$ 74,696	100.0%	$ 24,386	32.6%
Gross profit	12,558	12.7%	11,376	15.2%	1,182	10.4%
Operating expenses	12,083	12.2%	12,524	16.7%	(441)	(3.5)%
Income (Loss) from operations	475	0.5%	(1,148)	(1.5)%	1,623	—
Net income (loss)	$ 434	0.4%	$ (1,136)	(1.5)%	$ 1,570	—

Net Revenues

The increase in net revenues during the six months ended March 31, 2010 as compared to the six months ended March 31, 2009 was primarily the result of increased sales volume to some of our larger customers, in particular a design win achieved in the fourth quarter of fiscal year 2009 with our largest customer, combined with lower overall sales volumes in the six months ended March 31, 2009 due to the global economic downturn. The

increase in revenues was partially offset by a decrease in net revenues related to our transition away from some of our non-strategic, transactional revenues to projects that are more in line with our business model.

Gross Profit

Gross profit increased in the six months ended March 31, 2010 as compared to the six months ended March 31, 2009, primarily due to increased sales volumes to our largest customer.

Gross profit as a percentage of net revenues decreased for the six months ended March 31, 2010, as compared to the six months ended March 31, 2009. The decrease from the prior year was primarily due to changes in customer and product mix, which were impacted by a high volume design win achieved in the fourth quarter of fiscal year 2009 with our largest customer, which has gross margins that are lower than historical levels. The first shipments of product related to some of this business occurred (and the related revenues were recognized) during the three months ended December 31, 2009 and continued to ramp up in the three months ended March 31, 2010. We have pursued such opportunities in order to increase revenues and leverage those revenues over our existing infrastructure to improve operating margins. In addition, certain planned price decreases took effect during the six months ended March 31, 2010 in connection with the design win achieved in the fourth quarter of fiscal year 2009 with our largest customer.

Operating Expenses

The following table presents operating expenses during the periods indicated, in thousands and as a percentage of net revenues, and provides the changes in thousands and percentages:

	Six months ended March 31 ,					
	2010		2009		Increase (Decrease)	
	Dollars	% of Net Revenues	Dollars	% of Net Revenues	Dollars	Percentage
Operating expenses:						
Research and development	$ 3,267	3.3%	$ 3,095	4.1%	$ 172	5.6%
Selling and marketing	3,818	3.9%	4,201	5.6%	(383)	(9.1)%
General and administrative	4,220	4.3%	4,350	5.8%	(130)	(3.0)%
Amortization of intangible asset	778	0.8%	878	1.2%	(100)	(11.4)%
Total operating expenses	$ 12,083	12.2%	$ 12,524	16.7%	$ (441)	(3.5)%

Research and Development

The following table summarizes the most significant components of research and development expense for the periods indicated, in thousands and as a percentage of total research and development expense, and provides the changes in thousands and percentages:

	Six months ended March 31 ,					
	2010		2009		Increase (Decrease)	
	Dollars	% of Expense Category	Dollars	% of Expense Category	Dollars	Percentage
Research and development:						
Compensation and related expenses	$ 2,242	68.6%	$ 2,005	64.8%	$ 237	11.8%
Stock-based compensation	89	2.7%	142	4.6%	(53)	(37.3)%
Prototype	514	15.7%	384	12.4%	130	33.9%
Consulting and professional services	214	6.6%	289	9.3%	(75)	(26.0)%
Other	208	6.4%	275	8.9%	(67)	(24.4)%
Total research and development	$ 3,267	100%	$ 3,095	100%	$ 172	5.6%

Research and development expenses increased in the six months ended March 31, 2010, as compared to the six months ended March 31, 2009 , primarily due to an increase in compensation and related expenses and prototype expenses. Compensation and related expenses increased primarily due to an increase in headcount from 37 at March 31, 2009 to 40 at March 31, 2010 and an increase in variable compensation, which was directly related to the results of operations. Because our prototype and consulting and professional services expenses are project driven, the timing of these expenditures can vary.

Selling and Marketing

The following table summarizes the most significant components of selling and marketing expense for the periods indicated, in thousands and as a percentage of total selling and marketing expense, and provides the changes in thousands and percentages:

	Six months ended March 31 ,					
	2010		2009		Increase (Decrease)	
	Dollars	% of Expense Category	Dollars	% of Expense Category	Dollars	Percentage
Selling and marketing:						
Compensation and related expenses	$ 2,878	75.5%	$ 3,135	74.6%	$ (257)	(8.2)%
Stock-based compensation	169	4.4%	138	3.3%	31	22.5%
Marketing programs	204	5.3%	287	6.8%	(83)	(28.9)%
Travel	169	4.4%	185	4.4%	(16)	(8.6)%
Other	398	10.4%	456	10.9%	(58)	(12.7)%
Total selling and marketing	$ 3,818	100%	$ 4,201	100%	$ (383)	(9.1)%

Selling and marketing expenses decreased in the six months ended March 31, 2010, as compared to the six months ended March 31, 2009, primarily due to decreases in compensation and related expenses and marketing programs. The decrease in compensation and related expenses was primarily attributed to a decrease in headcount from 43 at March 31, 2009 to 38 at March 31, 2010. The decrease in marketing programs was primarily attributed to a decrease in market research, public relations, and advertising related expenses incurred during the six months ended March 31, 2010 as compared to the six months ended March 31, 2009, in an effort to manage operating expenses.

General and Administrative

The following table summarizes the most significant components of general and administrative expense for the periods indicated, in thousands and as a percentage of total general and administrative expense, and provides the changes in thousands and percentages:

	Six months ended March 31 ,					
	2010		2009		Increase (Decrease)	
	Dollars	% of Expense Category	Dollars	% of Expense Category	Dollars	Percentage
General and administrative:						
Compensation and related expenses	$ 2,381	56.4%	$ 2,158	49.6%	$ 223	10.3%
Stock-based compensation	259	6.1%	325	7.5%	(66)	(20.3)%
Consulting and professional services	930	22.1%	1,125	25.9%	(195)	(17.3)%
Director and officer insurance	76	1.8%	111	2.5%	(35)	(31.5)%
Other	574	13.6%	631	14.5%	(57)	(9.0)%
Total general and administrative	$ 4,220	100%	$ 4,350	100%	$ (130)	(3.0)%

General and administrative expenses decreased in the six months ended March 31, 2010, as compared to the six months ended March 31, 2009, primarily due to decreases in consulting and professional services and stock-

based compensation expenses, partially offset by an increase in compensation and related expenses. The decrease in consulting and professional services was primarily attributed to a decrease in legal and outside service expenses incurred during the six months ended March 31, 2010 as compared to the six months ended March 31, 2009. The decrease in stock-based compensation was primarily due to the fact that certain stock options granted in prior periods reached the end of their vesting periods during the six months ended March 31, 2010. Compensation and related expenses increased primarily due to an increase in variable compensation, which was directly related to the results of operations.

Amortization of Intangible Asset

Amortization of the intangible asset decreased by $100,000 in the six months ended March 31, 2010, as compared to the six months ended March 31, 2009. Amortization expense for the intangible asset decreases annually over its life of 17 years, to reflect the fact that the estimated economic benefit expected to be received from the intangible asset declines over time.

Interest and Other Income (Expense), net

Interest and other income (expense), net, decreased to $(8,000) of expense for the six months ended March 31, 2010, as compared to $12,000 of income for the six months ended March 31, 2009. The change was primarily due to a decrease of $86,000 in interest income, primarily attributable to lower interest rates on the cash balances held by us during the six months ended March 31, 2010 as compared to the six months ended March 31, 2009. The decrease in interest income was partially offset by foreign currency exchange losses of $18,000 recorded during the six months ended March 31, 2010, as compared to foreign currency exchange losses of $80,000 recorded during the six months ended March 31, 2009. These gains and losses relate primarily to VAT refunds receivable. The refundable VAT amounts, which we pay on products and services purchased from our contract manufacturer located in Ireland, are denominated in Euros.

Provision for Income Taxes

The provision for income taxes for the six months ended March 31, 2010 was $33,000, based upon our estimate of effective tax rate for fiscal year 2010. There was no provision for income taxes during the six months ended March 31, 2009. Although we have significant net operating loss carryforwards which can be used to offset taxable income, we are still subject to federal alternative minimum tax. In addition, we will be subject to state taxes in various jurisdictions where we do not have net operating loss carryforwards or where states have suspended the use of net operating loss carryforwards to offset taxable income.

Liquidity and Capital Resources

The following table summarizes cash flow activities, in thousands, for the periods indicated:

	Six months ended March 31,	
	2010	**2009**
Net income (loss)	$ 434	$ (1,136)
Non-cash adjustments to net income (loss)	1,795	2,046
Changes in working capital	(10,256)	8,109
Net cash (used in) provided by operating activities	(8,027)	9,019
Net cash provided by (used in) investing activities	3,221	(544)
Net cash used in financing activities	(95)	(143)
Net (decrease) increase in cash and cash equivalents	(4,901)	8,332
Beginning cash and cash equivalents	21,039	10,003
Ending cash and cash equivalents	$ 16,138	$ 18,335

Operating Activities

Cash used in operating activities of $8.0 million during the six months ended March 31, 2010 was primarily the result of net cash used in changes in working capital, partially offset by net income and the impact of non-cash adjustments to net income. The changes in working capital were partially the result of an increase in accounts receivable, which was primarily related to higher net revenues in the three months ended March 31, 2010 compared to the three months ended September 30, 2009. The changes in working capital were also partially the result of an increase in inventories, which was primarily due to increased purchasing to meet expected future customer demand, in particular as a result of the ramping up of new business relating to our fiscal year 2009 design wins.

Cash provided by operating activities of $9.0 million during the six months ended March 31, 2009 was primarily the result of net cash provided by changes in working capital and the impact of non-cash adjustments to net loss, partially offset by the net loss for the period. The change in accounts receivable was related to collections of payments from customers. The change in inventories was related to the depletion of inventories on hand and lower purchases during the six months ended March 31, 2009, which was related to the downward trend in revenues and efforts undertaken by management to control inventory quantities on hand. Changes in working capital during the six months ended March 31, 2009 also included the receipt of $1.9 million of income tax refunds related to taxes paid by Alliance Systems in prior years.

Investing Activities

Cash provided by investing activities during the six months ended March 31, 2010 was primarily the result of the receipt of the $3.6 million in refundable acquisition consideration, which was a return of cash we originally paid in connection with our acquisition of Alliance Systems (see Note 3 in the notes to the condensed consolidated financial statements for details regarding the acquisition). This increase in cash was partially offset by the use of $408,000 of cash for purchases of property and equipment.

Cash used in investing activities during the six months ended March 31, 2009 consisted of the use of $544,000 of cash for purchases of property and equipment.

Financing Activities

Cash used in financing activities during the six months ended March 31, 2010 consisted primarily of $177,000 used to repurchase shares of our common stock and $38,000 used to pay fees associated with our bank line of credit, partially offset by the receipt of $130,000 as the result of employee stock option exercises (see Note 10 in the notes to the condensed consolidated financial statements for details regarding the line of credit). Cash used in financing activities during the six months ended March 31, 2009 consisted primarily of $218,000 used to repurchase shares of our common stock, partially offset by the receipt of $89,000 as the result of purchases under the Employee Stock Purchase Plan.

On June 12, 2008, our Board of Directors authorized the repurchase of up to $5 million of our common stock through a share repurchase program. As authorized by the program, shares may be purchased in the open market or through privately negotiated transactions, in a manner consistent with applicable securities laws and regulations. This stock repurchase program does not obligate us to acquire any specific number of shares, does not have an expiration date, and may be terminated at any time by our Board of Directors. All repurchases are expected to be funded from our current cash balances or from cash generated from operations. To facilitate repurchases of shares under this program, we have established Rule 10b5-1 plans intended to comply with the requirements of Rule 10b5-1 and Rule 10b-18 under the Securities Exchange Act of 1934. A Rule 10b5-1 plan permits the repurchase of shares by a company at times when it otherwise might be prevented from doing so under insider trading laws or because of company blackout periods, provided that the plan is adopted when the company is not aware of material non-public information. Pursuant to the plan, a broker designated by us has the authority to repurchase shares, in accordance with the terms of the plan, without further direction from us. The amount and timing of specific repurchases are subject to the terms of the plan and market conditions. During the three months ended March 31, 2010, we did not repurchase any shares of our common stock. During the six months ended March 31, 2010, we repurchased 158,200 shares of our common stock at an average cost of $1.12 per share. From the inception of the share repurchase program through March 31, 2010, we had repurchased 2,581,546 shares of our common stock at an average cost of $0.84 per share. Upon the expiration of the first 10b5-1 plan on November 7, 2008, we suspended repurchases of our common stock. We resumed the stock repurchase program on March 16, 2009 under a new

10b5-1 plan, as authorized by the Board of Directors. As of March 31, 2010, the maximum dollar value that may yet be used for purchases under the program was $2,820,000.

Our future liquidity and capital requirements will depend upon numerous factors, including:

- the timing and size of orders from our customers;
- the timeliness of receipts of payments from our customers;
- the timing and size of our purchases of inventories;
- our ability to enter into partnerships with OEMs and ISVs;
- the level of success of our customers in selling systems that include our application platform solutions;
- the costs and timing of product engineering efforts and the success of these efforts; and
- market developments.

We believe that our available cash resources and cash that we expect to generate from sales of our products and services will be sufficient to meet our operating and capital requirements through at least the next twelve months.

In the event that our available cash resources and the Silicon Valley Bank line of credit are not sufficient, or if an event of default occurs, such as failure to achieve certain financial covenants, that limits our ability to borrow under the line of credit, we may need to raise additional funds. We may in the future seek to raise additional funds through borrowings, public or private equity financings or from other sources. On April 28, 2010, we filed a shelf registration statement on Form S-3 (the "shelf registration statement"), pursuant to which we may sell, from time to time, any combination of securities under the prospectus included in the shelf registration statement, for an aggregate offering price of up to $40,000,000. Under the shelf registration statement, we may offer, from time to time, common stock, preferred stock, debt securities, depository shares, purchase contracts, purchase units, warrants, or any combination of the above offerings.

There can be no assurance that additional financing will be available at all or, if available, will be on terms acceptable to us. Additional equity financings could result in dilution to our shareholders. If additional financing is needed and is not available on acceptable terms, we may need to reduce our operating expenses and scale back our operations.

Contractual Obligations and Commitments

During the six months ended March 31, 2010, there were no material changes to our contractual obligations and commitments as disclosed in our Annual Report on Form 10-K for the year ended September 30, 2009.

Off-Balance Sheet Arrangements

We have not created, and are not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating parts of our business that are not consolidated into our financial statements. We have not entered into any transactions with unconsolidated entities whereby the Company has subordinated retained interests, derivative instruments or other contingent arrangements that expose the Company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the Company.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued authoritative guidance which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. This guidance was effective for fiscal years beginning after November 15, 2007; however, the FASB delayed the effective date to fiscal years beginning

after November 15, 2008 for nonfinancial assets and nonfinancial liabilities, except those items recognized or disclosed at fair value on an annual or more frequent basis. We adopted this guidance, as it applies to our financial assets and liabilities which are recognized or disclosed at fair value on a recurring basis (at least annually), as of October 1, 2008. We adopted this guidance, as it applies to our nonfinancial assets and liabilities, as of October 1, 2009. The adoption of this guidance did not have an impact on our financial position, results of operations, or cash flows.

In December 2007, the FASB issued authoritative guidance related to business combinations. This guidance establishes principles and requirements for how the acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This guidance is effective for business combinations on a prospective basis for which the acquisition date is on or after the beginning of our first annual reporting period beginning on or after December 15, 2008. We adopted this guidance on October 1, 2009 and the adoption did not have a material impact on our financial position, results of operations, or cash flows.

In April 2008, the FASB issued authoritative guidance used to determine the useful life of intangible assets. This guidance amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. This change is intended to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. The requirement for determining useful lives must be applied prospectively to intangible assets acquired after the effective date and the disclosure requirements must be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. This guidance is effective as of the beginning of our fiscal year that begins after December 15, 2008. We adopted this guidance on October 1, 2009 and the adoption did not have a material impact on our financial position, results of operations, or cash flows.

In October 2009, the FASB issued authoritative guidance for multiple-deliverable revenue arrangements, which amends previously issued guidance to require an entity to use its best estimate of selling price when vendor-specific objective evidence or acceptable third party evidence of selling price does not exist for any products or services included in a multiple element arrangement. The arrangement consideration should be allocated among the products and services based upon their relative selling prices, thus eliminating the use of the residual method of allocation. This standard also requires expanded qualitative and quantitative disclosures regarding significant judgments made and changes in applying this guidance. This standard is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption and retrospective application are also permitted. We adopted this authoritative guidance as of January 1, 2010 and the adoption did not have a material impact on our financial position, results of operations, or cash flows, and does not change the units of accounting for our revenue transactions.

In October 2009, the FASB issued authoritative guidance for certain revenue arrangements that include software elements. Under this guidance, tangible products containing software elements that function together to deliver the product's essential functionality are no longer within the scope of software revenue guidance. Entities that sell joint hardware and software products that meet this scope exception will be required to follow the guidance for multiple-deliverable revenue arrangements. This standard is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption and retrospective application are also permitted. We adopted this authoritative guidance as of January 1, 2010 and the adoption did not have a material impact on our financial position, results of operations, or cash flows.

In January 2010, the FASB issued authoritative guidance requiring additional disclosure related to fair value measurements that are made on a recurring and non-recurring basis. This guidance updates the guidance previously issued by the FASB related to fair value measurement disclosures. Under this guidance, entities will be required to provide disclosures for transfers in and out of Level 1 and Level 2 fair value inputs. In addition, entities will be required to provide disclosures for activity within the Level 3 fair value input tier, including purchases, sales, issuances, and settlements during the reporting period. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for the Level 3 disclosure requirements, which will be effective for fiscal years beginning after December 15, 2010. We adopted the guidance as it relates to Level 1 and Level 2 fair value inputs as of January 1, 2010 and the adoption did not have a material impact on our financial position, results of operations, or cash flows. We do not expect the adoption of this guidance as it relates to Level 3 inputs to have a material impact on our financial position, results of operations, or cash flows.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We engage in certain transactions which are denominated in currencies other than the U.S. dollar (primarily the Euro). These transactions may subject us to exchange rate risk based on fluctuations in currency exchange rates, which occur between the time such a transaction is recognized in our financial statements and the time that the transaction is settled. However, based on the historical magnitudes and timing of such transactions, we do not believe we are subject to material exchange rate risk. We do not engage in any foreign currency hedging transactions. We are exposed to market risk related to changes in interest rates. In the past, we have invested excess cash balances in cash equivalents and short-term investments, and if we were to do so in the future, we believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations and cash flows would not be material. In addition, we believe that a hypothetical 10% increase or decrease in interest rates would not have a material adverse effect on our financial condition.

ITEM 4. CONTROLS AN D PROCEDURES

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of March 31, 2010. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of March 31, 2010, our disclosure controls and procedures (1) were designed to effectively accumulate and communicate information to the Company’s management, as appropriate, to allow timely decisions regarding required disclosure and (2) were effective, in that they provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms.

During the three months ended March 31, 2010 , no change in our internal control over financial reporting (as defined in Rules 13a-15 (f) and 15d-15(f) under the Exchange Act) occurred that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Initial Public Offering Lawsuit

On or about December 3, 2001, a putative class action lawsuit was filed in the United States District Court for the Southern District of New York against us, Lawrence A. Genovesi (our former Chairman and Chief Executive Officer), Douglas G. Bryant (our Chief Financial Officer), and several underwriters of our initial public offering. The suit alleges, *inter alia* , that the defendants violated the federal securities laws by issuing and selling securities pursuant to our initial public offering in July 2000 (“IPO”) without disclosing to investors that the underwriter defendants had solicited and received excessive and undisclosed commissions from certain investors. The suit seeks damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between July 13, 2000 and December 6, 2000.

In October 2002, Lawrence A. Genovesi and Douglas G. Bryant were dismissed from this case without prejudice. On December 5, 2006, the United States Court of Appeals for the Second Circuit overturned the District Court’s certification of a plaintiff class. On April 6, 2007, the Second Circuit denied plaintiffs’ petition for rehearing, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. On September 27, 2007, plaintiffs filed a motion for class certification in certain designated “focus cases” in the District Court. That motion has since been withdrawn. On November 13, 2007, the issuer defendants in certain designated “focus cases” filed a motion to dismiss the second consolidated amended class action complaints that were filed in those cases. On March 26, 2008, the District Court issued an Opinion and Order denying, in large part, the motions to dismiss the amended complaints in the “focus cases.” On April 2, 2009, the plaintiffs filed a motion for preliminary approval of a new proposed settlement between plaintiffs, the underwriter defendants, the issuer defendants and the insurers for the issuer defendants. On June 10, 2009, the District Court issued an opinion preliminarily approving the proposed settlement, and scheduling a settlement fairness hearing for September 10, 2009. On October 5, 2009, the District Court issued an opinion granting plaintiffs’ motion for final approval of the settlement, approval of the plan of distribution of the settlement fund, and certification of the settlement classes. An

Order and Final Judgment was filed on December 30, 2009. Various notices of appeal of the District Court's October 5, 2009 order have now been filed. We are unable to predict the outcome of this suit and as a result, no amounts have been accrued as of March 31, 2010.

Customer Claim

On January 20, 2009, a lawsuit was filed in the United States District Court for the Eastern District of Texas against us and several other co-defendants. The suit, filed by Cordsen Engineering GmbH ("Cordsen"), a former customer of Alliance Systems, alleges breach of contract and other claims with regard to certain products that Cordsen purchased from Alliance Systems (prior to our acquisition of Alliance Systems) and which Cordsen alleges did not meet its desired specifications. (See Note 3 in the notes to the consolidated financial statements for details regarding the acquisition.) Cordsen alleges that by virtue of our acquisition of Alliance Systems in October 2007, we became the assignee of Alliance Systems' agreement with Cordsen. In April 2010, a settlement was reached with Cordsen, whereby the former Alliance Systems shareholders have agreed to pay a settlement of $100,000 and our insurer has agreed to pay a settlement of $300,000 to Cordsen. Payment of the settlement is due on May 12, 2010.

ITEM 1A. RISK FACTORS

The risks and uncertainties described below are not the only ones we are faced with. Additional risks and uncertainties not presently known to us, or that are currently deemed immaterial, may also impair our business operations. If any of the following risks actually occur, our financial condition and operating results could be materially adversely affected. Subsequent to the previous disclosure of risk factors in Item 1A of Part I of our most recent Annual Report on Form 10-K for the fiscal year ended September 30, 2009, there have been no significant changes in our risk factors.

Risks of dependence on one strategic customer.

We derive a significant portion of our revenues from sales of application platform solutions directly to EMC and our revenues may decline significantly if this customer reduces, cancels or delays purchases of our products, terminates its relationship with us or exercises certain of its contractual rights.

For the three months ended March 31, 2010 and 2009, sales directly to EMC, our largest customer, accounted for 44% and 38%, of our total net revenues, respectively. For the six months ended March 31, 2010 and 2009, sales directly to EMC accounted for 42% and 36%, of our total net revenues, respectively. These sales are primarily attributable to a limited number of products pursuant to non-exclusive contracts. We anticipate that our future operating results will continue to depend heavily on sales to, and our relationship with, this customer. Accordingly, the success of our business will depend, in large part, on this customer's willingness to continue to utilize our application platform solutions in its existing and future products. In the fourth quarter of fiscal year 2009, we won new business to provide additional products to this customer. As this business ramps up, we expect our revenues from this customer to increase during the remainder of fiscal year 2010. However, gross margins associated with this customer have decreased and may continue to decrease, due to the nature of the new business that we have begun providing to this customer.

Our financial success is dependent upon the future success of the products we sell to this customer and the continued growth of this customer, whose industry has a history of rapid technological change, short product lifecycles, consolidation and pricing and margin pressures. As we have experienced in recent periods, advances in hard drive storage capacity could also result in lower sales volumes to this customer. A significant reduction in sales to this customer, or significant pricing and additional margin pressures exerted on us by this customer, would have a material adverse effect on our results of operations. In addition, if this customer delays or cancels purchases of our products, our operating results would be harmed and we may be unable to accurately predict revenues, profitability and cash flows.

Under the terms of our non-exclusive contracts, this customer has the right to enter into agreements with third parties for similar products, is not obligated to purchase any minimum quantity of products from us and may choose to stop purchasing from us at any time, with or without cause. In addition, this customer may terminate the agreements in the event that we attempt to assign our rights under the agreements to another party without this customer's prior approval. Furthermore, in the event that we default on certain portions of the agreement, this customer has the right to manufacture certain products in exchange for a mutually agreeable royalty fee. If any of

these events were to occur, or if this customer were to delay or discontinue purchases of our products as a result of dissatisfaction or otherwise, our revenues and operating results would be materially adversely affected, our reputation in the industry might suffer, and we may be unable to accurately predict revenues, profitability and cash flows.

Risks related to business strategy.

Our future success is dependent upon our ability to generate significant revenues from application platform development relationships.

We believe we must diversify our revenues and a major component of our business strategy is to form application platform design relationships with new OEMs and ISVs. Under this strategy, we work with our customers to design an application platform branded with their name. The customers then perform all of the selling and marketing efforts related to sales of their branded appliance.

There are multiple risks associated with this strategy including:

- the expenditure of significant product design and engineering costs, which if not recovered through application platform sales could negatively affect our operating results;
- a significant reliance on our customers' application software products, which could be technologically inferior to competitive products and result in limitations on our application platform sales, causing our revenues and operating results to suffer;
- our customers will most likely continue selling their software products as separate products in addition to selling them in the form of an application platform, which will require us to effectively communicate the benefits of delivering their software in the form of an application platform;
- our reliance on our customers to perform all of the selling and marketing efforts associated with further sales of the application platform solution we develop with them;
- continued consolidation within the data storage, network security, carrier communications and enterprise communications industries that results in existing customers being acquired by other companies;
- our ability to leverage strategic relationships to obtain new sales leads;
- our ability to provide our customers with high quality application platform solutions at competitive prices; and
- there is no guarantee that design wins will result in actual orders or sales. A "design win" occurs when a new customer or a separate division within an existing customer notifies us that we have been selected to integrate the customer's application. There can be delays of several months or more between the design win and when a customer initiates actual orders. The design win may never result in actual orders or sales. Further, if the customer's plans change, we may commit significant resources to design wins that do not result in actual orders.

Additionally, our future success will depend on our ability to establish relationships with new customers while expanding sales of application platform solutions within our existing customer base. If these customers are unsuccessful in their marketing and sales efforts, or if we are unable to expand our sales to existing customers and develop relationships with new customers, our revenues and operating results could suffer.

We have begun to pursue (and in some cases we have won) larger opportunities which we expect to have a more significant impact on our net revenues. We expect that these opportunities will have gross margins as a percentage of revenues which are lower than historical levels, but we believe that such opportunities can be leveraged over our existing infrastructure without requiring us to incur significant additional operating costs. However, if we cannot meet customer demand utilizing our existing infrastructure, we may need to increase our infrastructure and associated operating costs, which would negatively impact our operating results. Also, our

revenue growth may be lower than expected if we are unsuccessful in winning large opportunities, which would lead us to pursue smaller opportunities in order to grow revenues.

We may not be able to effectively commercialize our application platform solutions or may be at a competitive disadvantage if we cannot license or integrate third-party applications that are essential for the functionality of certain platforms.

We believe our success will depend on our ability to license or integrate certain applications from third-parties that would be incorporated in certain of our application platform solutions. Because we do not currently know with certainty which of these prospective technologies will be desired in the marketplace, we may incorrectly invest in development or prioritize our efforts to integrate these technologies in our application platforms. Additionally, even if we correctly focus our efforts, there can be no assurance that we will select the preferred provider of these technologies, the third-party provider will be committed to the relationship and integration of their technology, or that they will license their technology to us without obtaining significant certification or training, which could be costly and time consuming. If we are unable to successfully integrate the correct third-party technologies in a timely manner, our application platform solutions may be inferior to other competitive products in the marketplace, which may adversely affect the results of our operations and our ability to grow our business. We believe that our services are a key competitive differentiation point and an important element of the total solution we offer. If our current and prospective customers do not find the services we offer to be of value to them or their end users, they may decide to perform these services in-house or we may lose their business to competitors. If this were to occur, our revenues and operating results would be adversely impacted.

Our business could be harmed if we fail to adequately integrate new technologies into our application platform solutions or if we invest in technologies that do not result in the desired effects on our current and/or future product offerings.

As part of our strategy, we review opportunities to incorporate products and technologies that could be required in order to add new customers, retain existing customers, expand the breadth of product offerings or enhance our technical capabilities. Investing in new technologies presents numerous risks, including:

- we may experience difficulties integrating new technologies into our current or future products;
- our new products may be delayed because selected new technologies themselves are delayed or have defects and/or performance limitations;
- we may incorporate technologies that do not result in the desired improvements to our current and/or future application platform products;
- we may incorporate new technologies that either may not be desired by our customers or may not be compatible with our customers' existing technology;
- new technologies are unproven and could contain latent defects, which could result in high product failure rates; and
- we could find that the new products and/or technologies that we choose to incorporate into our products are technologically inferior to those utilized by our competitors.

If we are unable to adequately integrate new technologies into our application platform products or if we invest in technologies that do not result in the desired effects on our current and/or future product offerings, our business could be harmed and operating results could suffer.

Risks related to the application platform markets.

If application platforms are not increasingly adopted as a solution to meet a significant portion of companies' software application needs, the market for application platform solutions may not grow, which could negatively impact our revenues.

We expect that all of our future revenues will come from sales of application platform solutions and related services. As a result, we are substantially dependent on the growing use of application platforms to meet businesses' software application needs. Our revenues may not grow and the market price of our common stock could decline if the application platform market does not grow as rapidly as we expect.

Our expectations for the growth of the application platform market may not be fulfilled if customers continue to use general-purpose servers or proprietary platforms. The role of our products could, for example, be limited if general-purpose servers out-perform application platforms, provide more capabilities and/or flexibility than application platforms or are offered at a lower cost. This could force us to lower the prices of our application platform solutions or could result in fewer sales of these products, which would negatively impact our revenues and decrease our gross profits.

To an extent, the application platform market is trending towards virtual application platforms and services and cloud computing. A virtual application platform is a software solution, comprised of one or more virtual machines that is packaged, maintained, updated, and managed as a unit. Cloud computing is a web-based concept, whereby vendors provide customers with a virtual (i.e. web-based) network appliance infrastructure, reducing the customer's need to purchase appliance hardware. While we currently provide virtual application platforms, our revenues and operating results may be negatively impacted if current and prospective customers move toward using virtual or cloud-based platforms provided by other vendors.

The products that we sell are subject to rapid technological change and our sales will suffer if these products are rendered obsolete by new technologies.

The markets we serve are characterized by rapid technological change, frequent new product introductions and enhancements, potentially short product lifecycles, changes in customer demands and evolving industry standards. In the application platform market, we attempt to mitigate these risks by utilizing standards-based hardware platforms and by maintaining an adequate knowledge base of available technologies. However, the application platform solutions that we sell could be rendered obsolete if products based on new technologies are introduced or new industry standards emerge and we are not able to incorporate these technological changes into our products. In addition, we depend on third parties for the base hardware of our application platforms and we are at risk if these third parties do not integrate new technologies. Releasing new products and services prematurely may result in quality problems, and delays may result in loss of customer confidence and market share. We may be unable to design new products and services or achieve and maintain market acceptance of them once they have come to market. Furthermore, when we do release new or enhanced products and services, we may be unable to manage the transition from the older products and services to minimize disruption in customer ordering patterns, avoid excessive inventories of older products and deliver enough new products and services to meet customer demand.

To remain competitive in the application platform market, we must successfully identify new product opportunities and partners and develop and bring new products to market in a timely and cost-effective manner. Our failure to select the appropriate partners and keep pace with rapid industry, technology or market changes could have a material adverse effect on our business, results of operations or financial condition.

Risks related to financial results.

We have a history of losses and may continue to experience losses in the future, which could cause the market price of our common stock to decline.

In the past, we have incurred significant net losses and could incur net losses in the future. At March 31, 2010 and September 30, 2009, our accumulated deficit was $140 million and $141 million, respectively. If we are successful in winning large opportunities in future periods but cannot meet our customer requirements utilizing our existing infrastructure and production capabilities, we may need to increase our infrastructure. This would increase operating expenses and negatively impact our operating results. Also, our revenue growth may be lower than

expected if we are unsuccessful in winning large opportunities, which would lead us to pursue smaller opportunities in order to grow revenues. As a result, we will need to generate significant revenues to achieve and sustain profitability. If we do not achieve and sustain profitability, the market price for our common stock may decline. Even if we achieve sustained profitability there can be no guarantee that our stock price will increase.

We may not be able to borrow funds under our credit facility or secure future financing if there is a material adverse change in our business.

In October 2007, we entered into an agreement with Silicon Valley Bank to provide for a line of credit. We view this line of credit as a source of available liquidity to fund fluctuations in our working capital requirements. This facility contains various conditions, covenants and representations with which we must be in compliance in order to borrow funds. However, if we wish to borrow under this facility in the future, there can be no assurance that we will be in compliance with these conditions, covenants and representations. In addition, this line of credit facility with Silicon Valley Bank expires on February 4, 2012. After that, we may need to secure new financing to continue funding fluctuations in our working capital requirements. However, we may not be able to secure new financing, or financing on favorable terms, if we experience an adverse change in our business. If we experience an increase in order activity from our customers, our cash balance may decrease due to the need to purchase inventories to fulfill those orders. If this occurs, we may have to draw on this facility, or secure other financing, in order to maintain our liquidity. As of May 10, 2010, we have not borrowed on this line of credit.

If our estimates or judgments relating to our critical accounting policies are based on assumptions that change or prove to be incorrect, our operating results could fall below expectations of securities analysts and investors, resulting in a decline in our stock price.

Our discussion and analysis of financial condition and results of operations is based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate significant estimates used in preparing our consolidated financial statements, including those related to:

- revenue recognition;
- collectibility of accounts receivable;
- inventory write-downs;
- stock-based compensation;
- valuation of intangible assets;
- warranty reserves; and
- realization of deferred tax assets.

We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, as provided in our discussion and analysis of financial condition and results of operations, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these and other estimates if our assumptions change or if actual circumstances differ from those in our assumptions, which could cause our operating results to fall below the expectations of securities analysts and investors, resulting in a decline in our stock price.

Our quarterly revenues and operating results may also fluctuate for various reasons, which could cause our operating results to fall below expectations and thus impact the market price of our common stock.

Our quarterly revenues and operating results are difficult to predict and may fluctuate significantly from quarter to quarter. None of our customers are obligated to purchase any quantity of our products in the future nor are they obligated to meet forecasts of their product needs. Our operating expense levels are based in part on expectations of future revenues and gross profits, which are partially dependent on our customers' ability to accurately forecast and communicate their future product needs. If revenues or gross profits in a particular quarter do not meet expectations, operating results could suffer and the market price of our common stock could decline. Factors affecting quarterly operating results include:

- the degree to which our customers are successful in reselling application platform solutions to their end customers;
- our customers' consumption of their existing inventories of our products;
- the variability of orders we receive from customers who have project-based businesses;
- the loss of key suppliers or customers;
- the product mix of our sales;
- the timing of new product introductions by our customers;
- the availability and/or price of products from suppliers;
- price competition;
- costs associated with our introduction of new application platform solutions and the market acceptance of those products; and
- the mix of product manufactured internally and by our contract manufacturer.

If the products and services that we sell become more commoditized and competition in the data storage, network security, carrier communications and enterprise communications markets continues to increase, then our gross profit as a percentage of net revenues may decrease and our operating results may suffer.

Products and services in the data storage, network security, carrier communications and enterprise communications markets may be subject to further commoditization as these industries continue to mature and other businesses introduce additional competing products and services. Our gross profit as a percentage of revenues for our products may decrease in response to changes in our product mix, competitive pricing pressures, or new product introductions into these markets. If we are unable to offset decreases in our gross profits as a percentage of revenues by increasing our sales volumes, or by decreasing our product costs, operating results will decline. Changes in the mix of sales of our products, including the mix of higher margin products sold in smaller quantities and lower margin products sold in larger quantities, could adversely affect our operating results for future quarters. To maintain our gross profits, we also must continue to reduce the manufacturing cost of our application platform solutions. Our efforts to produce higher margin application platform solutions, continue to improve our application platform solutions and produce new application platform solutions may make it difficult to reduce our manufacturing cost per product. Further, utilization of a contract manufacturer to produce a portion of our customer requirements for certain application platform solutions may not allow us to reduce our cost per product. If we fail to respond adequately to pricing pressures, to competitive products with improved performance or to developments with respect to the other factors on which we compete, we could lose customers or orders and may lose new customer opportunities. If we are unable to offset decreases in the prices we are able to charge our customers and/or our gross margin percentage with increased sales volumes, our business will suffer.

An intangible asset represents a significant portion of our assets, and any impairment of the intangible asset would adversely impact our operating results.

At March 31, 2010, the carrying value of our intangible asset, which consists of customer relationships associated with our acquisition of Alliance Systems, Inc. ("Alliance Systems"), was approximately $7.4 million, net of accumulated amortization. We will continue to incur non-cash charges relating to the amortization of our intangible asset over its remaining useful life. Future determinations of significant write-offs of the intangible asset resulting from an impairment test or any accelerated amortization of the intangible asset could have a significant impact on our operating results and affect our ability to achieve or maintain profitability. Although we do not believe that any impairment of the intangible asset exists at this time, in the event that any indicators of possible impairment exist, we may record charges which could have a material adverse effect on our results of operations. Such indicators include, but are not limited to, a worsening in customer attrition rates compared to historical attrition rates, or lower than initially anticipated cash flows associated with customer relationships.

Risks related to competition.

Competition in the application platform market is significant and if we fail to compete effectively, our financial results will suffer.

In the application platform market, we face significant competition from a number of different types of companies. Our competitors include companies who market general-purpose servers, server virtualization software, specific-purpose servers and application platforms as well as companies that sell custom integration services utilizing hardware produced by other companies. Many of these companies are larger than we are and have greater financial resources and name recognition than we do, as well as significant distribution capabilities and larger, more established service organizations to support their products. Our larger competitors may be able to leverage their existing resources, including their extensive distribution capabilities and service organizations, to provide a wider offering of products and services and higher levels of support on a more cost-effective basis than we can. We expect competition in the application platform market to increase significantly as more companies enter the market and as our existing competitors continue to improve the performance of their current products and to introduce new products and technologies. Such increased competition could adversely affect sales of our current and future products. In addition, competing companies may be able to undertake more extensive promotional activities, adopt more aggressive pricing policies and offer more attractive terms to their customers than we can. If our competitors provide lower cost products with greater functionality or support than our application platform solutions, or if some of their products are comparable to ours and are offered as part of a range of products that is broader than ours, our application platform solutions could become undesirable.

Even if the functionality of competing products is equivalent to ours, we face a risk that a significant number of customers would elect to pay a premium for similar functionality from a larger vendor rather than purchase products from us. We attempt to differentiate ourselves from our competition by offering a wide variety of software integration, branding, supply-chain management, engineering, support, logistics and fulfillment services. If we are unable to effectively differentiate ourselves from our competition, we may be forced to offer price reductions to maintain certain customers. As a result, our revenues may not increase and may decline, and our gross margins may decline. Furthermore, increased competition could lead to higher selling expenses which would negatively affect our business and future operating results.

Risks related to marketing and sales efforts and customer service.

We need to effectively manage our sales and marketing operations to increase market awareness and sales of our products and to promote our brand recognition. If we fail to do so, our growth will be limited.

Although we currently have a relatively small sales and marketing organization, we must continue to increase market awareness and sales of our products and services and promote our brand in the marketplace. We believe that to compete successfully we will need OEMs and ISVs to recognize us as a top-tier provider of application platform solutions and services. If we are unable to increase market awareness and promote ourselves as a leading provider of application platform solutions with our available resources, we may be unable to develop new customer relationships or expand our product and service offerings at existing customers.

If we are unable to effectively manage our customer service and support activities, we may not be able to retain our existing customers or attract new customers.

We need to effectively manage our customer support operations to ensure that we maintain good relationships with our customers. We believe that providing a level of high quality customer support will be a key differentiator for our product offerings and may require more technically qualified staff which could be more costly. If we are unable to provide this higher level of service we may be unable to successfully attract and retain customers.

If our customer support organization is unsuccessful in maintaining good customer relationships, we may lose customers to our competitors and our reputation in the market could be damaged. As a result, we may lose revenues and our business could suffer. Furthermore, the costs of providing this service could be higher than we expect, which could adversely affect our operating results.

Risks related to product manufacturing.

Our dependence on sole source and limited source suppliers for key application platform components makes us susceptible to supply shortages and potential quality issues that could prevent us from shipping customer orders on time, or at all, and could result in lost sales and customers.

We depend upon single source and limited source suppliers for our industry standard processors, main logic boards, telephony boards, certain disk drives, hardware platforms and power supplies as well as certain of our chassis and sheet metal parts. Additionally, we depend on limited sources to supply certain other industry standard and customized components. We have in the past experienced, and may in the future experience, shortages of or difficulties in acquiring components in the quantities and of the quality needed to produce our application platform solutions. Shortages in supply or quality issues related to these key components for an extended time would cause delays in the production of our application platform solutions, prevent us from satisfying our contractual obligations and meeting customer expectations, and result in lost sales and customers. If we are unable to buy components in the quantities and of the quality that we need on a timely basis or at acceptable prices, we will not be able to manufacture and deliver our application platform solutions on a timely or cost effective basis to our customers, and our competitive position, reputation, business, financial condition and results of operations could be seriously harmed. If we are able to secure other sources of supply for such components, our costs to purchase such components could increase, which would negatively impact our gross margins. A significant portion of our components are purchased from suppliers located in China. During the past year, several factories in China have closed without notice. If a factory which supplies parts to us closes with little or no notice, we could experience shortages and difficulties in locating alternative sources of supply.

Tighter management of inventories across global supply chains may lead to longer lead times for our purchases of certain inventory components. If we are unable to manage our supply chain and maintain sufficient inventories to meet customer demand, this could result in lost sales and customers.

Due largely to the recent economic downturn, we have experienced tighter management of inventories across our supply chain, resulting in longer lead times to obtain inventory components from our vendors. To a significant degree, we plan our purchasing of inventory components based on forecasts of future demand from our customers. If actual order volumes from our customers exceed those forecasts, we may experience supply depletions or shortages. In some cases, this may lead to delays in our deliveries of products to our customers due to the long lead times required to obtain new supplies of certain inventory components. In other cases, this may cause our customers to cancel their orders with us. These factors could adversely impact our relationships with our customers and could cause certain customers to seek other sources of product supply. Also, we may purchase larger quantities of certain inventory components in order to mitigate the risks described above. Such inventory may later become excess or obsolete, which would result in higher than expected costs to write down inventory to its net realizable value.

If our application platform solutions fail to perform properly and conform to specifications, our customers may demand refunds, assert claims for damages or terminate existing relationships with us, and our reputation and operating results may suffer materially.

As application platform solutions are complex, they may contain errors that can be detected at any point in a product's lifecycle. If flaws in design, production, assembly or testing of our products (by us or our suppliers) were to occur, we could experience a rate of failure in our products that could result in substantial repair, replacement or service costs and potential damage to our reputation. In addition, because our solutions are combined with products from other vendors, should problems occur, it might be difficult to identify the source of the problem. Continued improvement in manufacturing capabilities, control of material and manufacturing quality and costs, and product testing are critical factors in our future growth. There can be no assurance that our efforts to monitor, develop, modify and implement appropriate test and manufacturing processes for our products will be sufficient to permit us to avoid a rate of failure in our products that results in substantial delays in shipment, significant repair or replacement costs or potential damage to our reputation, any of which could have a material adverse effect on our business, results of operations or financial condition.

In the past, we have discovered errors in some of our application platform solutions and have experienced delays in the shipment of our products during the period required to correct these errors or we have had to replace defective products that were already shipped. Errors in our application platform solutions may be found in the future and any of these errors could be significant. Significant errors, including those discussed above, may result in:

- the loss of or delay in market acceptance and sales of our application platform solutions;
- diversion of engineering resources;
- increased manufacturing costs;
- the loss of customers;
- injury to our reputation and other customer relations problems; and
- increased maintenance and warranty costs.

Any of these problems could harm our business and future operating results. Product errors or delays could be material, including any product errors or delays associated with the introduction of new products or versions of existing products. If our application platform solutions fail to conform to warranted specifications, customers could demand a refund for the purchase price and assert claims for damages.

Moreover, because our application platform solutions may be used in connection with critical computing systems services, including providing security to protect valuable information, we may receive significant liability claims if they do not work properly. While our agreements with customers typically contain provisions intended to limit our exposure to liability claims, these limitations do not preclude all potential claims. Liability claims could exceed our insurance coverage and require us to spend significant time and money in litigation or to pay significant damages. Any claims for damages, even if unsuccessful, could seriously damage our reputation and business.

If we do not accurately forecast our application platform materials requirements, our business and operating results could be adversely affected.

We use rolling forecasts based on anticipated product orders to determine our application platform component requirements. Lead times for materials and components that we order may change significantly depending on variables such as specific supplier requirements, contract terms and current market demand for those components. In addition, a variety of factors, including the timing of product releases, potential delays or cancellations of orders, the timing of large orders and the unproven acceptance of new products in the market make it difficult to predict product orders. As a result, our materials requirement forecasts may not be accurate. If we overestimate our materials requirements, we may have excess inventory, which would increase costs and negatively impact our cash position. Our agreements with certain customers provide us with protections related to inventory purchased in accordance with the terms of these agreements; however, these protections may not be sufficient to prevent certain losses as a result of excess or obsolete inventory. If we underestimate our materials requirements, we

may have inadequate inventory which could interrupt our manufacturing and delay delivery of our application platform solutions to customers, resulting in a loss of sales or customers. Any of these occurrences would negatively impact our business and operating results.

Other risks related to our business.

Our operating results would suffer if we, our customers, or other third-party software providers from whom we license technology, were subject to an infringement claim that resulted in protracted litigation, the award of significant damages against us or the payment of substantial ongoing royalties.

Substantial litigation regarding intellectual property rights exists in the technology industry. We expect that application platform solutions may be subject to third-party infringement claims as the number of competitors in the industry segment grows and the functionality of products in different industry segments overlap. In the past we have received claims from third parties that our application platform solutions infringed their intellectual property rights. We do not believe that our application platform solutions employ technology that infringes the proprietary rights of any third parties. We are also not aware of any claims made against any of our customers related to their infringement of the proprietary rights of other parties in relation to products that include our application platform solutions. Other parties may make claims against us or our customers that, with or without merit, could:

- be time consuming for us to address;
- require us to enter into royalty or licensing agreements;
- result in costly litigation, including potential liability for damages;
- divert our management's attention and resources; and
- cause product shipment delays.

In addition, other parties may make claims against our customers related to products that are incorporated into our application platform solutions. Our business could be adversely affected if such claims resulted in the inability of our customers to continue producing the infringing product.

If we fail to retain and attract appropriate levels of qualified employees and members of senior management, we may not be able to successfully execute our business strategy.

Our success depends in large part on our ability to retain and attract highly skilled engineering, sales, marketing, customer service and managerial personnel. If we are unable to attract a sufficient number of qualified personnel, we may not be able to meet key objectives such as developing, upgrading, or enhancing our products in a timely manner, which could negatively impact our business and could hinder any future growth.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results. As a result, current and potential stockholders could lose confidence in our financial reporting, which could have a negative market reaction.

Section 404 of the Sarbanes-Oxley Act of 2002 requires our management to report on, and our independent registered public accounting firm to attest to, the effectiveness of our internal control over financial reporting. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements. As a result, we have incurred expenses and have devoted additional management resources to Section 404 compliance. Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our business and operating results could be harmed.

If either of the sites of our manufacturing operations were to experience a significant disruption in its operations, it would have a material adverse effect on our financial condition and results of our operations.

Our manufacturing facilities and headquarters are concentrated in two locations. If the operations in either facility were disrupted as a result of a natural disaster, fire, power or other utility outage, work stoppage or other similar event, our business could be seriously harmed for a period of at least one quarter as a result of interruptions or delays in our manufacturing, engineering, or post-sales support operations.

The market price for our common stock may be particularly volatile, and our stockholders may be unable to resell their shares at a profit.

The market price of our common stock has been subject to significant fluctuations and may continue to fluctuate or decline. During the fiscal year ended September 30, 2009, the closing price of our common stock ranged from a low of $0.29 to a high of $1.32, and during the six months ended March 31, 2010, from a low of $1.07 to a high of $2.19. The market for technology and micro-cap stocks has been extremely volatile and frequently reaches levels that bear no relationship to the past or present operating performance of those companies. General economic conditions, such as recession or interest rate or currency rate fluctuations in the United States or abroad, could negatively affect the market price of our common stock. In addition, our operating results may be below the expectations of securities analysts and investors. If this were to occur, the market price of our common stock may decrease significantly. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted against such companies. Such litigation could result in substantial cost and a diversion of management's attention and resources.

Any decline in the market price of our common stock or negative market conditions could adversely affect our ability to raise additional capital, to complete future acquisitions of or investments in other businesses and to attract and retain qualified technical and sales and marketing personnel.

If the market price o f our common stock is not quoted on a national exchange, our ability to raise future capital may be hindered and the market price of our common stock may be negatively impacted.

At certain times in the past, the market price of our common stock has been less than $1.00 per share. If we are unable to meet the stock price listing requirements of NASDAQ, our common stock could be de-listed from the NASDAQ Global Market. If our common stock were de-listed from the NASDAQ Global Market, among other things, this could result in a number of negative implications, including reduced liquidity in our common stock as a result of the loss of market efficiencies associated with NASDAQ and the loss of federal preemption of state securities laws, as well as the potential loss of confidence by suppliers, customers and employees, the loss of institutional investor interest, fewer business development opportunities and greater difficulty in obtaining financing. As of May 10, 2010, we were in compliance with all applicable requirements for continued listing on the NASDAQ Global Market.

A continued or prolonged downturn in the economy could have a material adverse effect on our financial performance and other aspects of our business.

The current downturn in the economy, and any further slowdown in future periods, could adversely affect our business in ways that we are unable to fully anticipate. Tightened credit markets may negatively impact operations by affecting solvency of customers, suppliers and other business partners, or the ability of our customers to obtain credit to finance purchases of our products and services, which in turn could lead to increased difficulty in collecting accounts receivable. Tightened credit markets may also negatively impact our ability to borrow funds, if needed, either under our line of credit with Silicon Valley Bank or from other sources. In addition, government responses to the disruptions in the financial markets may not stabilize the markets or increase liquidity or the availability of credit for us or our customers. A widespread reduction of global business activity could cause customers to reduce capital expenditures, put increased pricing pressure on our products and services, and subject us, our suppliers and our customers to interest rate risks and tax changes that could impact our financial strength. These and other economic factors could have a material adverse effect on our financial condition, operating results and liquidity.

We have anti-takeover defenses that could delay or prevent an acquisition and could adversely affect the market price of our common stock.

Our Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock and, without any further vote or action on the part of the stockholders, to determine the price, rights, preferences, privileges and restrictions of the preferred stock. This preferred stock, if issued, might have preference over the rights of the holders of common stock and could adversely affect the market price of our common stock. The issuance of this preferred stock may make it more difficult for a third party to acquire us or to acquire a majority of our outstanding voting stock. We currently have no plans to issue preferred stock.

In addition, provisions of our second amended and restated certificate of incorporation and our second amended and restated by-laws may deter an unsolicited offer to purchase us. These provisions, coupled with the provisions of the Delaware General Corporation Law, may delay or impede a merger, tender offer or proxy contest involving us. For example, our Board of Directors is divided into three classes, only one of which is elected at each annual meeting. These factors may further delay or prevent a change of control of our business.

Class action lawsuits have been filed against us, our board of directors, our former chairman and certain of our executive officers and other lawsuits may be instituted against us from time to time.

In December 2001, a class action lawsuit relating to our initial public offering was filed against us, our chairman, one of our executive officers and the underwriters of our initial public offering. For more information on lawsuits, see "Part II, Item 1 — Legal Proceedings." We are currently attempting to settle the lawsuit filed against us related to our initial public offering. We are unable to predict the effects on our financial condition or business of the lawsuit related to our initial public offering or other lawsuits that may arise from time to time. While we maintain certain insurance coverage, there can be no assurance that claims against us will not result in substantial monetary damages in excess of such insurance coverage. This class action lawsuit, or any future lawsuits, could cause our director and officer insurance premiums to increase and could affect our ability to obtain director and officer insurance coverage, which would negatively affect our business. In addition, we have expended, and may in the future expend, significant resources to defend such claims. This class action lawsuit, or other similar lawsuits that may arise from time to time, could negatively impact both our financial condition and the market price of our common stock and could result in management devoting a substantial portion of their time to these lawsuits, which could adversely affect the operation of our business.

ITEM 6. EXHIBITS

(a) Exhibits

The exhibits which are filed with this report or which are incorporated by reference are set forth in the Exhibit Index hereto.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NETWORK ENGINES, INC.

Date: May 10, 2010

/s/ Gregory A. Shortell

Gregory A. Shortell
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Douglas G. Bryant

Douglas G. Bryant
Chief Financial Officer, Treasurer and Secretary
(Principal Financial Officer and Principal Accounting Officer)

EXHIBIT INDEX

Exhibit No.	Exhibit
31.1	Certification of Gregory A. Shortell, the Chief Executive Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Douglas G. Bryant, the Chief Financial Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Gregory A. Shortell, the Chief Executive Officer of the Company, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Douglas G. Bryant, the Chief Financial Officer of the Company, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

EXHIBIT 31.1

CERTIFICATION

I, Gregory A. Shortell , certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Network Engines, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: May 10, 2010

/s/ Gregory A. Shortell

Gregory A. Shortell
Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION

I, Douglas G. Bryant, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Network Engines, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Dated: May 10, 2010

/s/ Douglas G. Bryant

Douglas G. Bryant
Chief Financial Officer

EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report on Form 10-Q of Network Engines, Inc. (the “Company”) for the quarterly period ended March 31, 2010 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), the undersigned, Gregory A. Shortell, Chief Executive Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, that:

(1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 10, 2010

/s/ Gregory A. Shortell

Gregory A. Shortell
Chief Executive Officer

EXHIBIT 32.2

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report on Form 10-Q of Network Engines, Inc. (the "Company") for the quarterly period ended March 31, 2010 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Douglas G. Bryant, Chief Financial Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, that:

(1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 10, 2010

/s/ Douglas G. Bryant

Douglas G. Bryant
Chief Financial Officer