

AVOCENT CORP  
Form 10-Q  
May 06, 2008

**U.S. 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 28, 2008 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: 000-30575

## **AVOCENT CORPORATION**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or Other Jurisdiction of Incorporation or Organization)

**91-2032368**

(I.R.S. Employer Identification Number)

**4991 Corporate Drive**

**Huntsville, Alabama**

(Address of Principal Executive Offices)

**35805**

(Zip Code)

**256-430-4000**

(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, as amended, 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 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 ☐

Edgar Filing: AVOCENT CORP - Form 10-Q

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

As of April 30, 2008, the number of outstanding shares of the Registrant's Common Stock was 44,734,761.

---

AVOCENT CORPORATION

FORM 10-Q

March 28, 2008

INDEX

		Page(s)
<u>Part I</u>	<u>Financial Information</u>	
	<u>Item 1.</u>	
	<u>Financial Statements (unaudited)</u>	
	<u>Consolidated Statements of Income for the Three Months Ended March 28, 2008 and March 30, 2007</u>	3
	<u>Consolidated Balance Sheets at March 28, 2008 and December 31, 2007</u>	4
	<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 28, 2008 and March 30, 2007</u>	5
	<u>Notes to Condensed Consolidated Financial Statements</u>	6-13
	<u>Item 2.</u>	
	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14-23
	<u>Item 3.</u>	
	<u>Quantitative and Qualitative Disclosures about Market Risks</u>	23
	<u>Item 4.</u>	
	<u>Controls and Procedures</u>	23
<u>Part II Other Information</u>		
	<u>Item 1.</u>	
	<u>Legal Proceedings</u>	24
	<u>Item 1A.</u>	
	<u>Risk Factors</u>	24
	<u>Item 2.</u>	
	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	41
	<u>Item 6.</u>	
	<u>Exhibits</u>	41
<u>Signature</u>		42

**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**AVOCENT CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME**

**(Unaudited, in thousands, except per share data)**

Edgar Filing: AVOCENT CORP - Form 10-Q

	For the three months ended	
	March 28, 2008	March 30, 2007
Net sales:		
Products and services	\$ 117,582	\$ 113,576
Licenses and royalties	23,817	19,575
Total net sales	141,399	133,151
Cost of sales:		
Products and services	46,797	49,094
Licenses and royalties	701	359
Amortization of intangibles licenses and royalties	2,767	2,683
Total cost of sales (includes \$244 and \$179 of stock-based compensation expense in 2008 and 2007, respectively)	50,265	52,136
Gross profit	91,134	81,015
Research and development expenses (includes \$1,015 and \$1,116 of stock-based compensation expense in 2008 and 2007, respectively)	23,367	20,881
Selling, general and administrative expenses (includes \$2,679 and \$2,366 of stock-based compensation expense in 2008 and 2007, respectively)	55,119	48,660
Retirement and restructuring expenses (includes \$615 of stock-based compensation expense in 2008)	2,971	
Amortization of intangible assets	7,535	8,962
Total operating expenses	88,992	78,503
Income from operations	2,142	2,512
Net investment income	897	879
Interest expense	(1,838)	(2,234)
Other income (expense), net	455	(317)
Income before provision for income taxes	1,656	840
Provision for income taxes	925	94
Net income	\$ 731	\$ 746
Earnings per share:		
Basic	\$ 0.02	\$ 0.01
Diluted	\$ 0.02	\$ 0.01
Weighted average shares used in computing earnings per share:		
Basic	46,233	50,733
Diluted	46,617	51,886

See notes accompanying these condensed consolidated financial statements.

## Avocent Corporation

## Consolidated Balance Sheets

(Unaudited, in thousands, except per share data)

	March 28, 2008	December 31, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 98,494	\$ 105,183
Investments maturing within one year		5,943
Accounts receivable, less allowance for doubtful accounts of \$2,398 and \$2,481 at March 28, 2008 and December 31, 2007, respectively	107,078	109,851
Other receivables	10,727	10,799
Inventories	30,373	30,103
Other current assets	5,195	4,399
Deferred tax assets, net	159	5,928
Total current assets	252,026	272,206
Property and equipment, net	36,950	37,298
Goodwill	584,949	584,949
Other intangible assets, net	157,713	167,982
Deferred tax asset, non-current	19,040	13,297
Other assets	2,541	2,701
Total assets	\$ 1,053,219	\$ 1,078,433
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 15,061	\$ 20,031
Accrued wages and commissions	22,051	25,072
Accrued liabilities	29,777	30,630
Income taxes payable	8,366	14,950
Deferred revenue, current	59,116	54,738
Total current liabilities	134,371	145,421
Unsecured bank line of credit	140,000	95,000
Deferred revenue, non-current	10,967	11,325
Other non-current liabilities	1,449	1,025
Total liabilities	286,787	252,771
Commitments and contingencies (see Note 12)		
Stockholders' equity:		
Preferred stock, par value \$0.001 per share; 5,000 shares authorized; no shares issued and outstanding		
Common stock, par value \$0.001 per share; 200,000 shares authorized; March 31, 2008 54,313 shares issued and 44,686 outstanding; December 31, 2007 53,910 shares issued and 48,283 outstanding;	54	54
Additional paid-in capital	1,209,812	1,208,674
Accumulated other comprehensive income	3,987	2,130
Accumulated deficit	(217,988)	(218,719)
Treasury stock, at cost; March 28, 2008, 9,539 shares; December 31, 2007, 5,627 shares;	(229,433)	(166,477)
Total stockholders' equity	766,432	825,662

Edgar Filing: AVOCENT CORP - Form 10-Q

Total liabilities and stockholders' equity	\$	1,053,219	\$	1,078,433
--	----	-----------	----	-----------

See notes accompanying these condensed consolidated financial statements.



**AVOCENT CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited, in thousands)

	For the three months ended	
	March 28, 2008	March 30, 2007
Cash flows from operating activities:		
Net income	\$ 731	\$ 746
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,592	2,354
Amortization of intangible assets	10,454	11,747
Stock-based compensation	4,547	3,661
Amortization of premiums (discounts) on investments		(73)
Net loss on disposition of fixed assets	14	214
Excess tax benefit from stock-based compensation	(3)	(820)
Changes in operating assets and liabilities, net of acquisition:		
Accounts receivable, net	3,457	17,332
Inventories	(247)	1,640
Other assets	(426)	(302)
Accounts payable	(6,153)	(956)
Accrued wages and commissions	(3,021)	(9,424)
Accrued other liabilities and deferred revenue	(824)	(4,984)
Income taxes, current and deferred	(6,420)	(3,291)
Net cash provided by operating activities	4,701	17,844
Cash flows from investing activities:		
Purchase of other intangible assets	(199)	(2,769)
Purchases of property and equipment	(2,123)	(2,616)
Purchases of investments		(26,124)
Maturities and proceeds from sales of investments	5,942	15,005
Net cash (used in) provided by investing activities	3,620	(16,504)
Cash flows from financing activities:		
Borrowings under unsecured line of credit, net	45,000	
Proceeds from employee stock option exercises	129	2,793
Excess tax benefit from stock-based compensation	3	820
Purchases of treasury stock	(62,956)	(15,438)
Net cash used in financing activities	(17,824)	(11,825)
Effect of exchange rate changes on cash and cash equivalents	2,814	24
Net decrease in cash and cash equivalents	(6,689)	(10,461)
Cash and cash equivalents at beginning of period	105,183	81,301
Cash and cash equivalents at end of period	\$ 98,494	\$ 70,840

See notes accompanying these condensed consolidated financial statements.



## AVOCENT CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited, in thousands, except share data)

## Note 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with United States generally accepted accounting principles and reflect all adjustments consisting of normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results for the periods shown. The results of operations for these periods are not necessarily indicative of the results expected for the full fiscal year nor for any future period. The preparation of 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 the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the related notes contained in our Annual Report on Form 10-K for the year ended December 31, 2007, which is on file with the Securities and Exchange Commission and is available at our website, [www.avocent.com](http://www.avocent.com). The consolidated balance sheet presented in the accompanying condensed consolidated financial statements for December 31, 2007, was derived from the audited financial statements filed in our 10-K for the period ended December 31, 2007, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

We report our annual results based on years ending December 31. We report our quarterly results for the first three interim periods based on 13 week periods ending on Fridays and for the fourth interim period ending on December 31.

Our financial statements are consolidated and include the accounts of Avocent Corporation and our wholly owned subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation.

## Note 2. Inventories

Inventories consisted of the following at:

	March 28, 2008	December 31, 2007
Raw materials	\$ 1,086	\$ 1,394
Work-in-process	320	1,058
Finished goods	28,967	27,651

## Edgar Filing: AVOCENT CORP - Form 10-Q

Inventories	\$	30,373	\$	30,103
-------------	----	--------	----	--------

Inventories above have been reduced by reserves for excess and obsolete inventories of \$7,482 and \$7,328 as of March 28, 2008 and December 31, 2007, respectively.

### Note 3. Equity and Treasury Stock

**Stock option exercises and restricted stock unit (RSU) vesting** Shares of our common stock issued as a result of option exercises totaled 17,000 shares during the quarter ended March 28, 2008 and 136,000 shares during the quarter ended March 30, 2007. In the first quarter of 2008, a total of 545,000 restricted stock units vested. On the issuance of these shares, 159,000 shares were withheld for taxes, resulting in issuance of 386,000 shares, net of tax withholding. In the first quarter of 2007, a total of 329,000 restricted stock units vested. On the issuance of these shares, 96,000 shares were withheld for taxes, resulting in issuance of 233,000 shares, net of tax withholding.

**Stock repurchases** We repurchased 3,912,000 shares of our common stock during the quarter ended March 28, 2008 at a cost totaling \$62,956. We repurchased 487,000 shares of our common stock during the quarter ended March 30, 2007 at a cost totaling \$15,438. These treasury shares were purchased on the open market through various brokers under the stock re-purchase plan previously approved by our Board of Directors. During the first quarter of 2008, our Board authorized the purchase of an additional 4,000,000 shares under our program. As of March 28, 2008, we are authorized to repurchase an additional 2,400,000 shares under this program.

## AVOCENT CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited, in thousands, except share data)

RSUs granted During the first quarter of 2008, our Compensation Committee approved the grant of 172,000 time-based and 184,000 market condition-based restricted stock units to our officers and directors (*see note 13*).

## Note 4. Accumulated Other Comprehensive Income

We record unrealized gains and losses on our foreign currency translation adjustments, unrealized gains and losses on derivatives which are cash flow hedges, and unrealized holding gains or losses on our available-for-sale securities, net of tax, as accumulated other comprehensive income, which is included as a separate component of stockholders' equity. Comprehensive income for the three months ended March 28, 2008 and March 30, 2007 is as follows:

	For the Three Months Ended	
	March 28, 2008	March 30, 2007
Comprehensive income		
Net income	\$ 731	\$ 746
Unrealized gains on investments		37
Unrealized gains (losses) on cash flow hedge	(249)	(38)
Foreign currency translation adjustment	2,107	80
Total comprehensive income	\$ 2,589	\$ 825

As of March 28, 2008 and December 31, 2007, total accumulated other comprehensive income was 3,987 and \$2,130, respectively.

## Note 5. Earnings Per Share (share data in thousands)

	Income (Numerator)	Shares (Denominator)	Per-Share Amount
<b><u>For the three months ended March 28, 2008</u></b>			
<b>Basic EPS</b>			
Net income available to common stockholders	\$ 731	46,233	\$ 0.02
<b>Effect of Dilutive Securities</b>			
Stock options and unvested RSUs		384	
<b>Diluted EPS</b>			
Net income available to common stockholders and assumed conversions	\$ 731	46,617	\$ 0.02
<b><u>For the three months ended March 30, 2007</u></b>			

## Edgar Filing: AVOCENT CORP - Form 10-Q

### Basic EPS

Net income available to common stockholders	\$	746	50,733	\$	0.01
---	----	-----	--------	----	------

### Effect of Dilutive Securities

Stock options and unvested RSUs			1,153		
---------------------------------	--	--	-------	--	--

### Diluted EPS

Net income available to common stockholders and assumed conversions	\$	746	51,886	\$	0.01
---	----	-----	--------	----	------

Anti-dilutive options to purchase common stock outstanding were excluded from the calculations above.

Anti-dilutive options totaled 4,365 and 2,130 as of March 28, 2008 and March 30, 2007, respectively.

### Note 6. Segment Reporting

In the first quarter of 2008, we dissolved our Desktops Solutions Division (DSD). DSD's results were previously reported within our Other Business Units. The related revenue and expenses of this business unit have not been material to our consolidated results, and this business unit was dissolved rather than being merged into another business unit.

## AVOCENT CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited, in thousands, except share data)

Accordingly, we will continue to report historical results for DSD within our Other Business Units. In addition, no goodwill was allocated to this business unit and all related intangibles were fully amortized prior to the dissolution of the business unit, so there was no related write-off of goodwill or write-down of intangible assets as a result of the dissolution of this business unit. Costs associated with the dissolution of DSD are included in retirement and restructuring expenses for the first quarter of 2008. Retirement and restructuring expenses includes costs relate to severance charges incurred due to the termination of certain research and development activities and also include the retirement costs for our former CEO.

We evaluate the performance of our segments based on revenue and operating profit, which is calculated before corporate and unallocated costs, amortization of intangibles, acquired in-process research and development expense, and stock compensation costs. We do not track or use assets by segment as a measure of performance, therefore, we have not presented assets by segment. The following is a presentation of information for our two reportable segments, Management Systems and LANDesk:

	For the three months ended	
	March 28, 2008	March 30, 2007
Net revenue:		
Management Systems	\$ 107,731	\$ 105,104
LANDesk	29,193	23,859
Other business units	3,699	4,219
Corporate and unallocated	776	750
Amortization of fair value adjustment to LANDesk deferred revenue		(781)
Total net revenue	\$ 141,399	\$ 133,151

	For the three months ended	
	March 28, 2008	March 30, 2007
Operating income (loss):		
Management Systems	\$ 26,432	\$ 25,911
LANDesk	610	(536)
Other business units	(1,072)	(3,151)
Corporate and unallocated costs	(6,615)	(3,613)
Amortization of fair value adjustment to LANDesk deferred revenue		(781)
Amortization of intangibles	(10,304)	(11,657)
Retirement and restructuring expenses	(2,356)	
Stock-based compensation expense	(4,553)	(3,661)
Total income from operations	2,142	2,512
Other expense	(486)	(1,672)
Income before provision for income taxes	\$ 1,656	\$ 840

Sales by product line for Management Systems and LANDesk for the three months ended March 28, 2008 and March 30, 2007 are as follows:

For the Three Months Ended

Edgar Filing: AVOCENT CORP - Form 10-Q

	March 28, 2008	March 30, 2007
Management Systems net revenue:		
KVM	\$ 78,926	\$ 80,688
Serial management	12,719	11,286
Embedded software and solutions	8,347	7,577
Other	7,739	5,553
Total Management Systems net revenue	\$ 107,731	\$ 105,104



## AVOCENT CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited, in thousands, except share data)

	For the Three months ended March 28, 2008	For the Three months ended March 30, 2007
LANDesk net revenue:		
Licenses and royalties	\$ 17,042	\$ 13,376
Maintenance and services	12,151	10,483
Total LANDesk net revenue	\$ 29,193	\$ 23,859

We sell our products internationally to customers in several countries; however no foreign country accounted for more than 10% of sales in the first quarter of 2008 or 2007.

Following is a presentation of long-lived assets as of March 28, 2008 and December 31, 2007:

	March 28, 2008	December 31, 2007
Long-lived assets:		
United States	\$ 25,825	\$ 26,266
International	11,125	11,032
Total	\$ 36,950	\$ 37,298

**Note 7. Forward Contracts and Interest Rate Swap**

We use forward contracts to reduce our foreign currency exposure related to the net cash flows from our international operations. The majority of these contracts are short-term contracts (three months or less) and are marked-to-market each quarter and included in trade payables, with the offsetting gain or loss included in other income (expense) in the accompanying consolidated statements of income. As of March 28, 2008, we had three open forward contracts with an approximate fair value of \$20. As of December 31, 2007, we had three open forward contracts with an approximate fair value of \$8.

In 2006, we entered into an interest rate swap agreement with a notional amount of \$125,000. The notional amount of the interest rate swap was \$60,000 as of March 28, 2008. The objective of the rate swap agreement is to provide a hedge against rising LIBOR interest rates that would have a negative effect on our cash flows due to changes in interest rates on the line of credit. The swap was effective on August 31, 2006 and terminates on December 31, 2008. The swap calls for us to make fixed rate payments of 5.42% over the term of the hedge and to receive floating rate payments based on LIBOR (matching the LIBOR rate in the line of credit above) from the counter-party. We anticipate that the hedge will be settled upon maturity and it is being accounted for as a cash flow hedge. The interest rate swap is recorded at fair value each reporting period with the changes in the fair value of the hedge that take place through the date of maturity recorded in accumulated other comprehensive income (OCI).

At March 28, 2008, we recorded an unrealized loss on the swap, net of tax, of \$640 in accumulated OCI. There was no ineffectiveness in the quarter, and we anticipate no significant ineffectiveness throughout the remainder of 2008.

## AVOCENT CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited, in thousands, except share data)

**Note 8. Goodwill and Other Intangible Assets**

Other intangible assets subject to amortization were as follows:

	March 28, 2008		December 31, 2007	
	Gross Carrying Amounts	Accumulated Amortization	Gross Carrying Amounts	Accumulated Amortization
Developed technology	\$ 56,840	\$ 20,206	\$ 56,840	\$ 17,292
Internally developed software for resale	21,900	5,779	21,900	4,867
Patents and trademarks	30,795	7,655	30,670	6,590
Customer base and certifications	99,938	29,514	99,878	25,496
Maintenance contracts	9,600	3,040	9,600	2,560
Non-compete agreements	10,624	6,304	10,624	5,432
Other	2,310	1,796	2,310	1,603
	\$ 232,007	\$ 74,294	\$ 231,822	\$ 63,840

For the three months ended March 28, 2008 and March 30, 2007, amortization expense for other intangible assets was \$10,454 and \$11,747, respectively. The approximate estimated annual amortization for other intangibles is as follows:

**Years ending December 31:**

2008, remainder	\$ 32,103
2009	\$ 37,757
2010	\$ 34,724
2011	\$ 26,272
2012	\$ 17,112
Thereafter	\$ 9,745

There were no changes in the carrying amount of goodwill among the business units for the three months ended March 28, 2008.

**Note 9. Product Warranties and Deferred Revenue**

The activity within the liability for warranty returns for the three months ended March 28, 2008 is as follows:

# Edgar Filing: AVOCENT CORP - Form 10-Q

Balance, January 1, 2008	\$	1,854
Accruals for product warranties issued during the period		2,029
Settlements made during the period		(2,087)
Balance, March 28, 2008	\$	1,797

Deferred revenue related to our extended warranty for hardware products program was \$5,726 at March 28, 2008 and \$5,388 at December 31, 2007. We recorded earned revenue from the amortization of deferred revenue related to extended warranties of \$915 during the three months ended March 28, 2008. In addition, we recorded new extended warranties of \$1,253 during the three months ended March 28, 2008.

We defer revenue for subscription, service and maintenance contracts until earned, which is generally over the term of the contract or when services are performed. As of March 28, 2008, deferred revenue was \$64,338, of which approximately \$62,641 related to LANDesk. As of December 31, 2007, deferred revenue was \$60,647, of which approximately \$59,078 related to LANDesk.

**AVOCENT CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED**

(Unaudited, in thousands, except share data)

**Note 10. Income Taxes**

The effective tax rate in the first quarter of 2008 was 55.9% compared to an effective tax rate of 11.2% in the first quarter of 2007. The provision for income taxes was \$925 for the first quarter of 2008, compared to \$94 in the first quarter of 2007. The increase in the effective tax rate was primarily the result of the expiration of the U.S. Research and Development Tax Credit, which as of March 28, 2008 has not been reinstated, expenses related to stock options, and a net increase in our reserves for uncertain tax positions.

As of March 28, 2008, we had total reserves for uncertain tax positions related to gross unrecognized tax benefits of \$5,297, of which \$3,535, if recognized, would affect the effective tax rate. We recognize potential accrued interest and penalties related to unrecognized tax benefits from our global operations within income tax expense. We recorded \$241 of such expenses in the first quarter of 2008. As of March 28, 2008, we had accrued interest payable related to the unrecognized tax benefits of \$2,201.

We conduct business globally, and as a result our subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. In the normal course of business we are subject to examinations by taxing authorities throughout the world including the U.S. With few exceptions, we are no longer subject to U.S. federal, state, and local, or non-U.S. income tax examinations before 2004.

The Internal Revenue Service (IRS) commenced an examination in 2006 of our U.S. income tax returns for 2004 and 2005. During the first quarter of 2008, the IRS proposed certain adjustments relating primarily to transfer pricing, increasing our tax liabilities for those periods. We have reached a negotiated settlement with the IRS concerning those adjustments resulting in an additional tax payment of \$6,600, which we had previously accrued and was paid during the first quarter of 2008. We anticipate that a payment for interest will be made not to exceed \$1,500 (which we have accrued) by the end of the second quarter of 2008. We do not anticipate that this payment would result in a material change to our financial position.

**Note 11. Fair Value Measurements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, (SFAS 157), which is effective for fiscal years beginning after November 15, 2007 and for interim periods within those years. This statement defines fair value, establishes a framework for measuring fair value, and expands the related disclosure requirements. This statement applies under other accounting pronouncements that require or permit fair value measurements. The statement indicates, among other things, that a fair value measurement assumes that the transaction to sell an asset or transfer a liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. SFAS 157 defines fair value based upon an exit price model.

## Edgar Filing: AVOCENT CORP - Form 10-Q

Relative to SFAS 157, the FASB issued FASB Staff Positions (FSP) 157-1 and 157-2. FSP 157-1 amends SFAS 157 to exclude SFAS No. 13, *Accounting for Leases*, (SFAS 13) and its related interpretive accounting pronouncements that address leasing transactions, while FSP 157-2 delays the effective date of the application of SFAS 157 to fiscal years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis.

We adopted SFAS 157 as of January 1, 2008, with the exception of the application of the statement to nonfinancial assets and nonfinancial liabilities. Nonfinancial assets and nonfinancial liabilities for which we have not applied the provisions of SFAS 157 include those measured at fair value in goodwill impairment testing, indefinite lived intangible assets measured at fair value for impairment testing, asset retirement obligations initially measured at fair value, and those initially measured at fair value in a business combination.

SFAS 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on our own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

## AVOCENT CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited, in thousands, except share data)

The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of March 28, 2008:

	Fair Value Measurements at March 28, 2008			
	Total Carrying Value at March 28, 2008	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Derivative liabilities	\$ 1,016	\$	\$ 1,016	\$

The fair market value of over-the-counter derivatives is measured at fair value using expected cash flows over the life of the trade. The fair value measurement is prepared using the closing mid-market rate/price environment on March 28, 2008, using proprietary models, available market data and reasonable assumptions. These fair value measurements are classified within Level 2 of the valuation hierarchy.

## Note 12. Legal Matters

In March 2006, TFS Electronic Manufacturing Services, Inc. (TFS) filed a Third-Party Complaint and an Objection to Claim of Avocent Corporation with the United States Bankruptcy Court, District of Arizona. As a result of the complaint, an adversary proceeding was commenced against us in the TFS bankruptcy case in an effort to disallow our bankruptcy claim against TFS in its entirety. TFS also seeks damages in an undetermined amount for our alleged breach of contract, negligence, negligent misrepresentations, breaches of warranty, unjust enrichment, disparagement of TFS business, and quantum merit. TFS is seeking recovery of actual damages, punitive damages, attorneys' fees, pre- and post-judgment interest, costs from us. In late April 2008, we entered into a Settlement Agreement with TFS and are awaiting Bankruptcy Court approval of the Settlement Agreement. The settlement was not material to our financial statements but was included within the results for the quarter ended March 28, 2008.

In January 2007, we filed a complaint for patent infringement in the United States District Court for the Western District of Washington against Aten Technology, Inc., Aten International Co., Ltd, Belkin Corporation, Rose Electronics and its general partners, and Trippe Manufacturing Company. The defendants filed counterclaims alleging non-infringement, unenforceability, and invalidity. In May 2007, we entered into a Settlement and License Agreement with Trippe Manufacturing, and dismissed Trippe from the lawsuit. In October 2007, the District Court stayed the action pending a re-examination of our patents by the Patent and Trademark Office. That re-examination is currently underway.

In March 2007, KBM Enterprises, formerly a contract manufacturer for Avocent, filed a complaint against Avocent in the Circuit Court of Madison County, Alabama, seeking \$9,500 for costs allegedly incurred by KBM in its manufacturing efforts on behalf of Avocent. We have filed an answer and counterclaims against KBM and one of its principals. Discovery is currently underway.

In April 2007, we filed a complaint for declaratory judgment against Aten International Co., Ltd. in the United States District Court for the Northern District of Alabama. We are seeking a declaratory judgment that two patents owned by Aten and asserted against Avocent are invalid and that certain of products alleged by Aten to infringe do not infringe these patents. In August 2007, Aten's motion to dismiss for lack of personal jurisdiction was granted, and we have appealed that ruling to the Federal Circuit Court of Appeals. Oral arguments were held in February 2008.

In November 2007, Gemini IP, LLC filed a complaint for patent infringement in the United States District Court for the Eastern District of Texas, Sherman Division, against Avocent Corporation and our subsidiary LANDesk Software, Inc. The complaint alleges infringement of a Gemini patent through the sales of a LANDesk product. The complaint seeks injunctive relief, damages, attorneys' fees, and costs. Avocent Corporation was dismissed from the lawsuit in January 2008, and we have made a claim for indemnification against the LANDesk escrow account. In April 2008, the District Court stayed the action pending a review of the Gemini Patent by the Patent and Trademark Office.

We acquired LANDesk Group Limited, a privately-held company, in August 2006, and the acquisition agreements provided for total initial consideration of approximately \$407 million and a potential earn-out payment to the former shareholders of LANDesk of up to \$60 million if LANDesk achieved specified revenue targets for the full year of 2006. Based on LANDesk's 2006 revenue results, we concluded that LANDesk did not achieve the minimum revenue target required to cause any earn-out payment and that no earn-out was earned or payable. Accordingly, we did not pay, and have not accrued for, any earn-out payment. The Shareholder Representative for the former shareholders of LANDesk instituted the arbitration procedure described in the acquisition agreements and is challenging our conclusion that no earn-out was earned or payable.

We intend to vigorously defend each of these matters, but the outcome of any claim, litigation, or proceeding is always inherently uncertain. Based on the facts and circumstances currently known to us, we believe that resolution of the foregoing matters will not materially affect our operations, financial condition, or cash flows.



AVOCENT CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

(Unaudited, in thousands, except share data)

**Note 13. Recently Issued Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). See Note 11 for additional discussion.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS No. 159 permits an entity to elect fair value as the initial and subsequent measurement attribute for many financial assets and liabilities. Entities electing the fair value option would be required to recognize changes in fair value in earnings. Entities electing the fair value option are required to distinguish, on the face of the statement of financial position, the fair value of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The adjustment to reflect the difference between the fair value and the carrying amount would be accounted for as a cumulative-effect adjustment to retained earnings as of the date of initial adoption. We have adopted SFAS 159 and have elected not to measure any additional financial instruments or other items at fair value.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141(R)), which replaces SFAS 141. SFAS 141(R) revises the principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; 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. FAS 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity's fiscal year that begins after December 15, 2008. The application of SFAS 141(R) will result in a significant change in accounting for future acquisitions after the effective date.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161). SFAS No. 161 requires companies with derivative instruments to disclose information that would enable financial statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (SFAS No. 133) and how derivative instruments and related hedged items affect a company's financial position, financial performance and cash flows. The new requirements apply to derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under SFAS 133. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008; however, early application is encouraged.

**Note 14. Subsequent Events**

During the period from March 26, 2008 through March 28, 2008, we purchased 88,000 additional shares of our common stock under our share repurchase program for a total cost of \$1,493. However, as these transactions settled after March 28, 2008, we will record these trades as

occurring in the second quarter of 2008.

During the second quarter of 2008 our Compensation Committee approved the grant of 525,000 time-based and 196,000 market conditioned-based restricted stock units to our employees (*see Note 3*).

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

*THE INFORMATION IN THIS ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS AND IN OTHER PARTS OF THIS FORM 10-Q CONTAINS FORWARD-LOOKING STATEMENTS, INCLUDING, WITHOUT LIMITATION, STATEMENTS RELATING TO OUR FUTURE BUSINESS PROSPECTS AND ECONOMIC CONDITIONS IN GENERAL; STATEMENTS REGARDING OUR ABILITY TO PREDICT FUTURE SALES AND MANAGE INVENTORY LEVELS; STATEMENTS REGARDING PRICING PRESSURE; STATEMENTS REGARDING THE FLUCTUATION OF OUR REVENUE GROWTH IN RELATION TO ECONOMIC CONDITIONS AND IT RELATED SPENDING TRENDS; STATEMENTS REGARDING OUR PRODUCT PLATFORMS AND OUR ABILITY TO RESUME GROWTH IN OUR OVERALL BUSINESS; STATEMENTS REGARDING INCREASED SALES OF OUR DIGITAL PRODUCTS AND EMBEDDED SOLUTIONS AND THEIR ABILITY TO OFFSET PRICE DECLINES AND COMPETITIVE FACTORS; STATEMENTS REGARDING OUR ANTICIPATED FUTURE GROSS MARGINS, RESEARCH AND DEVELOPMENT EXPENSES, AND SELLING, GENERAL AND ADMINISTRATIVE EXPENSES; AND STATEMENTS REGARDING THE OUTCOME OF, AND OUR LEGAL COSTS FOR, PATENT AND OTHER LEGAL CLAIMS LITIGATION AND PROCEEDINGS. THESE FORWARD-LOOKING STATEMENTS ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE OUR ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED IN PART II, ITEM 1A RISK FACTORS.*

**Overview**

Avocent Corporation designs, manufactures, licenses, and sells software and hardware products and technologies that provide connectivity and centralized management of information technology (IT) infrastructure. We (meaning Avocent and its wholly-owned subsidiaries) provide connectivity and systems management, endpoint security, and service management products and technologies that centralize control of servers, desktop computers, serial devices, wireless devices, mobile devices, and network appliances, thus increasing the efficiency of IT resources. Server manufacturers resell private-labeled Avocent KVM (keyboard, video, and mouse) switches and embedded software and hardware technology in their systems, and companies large and small depend on our software and hardware products and technologies for managing their growing IT infrastructure.

For a more complete description of our products, technologies and markets, please refer to our Form 10-K, which was filed on February 21, 2008.

Most of our revenue is derived from sales to a limited number of OEMs (who purchase our switching systems on a private-label or branded basis for integration and sale with their own products), sales through our reseller and distributor network, and sales to a limited number of direct customers. Sales to our branded customers accounted for 66% of sales in the first quarter of 2008 and 64% of sales in the first quarter of 2007. Sales to our OEM customers accounted for 34% of sales in the first quarter of 2008 and 36% of sales in the first quarter of 2007. We do not have contracts with many of our branded customers, and in general, our OEM and branded business customers are obligated to purchase products from us only pursuant to binding purchase orders. The loss of, or material decline in orders from, these customers would have a material adverse effect on our business, financial condition, results of operations, and cash flows. Our top five customers include both OEM and branded customers, and accounted for 46% and 44% of sales in the first quarter of 2008 and 2007, respectively.

We sell products to resellers, distributors, end-users, and OEMs in the United States, Canada, Europe, and Asia as well as in other foreign markets. Sales within the United States accounted for approximately 52% and 55% of first quarter sales in 2008 and 2007, respectively. No foreign country accounted for more than 10% of sales in the first quarter of 2008 or 2007.

With continued industry-wide initiatives to reduce all channel inventories and to shorten lead times, trends with our major customers are, generally, to reduce the number of weeks of forward-committed firm orders. This trend continues to affect our business with certain distributors, OEMs, and other server manufacturers, and we believe that it will continue to make our future sales more difficult to predict and inventory levels more difficult to manage.

We experience significant price competition in the market for all of our products, and we expect that pricing pressures will continue in the future. In addition, general economic conditions are not predictable, and we expect our revenue growth rate to fluctuate in relation to economic conditions and IT related spending trends.

**Many of our executive officers and directors are vested in significant amounts of options to purchase shares of our common stock and RSUs. These officers and directors have informed us that they have sold, and may sell additional, shares of our common stock to provide liquidity and diversify their portfolios. During the first and second quarters of 2008, our Board of Directors granted both time-based and market condition-based restricted stock units (RSUs) with two and three year vesting. Awards with similar terms were also granted in the second quarter of 2007.**

**In the first quarter of 2008, we discontinued our Desktop Solutions business unit and transferred some of its personnel and a portion of its technology into Management Systems. We believe our remaining business units allow us to focus on new technology and**

growth opportunities and to add product and shareholder value in the future. We believe this structure enhances customer service, speeds delivery of products to market and better focuses our research, development, and marketing resources.

Our largest business unit, Management Systems, comprised 76% of our consolidated net revenue in the first quarter of 2008 and 79% in 2007. LANDesk contributed 21% of net revenue to the first quarter of 2008 and 17% in 2007. Our other business units and unallocated revenue comprised the remaining percentage of our consolidated net revenue in 2008 and 2007. See Note 6 in the notes to the condensed consolidated financial statements contained in Part I, Item 1 of this document.

## Results of Operations

The following table sets forth, for the periods indicated, selected statement of income data expressed as a percentage of net sales:

	For the three months ended	
	March 28, 2008	March 30, 2007
Net sales	100.0%	100.0%
Cost of sales	35.5	39.2
Gross profit	64.8	60.8
Operating expenses:		
Research and development expenses	16.5	15.7
Selling, general and administrative expenses	39.0	36.5
Retirement and restructuring expenses	2.1	
Amortization of intangible assets	5.3	6.7
Total operating expenses	62.9	58.9
Income from operations	1.6	1.9
Net investment income	0.6	0.7
Interest expense	(1.3)	(1.7)
Other income (expense), net	0.3	(0.2)
Income before provision for income taxes	1.2	0.7
Provision for income taxes	0.7	0.1
Net income	0.5%	0.6%

*Net sales.* Our net sales consist of sales of keyboard, video, and mouse (KVM) console switching systems, digital connectivity products and technologies, software licenses and subscriptions, support and maintenance agreements, serial connectivity devices, wireless extension products, IPMI, extension, remote access and management products and technologies, and royalties from licensing our intellectual property.

	For the three months ended			
	March 28, 2008	% of Sales	March 30, 2007	% of Sales
Net sales, customer distribution:				
Branded	\$ 93,663	66%	\$ 85,044	64%
OEM	47,736	34%	48,107	36%

# Edgar Filing: AVOCENT CORP - Form 10-Q

\$	141,399	100%	\$	133,151	100%
----	---------	------	----	---------	------

The 6.2% growth in sales was primarily the result of increased branded sales across our geographic regions, which served to offset a slight decline in our OEM sales. Branded sales in EMEA and Asia both grew approximately 19% in the first quarter of 2008 from the first quarter of 2007. Although our OEM sales were down slightly by approximately 1% from the first quarter of 2007, OEM sales did grow 10% in EMEA and 8% in Asia in the first quarter of 2008. We attribute the strength in our foreign markets partly to the decline in value of the dollar as compared to the other currencies, increasing the purchasing power of these currencies, as many of our international sales transactions are in dollars.

	March 28, 2008	For the three months ended % of Sales	March 30, 2007	% of Sales
Business unit net sales:				
Management Systems	\$ 107,731	76%	\$ 105,104	79%
LANDesk	29,193	21%	23,859	18%
Other business units	3,699	3%	4,219	3%
Corporate and unallocated	776		750	
Amortization of fair value adjustment to LANDesk deferred revenue			(781)	
	\$ 141,399	100%	\$ 133,151	100%

Our Management Systems business unit is comprised of our traditional KVM products, our serial products and our embedded software and solutions products. Management Systems sales increased approximately 3% in the first quarter 2008 compared to the first quarter of 2007, led by slight improvements in our serial and embedded software products, especially in our overseas markets. Our KVM products sales were down slightly in the first quarter 2008 from the first quarter of 2007 primarily as a result of the slower OEM sales experienced in the U.S. Sales were also affected by price reductions on certain older analog products. Sales by product line for Management Systems for the three months ended March 28, 2008 and March 30, 2007 are as follows:

	March 28, 2008	For the three months ended March 30, 2007
Management Systems, net revenue:		
KVM	\$ 78,926	\$ 80,688
Serial management	12,719	11,286
Embedded software and solutions	8,347	7,577
Other	7,739	5,553
Total Management Systems net revenue	\$ 107,731	\$ 105,104

LANDesk revenue and bookings are comprised of license-based revenue, primarily from the LANDesk Management Suite product, and subscription-based revenue, primarily from the LANDesk Security Suite and LANDesk Patch Manager products and from maintenance and support agreements related to LANDesk Management Suite. Compared to the first quarter of 2007, LANDesk revenues increased 22 % and bookings increased 32% during the first quarter of 2008. LANDesk's growth in bookings in the first quarter 2008 was attributable to new license sales of the LANDesk Management Suite and new subscriptions of the LANDesk Security Suite. LDMS products grew to \$16.7 million in the first quarter of 2008 from \$13.3 million in the first quarter of 2007, while security products grew to \$6.3 million in the first quarter of 2008 from \$5.6 million in the first quarter of 2007. The growth in subscription and maintenance revenue also results in an increase to deferred revenue recorded on the balance sheet. Deferred revenue increased to \$70.1 million at March 28, 2008 from \$66.1 million at December 31, 2007. Sales by product line for LANDesk for the three months ended March 28, 2008 and March 30, 2007 are as follows:

	March 28, 2008	For the three months ended March 30, 2007
LANDesk net revenue:		
Licenses and royalties	\$ 17,042	\$ 13,376
Maintenance and services	12,151	10,483
Total LANDesk net revenue	\$ 29,193	\$ 23,859

International sales grew 13% in 2008 from 2007, while sales within the United States grew less than 1% in 2008 from 2007. As mentioned previously, our OEM and branded businesses were both strong in EMEA and Asia, but only our branded business was up in North America. The growth experienced in our North America branded business was enough to partially offset the declines in our North America OEM business.





Edgar Filing: AVOCENT CORP - Form 10-Q

	March 28, 2007	For the three months ended % of Sales	March 30, 2007	% of Sales
Net sales, geographical distribution:				
United States	\$ 74,218	52%	\$ 73,797	55%
International	67,181	48%	59,354	45%
	\$ 141,399	100%	\$ 133,151	100%

*Gross profit.* Gross profit is affected by a variety of factors, including the ratio of sales among our distribution channels, as OEM sales typically have lower gross margins than our branded sales; absorption of fixed costs as sales levels fluctuate; product mix and component costs; labor costs; new product introductions by us and by our competitors; increasing sales of our software products which tend to have higher gross margins; and our outsourcing of manufacturing and assembly services.

	March 28, 2008	For the three months ended Gross Margin %	March 30, 2007	Gross Margin %
Management Systems	\$ 66,514	61.7%	\$ 61,670	58.7%
LANDesk	25,339	86.8%	20,965	87.9%
Other business units	1,548	41.8%	1,292	33.9%
Corporate and unallocated	744		731	
Stock-based compensation	(244)		(179)	
Intangible amortization				
LANDesk software	(2,767)		(2,683)	
Amortization of fair value adjustment to LANDesk deferred revenue			(781)	
Gross profit dollars and margin %	\$ 91,134	64.5%	\$ 81,015	60.8%

The improvement in gross margin resulted primarily from the increased sales across all business units, particularly at LANDesk and Management Systems. LANDesk sales grew 22% in the first quarter of 2008 compared to the first quarter of 2007. The gross margins for LANDesk software products are significantly higher than the remainder of our business. Therefore, the increase in LANDesk's sales directly increased our consolidated gross margin for the first quarter of 2008 compared to the first quarter of 2007. Management Systems revenue increased 3% in the first quarter of 2008 compared to the first quarter of 2007. In addition to increased sales, Management Systems experienced a change in product mix and reduced excess and obsolete inventory provisions in the first quarter of 2008 compared to the first quarter of 2007.

*Operating expenses.*

	March 28, 2008	For the three months ended % of Sales	March 30, 2007	% of Sales
Research and development expense	\$ 23,367	16.5%	\$ 20,881	15.7%
Selling, general, and administrative expense	55,119	39.0%	48,660	36.5%

Edgar Filing: AVOCENT CORP - Form 10-Q

Retirement and restructuring expenses	2,971	2.1%		
Amortization of intangible assets	7,535	5.3%	8,962	6.7%
Total operating expenses	\$ 88,992	62.9%	\$ 78,503	58.9%

*Research and development expenses.* Research and development expenses include compensation for engineers, support personnel, outside contracted services, and materials costs, all of which are expensed as incurred. R&D increased 12% in the first quarter of 2008 from the first quarter of 2007. The increase in R&D expense is primarily attributable to the impact of our continued investment in targeted integrated R&D projects, including Avocent Management Platform, real-time visualization and power management, which leverage technology from both Management Systems and LANDesk. We believe that the timely development of innovative products and enhancements to existing products is essential to maintaining our competitive position, and we will continue to

make significant investments in research and development.

***Selling, general and administrative expenses.*** Selling, general and administrative expenses include personnel, materials, services and other related costs for administration, finance, information systems, human resources, sales and marketing and general management, rent, utilities, legal and accounting expenses, bad debts, advertising, promotional material, trade show expenses, and related travel costs. Selling, general and administrative expenses increased 13% in the first quarter of 2008 from the first quarter of 2007. The increase in selling, general and administrative expenses was attributed primarily to increased sales commissions as a direct result of increased sales for the period. We also experienced higher legal expenses during the first quarter of 2008 as compared to the first quarter of 2007 in association with various patent and legal cases.

***Retirement and restructuring expenses.*** Retirement and restructuring expenses for the first quarter of 2008 relate to severance charges incurred due to the termination of certain research and development activities and include the retirement costs for our former CEO.

***Amortization of intangible assets.*** Amortization of \$7.5 million in the first quarter of 2008 included the amortization of intangible assets created as a result of the acquisitions of Sonic Mobility, Cyclades, and LANDesk. Amortization of \$9.0 million in the first quarter of 2007 included the amortization of the identifiable intangible assets created as a result of the acquisitions of OSA, Sonic Mobility, Cyclades, and LANDesk. The decrease in amortization expense relates primarily to fully amortizing certain intangible assets in 2007 recorded in relation to the OSA acquisition in 2004.

***Stock-based Compensation.*** We allocate stock-based compensation expense based on the department in which an employee works. Stock compensation expenses for the first quarter 2008 and 2007 were as follows:

	March 28, 2008	For the three months ended % of Sales	March 30, 2007	% of Sales
Stock-based compensation:				
Cost of sales	\$ 244		\$ 179	
Research and development expense	1,015		1,116	
Selling, general and administrative expense	2,679		2,366	
Retirement and restructuring expense	615			
	\$ 4,553	3.3%	\$ 3,661	2.8%

Stock-based compensation increased 24% in the first quarter 2008 from the first quarter 2007 primarily as a result of recording \$615,000 of charges associated with the acceleration of vesting for certain RSU's and other equity related charges for the retirement of our former CEO. Additionally, during the first quarter of 2008 our Compensation Committee approved the grant of time-based and market condition-based restricted stock units to our officers, and directors, which also increased the stock-based compensation. The awards will vest over two or three years and in some cases are subject to the achievement of certain performance goals.

*Net investment income.* Net investment income increased slightly to \$897,000 in the first quarter of 2008 as compared to \$879,000 in the first quarter of 2007.

*Interest expense.* Interest expense results from borrowings under our \$250 million unsecured line of credit obtained in the second quarter of 2006, which we used to finance a portion of the LANDesk acquisition and share repurchases. Interest expense declined to \$1.8 million in the first quarter 2008, compared to \$2.2 million in the first quarter of 2007 due to lower borrowings and lower interest rates on our line of credit. The balance on our line of credit decreased to \$140 million as of March 28, 2008 compared to \$150 million as of March 30, 2007.

*Other income (expense), net.* Net other income (expense) improved from an expense of \$317,000 in the first quarter of 2007 to income of \$455,000 in the first quarter of 2008. The improvement is the result of increased net foreign currency translation gains of approximately \$680,000 over the comparative periods.

*Provision for income taxes.* The effective tax rate in the first quarter of 2008 was 55.8% compared to an effective tax rate of 11.2% in the first quarter of 2007. The provision for income taxes was \$925,000 for the first quarter of 2008, compared to \$94,000 in the first quarter of 2007. The increase in the effective tax rate was primarily the result of the expiration of the U.S. Research and

Development Tax Credit, which as of March 28, 2008 has not been reinstated, expenses related to stock options, and additions in our reserves for uncertain tax positions less other reductions adjusted for accrued interest expense net of federal benefit. We adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 on January 1, 2007. As of March 28, 2008, we had total reserves for uncertain tax positions related to gross unrecognized tax benefits of \$5.3 million of which \$3.5 million, if recognized, would affect the effective tax rate.

*Net income.* Net income for the first quarter of 2008 was \$731,000 compared to \$746,000 for the first quarter of 2007, as a result of the factors detailed in the above discussion. Net income, as a percentage of sales for the first quarter of 2008 was 0.5%, compared to 0.6% for the first quarter of 2007.

### Liquidity and Capital Resources

As of March 28, 2008, our principal sources of liquidity consisted of \$98 million in cash and cash equivalents and a \$250 million unsecured five year revolving bank line of credit that is available for general corporate purposes. We plan to use borrowings under the line of credit to continue funding the purchase of shares in 2008 under our stock repurchase program and for strategic acquisitions of technologies or companies that we believe will enhance and/or complement our existing products and technologies and increase our sales. The line of credit currently bears an interest rate of LIBOR plus 70 basis points. There was \$140 million outstanding under the line of credit as of March 28, 2008. We classify the entire obligation as long-term as it carries a five year term and has no payment schedule. We expect to repay the borrowings from future cash flows from operations. A summary of our cash flows is as follows:

	Three months ended	
	March 28, 2008	March 30, 2007
Total cash provided by (used in):		
Operating activities	\$ 4,701	\$ 17,844
Investing activities	3,620	(16,504)
Financing activities	(17,824)	(11,825)
Effect of exchange rate changes on cash	2,814	24
Decrease in cash and cash equivalents	\$ (6,689)	\$ (10,461)

The decline in cash flow from operations in the first quarter of 2008 was primarily the result of significant decreases in accounts payable, accrued wages and commissions and income taxes payable, which were offset by higher accounts receivable collections during the first quarter of 2007. During the first quarter of 2008, we paid \$6.0 million to the Internal Revenue Service related to settling previously accrued federal income tax matters. Additionally, our accounts payable declined by \$6.0 million as a result of the timing of inventory receipts and subsequent payments in the first quarter of 2008 compared to the fourth quarter of 2007. We received a substantial portion of our inventory later in the fourth quarter of 2007 than in the first quarter of 2008, resulting in a higher accounts payable balance at December 31, 2007. We received our shipments earlier in the first quarter of 2008, which required us to remit payments for the resulting accounts payable prior to March 28, 2008. Our accounts receivable decreased \$3.5 million from December 31, 2007 to March 28, 2008 as a result of continued improved cash collections.

Our days sales outstanding (DSO) improved to 63 days at the end of the first quarter 2008 compared to 67 days at the end of the first quarter of 2007. DSO improved as a result of higher sales in the first quarter of 2008 compared to the first quarter of 2007 and to continued improved cash collections at each of our locations. Inventories increased slightly from December 31, 2007 to March 28, 2008. However, our inventory turns improved to 5.7 at the end of the first quarter of 2008 compared to 4.6 at the end of the first quarter of 2007, primarily as a result of our higher sales volume experienced in the first quarter of 2008.

## Edgar Filing: AVOCENT CORP - Form 10-Q

Our investing activities produced \$3.6 million of positive cash flow in the first quarter of 2008, primarily as we converted matured investments to cash for use in paying down our borrowings under the outstanding line of credit and for purchase of our treasury shares. Our investing activities in the first quarter of 2007 included cash payments for investment purchases.

Our financing activities used the cash provided by operations and investing activities, as well as additional borrowings, to repurchase approximately 4 million shares of our common stock during the first quarter of 2008 at a cost totaling \$63 million. These treasury shares were purchased through various brokers under the stock repurchase program approved by our Board of Directors. As of March 28, 2008 we have approximately 2.4 million shares available for purchase under the program.

We may use a portion of our cash and cash equivalents or our line of credit for strategic acquisitions of technologies and companies that will enhance and complement our existing technologies and help increase our sales.

**Off-Balance Sheet Arrangements and Contractual Obligations**

In the ordinary course of our business, we may at any point in time have a significant amount of contractual commitments not yet recognized in our financial statements. These commitments relate primarily to our need to schedule the purchase of inventories in advance of the related forecasted sales to customers. We have longer lead times for the products we purchase from suppliers based in Asia than those for our U.S. based and European based suppliers. Our actual contractual commitments are typically limited to products needed for one to three months of forecasted sales. The liabilities for these inventory purchases along with the related inventory assets are typically recognized upon our receipt of the products. We also have at any point in time a variety of short term contractual commitments for services such as advertising, marketing, accounting, legal, and research and development activities. The liabilities for these services and the related expenses are typically recognized upon our receipt of the related services. In our 2007 Form 10-K, we disclosed our off-balance sheet arrangements and contractual obligations. At March 28, 2008, there have been no material changes to these off-balance sheet arrangements outside the ordinary course of business. Our line of credit balance increased to \$140 million at March 28, 2008 from \$95 million at December 31, 2007. The increase in our level of borrowings, if sustained at the higher level, will result in higher interest payments in future periods.

**Non-GAAP Operational Measures**

To supplement our consolidated financial statements presented in accordance with GAAP, we present investors with certain non-GAAP operational measures which we use internally to manage our businesses, including net sales, gross profit, operating expenses, and the resulting operating income, income before taxes, operational net income, and operational earnings per share, all of which primarily exclude the effects of amortization and depreciation related to purchase accounting adjustments, stock-based compensation and acquired in-process research and development expenses and includes the amortization of the fair value adjustment to LANDesk deferred revenue related to the purchase accounting adjustment to reduce deferred revenue at the acquisition of LANDesk. Specifically, we use the following non-GAAP measures:

Non-GAAP Operational Measures	Three months ended	
	March 28, 2008	March 30, 2007
Operational net sales	\$ 141,399	\$ 133,932
Operational gross profit	\$ 91,145	\$ 84,658
Operational operating income	\$ 16,999	\$ 18,611
Operational net income	\$ 12,660	\$ 12,713
Operational diluted earnings per share	\$ 0.27	\$ 0.25

- The non-GAAP net sales operational measure consists of net sales increased by the pro forma amortization of deferred revenue of LANDesk at the date of acquisition which was reduced to estimated fair value pursuant to purchase accounting under GAAP. This deferred revenue was completely amortized on a pro forma basis as of the third quarter of 2007.

- The non-GAAP gross profit operational measure consists of the non-GAAP net sales operational measure described above, less cost of sales excluding the impact of stock-based compensation and amortization related to purchase accounting adjustments as they relate to cost of sales.

## Edgar Filing: AVOCENT CORP - Form 10-Q

- The non-GAAP operating expense operational measure consists of GAAP operating expenses, excluding the impact of stock-based compensation and amortization and depreciation related to purchase accounting adjustments as they relate to the particular operating expense.
- The non-GAAP operating income operational measure consists of GAAP operating income adjusted for the non-GAAP operational measures described above.
- The non-GAAP net income operational measure consists of GAAP net income, adjusted by the non-GAAP operational measures described above and the tax effects of these non-GAAP operational measures.
- The non-GAAP earnings per share operational measure is calculated by dividing the non-GAAP net income operational measure described above by GAAP weighted average basic and diluted shares outstanding.



## Edgar Filing: AVOCENT CORP - Form 10-Q

We provide the following reconciliations between GAAP and our operational measures:

	For the three months ended March 28, 2008			Non-GAAP Operational Measures
	GAAP Financial Measures	Stock-based Compensation	Purchase Accounting Adjustments	
Operational net sales	\$ 141,399			\$ 141,399
Operational gross profit	\$ 91,134	244	2,767	\$ 94,145
Operational operating income	\$ 2,142	4,553	10,304	\$ 16,999
Operational net income	\$ 731	3,491	8,438	\$ 12,660
Operational diluted earnings per share	\$ 0.02	0.07	0.18	\$ 0.27

	For the three months ended March 30, 2007			Non-GAAP Operational Measures
	GAAP Financial Measures	Stock-based Compensation	Purchase Accounting Adjustments	
Operational net sales	\$ 133,151		781	\$ 133,932
Operational gross profit	\$ 81,015	179	3,464	\$ 84,658
Operational operating income	\$ 2,512	3,661	12,438	\$ 18,611
Operational net income	\$ 746	2,656	9,311	\$ 12,713
Operational diluted earnings per share	\$ 0.01	0.06	0.18	\$ 0.25

We believe that excluding depreciation and amortization associated with purchase accounting adjustments as well as the tax impact of certain purchase accounting elections for prior acquisitions provides meaningful supplemental information and an alternative presentation useful to investors' understanding our core operating results and trends between periods. Not only are these depreciation and amortization and tax impact adjustments based on amounts assigned in purchase accounting that may have little bearing on present or future replacement costs, but they also are based on management's estimates of remaining useful lives.

Similarly, we believe that excluding stock-based compensation expense provides meaningful supplemental information and an alternative presentation useful to investors' understanding of our core operating results and trends, especially when comparing those results on a consistent basis to results for previous periods and anticipated results for future periods.

We also believe that, in excluding stock-based compensation expense and depreciation and amortization associated with purchase accounting adjustments (together with the related tax effects), our non-GAAP financial measures provide investors with transparency into the information and basis used by management and our Board of Directors to measure and forecast our results of operations, to compare on a consistent basis our results of operations for the current period to that of prior periods, to compare our results of operations on a more consistent basis against that of other companies in making financial and operating decisions, and to establish targets for management incentive compensation.

These non-GAAP operational measures have historically been used as key performance metrics by our senior management as they evaluate both the performance of the consolidated financial results as well as those of individual business segments. These non-GAAP operational measures are reviewed individually as well as in total in measuring our performance against internal and external expectations for the period and the expectations for such key non-GAAP operational measures are the basis for any financial guidance provided by management for future periods. We believe that the use of each of these non-GAAP financial measures provides enhanced consistency and comparability with our past financial reports, and also facilitates comparisons with other companies in our industry, many of which use similar non-GAAP financial measures to supplement their GAAP results. We provide this information to investors to enable them to perform additional analyses of past, present and

future operating performance, compare us to other companies, and evaluate our ongoing financial operations.

We believe that each of these operational measures is useful to investors in their assessment of our operating performance and the valuation of our company. Adjusted net sales, gross profit, operating expenses and income, operational income before taxes, operational net income, and operational earnings per share are significant measures used by management for:

- Reporting our financial results and forecasts to our Board of Directors;
- Evaluating the operating performance of our company;
- Managing and comparing performance internally across our businesses and externally against our peers; and
- Establishing internal operating targets.

These non-GAAP operational measures, including net sales, gross profit, operating income, operational net income, and operational earnings per share are used by us as broad measures of financial performance that encompass our operating performance, cash, capital structure, investment management, and income tax planning effectiveness. These operational measures are not calculated in accordance with GAAP, and should be considered supplemental to, and not as a substitute for, or superior to, financial measures calculated in accordance with GAAP. These operational measures have limitations in that they do not reflect all of the costs or reductions to revenues associated with the operations of our business as determined in accordance with GAAP. In addition, these operational measures may not be comparable to non-GAAP financial measures reported by other companies. As a result, one should not consider these measures in isolation or as a substitute for analysis of our results as reported under GAAP. We compensate for these limitations by analyzing current and future results on a GAAP basis as well as a non-GAAP basis, prominently disclosing GAAP results and providing reconciliations from GAAP results to operational measures. We expect to continue to incur expenses similar to the non-GAAP adjustments described above, and the exclusion or inclusion of these items from our non-GAAP financial measures should not be construed as an inference that these costs are unusual or infrequent. Some of the limitations in relying on our non-GAAP financial measures are:

- The non-GAAP net sales operational measure is a measure which we have defined for internal and investor purposes. A further limitation associated with this measure is that it includes certain revenues and the related impact on non-GAAP gross profit, operating income, income before taxes, net income, and earnings per share operational measures that impact our GAAP based measures.
- The non-GAAP gross profit, operating income, net income, and earnings per share operational measures are limited in that they do not include the impact of stock-based compensation expense or specific costs and benefits associated with certain purchase accounting adjustments.

We compensate for these limitations by prominently disclosing the reported GAAP results and providing investors with reconciliations from GAAP to the non-GAAP measures in the financial tables above.

#### **Recently Issued Accounting Standards and Regulatory Standards**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which clarifies that fair value estimates should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under SFAS 157, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for fiscal years beginning after November 15, 2007. On February 12, 2008, the FASB delayed the effective date of SFAS 157 for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), to fiscal years beginning after November 15, 2008. We adopted SFAS 157 as of January 1, 2008, with the exception of the application of the statement to nonfinancial assets and nonfinancial liabilities. Refer to Note 11 to the

## Edgar Filing: AVOCENT CORP - Form 10-Q

Condensed Consolidated Financial Statements for additional discussion on fair value measurements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS No. 159 permits an entity to elect fair value as the initial and subsequent measurement attribute for many financial assets and liabilities. Entities electing the fair value option would be required to recognize changes in fair value in earnings. Entities electing the fair value option are required to distinguish, on the face of the statement of financial position, the fair value of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The adjustment to reflect the difference between the fair value and the carrying amount would be accounted for as a cumulative-

effect adjustment to retained earnings as of the date of initial adoption. We have adopted SFAS 159 and have elected not to measure any additional financial instruments or other items at fair value.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141(R)), which replaces SFAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; 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. FAS 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity's fiscal year that begins after December 15, 2008. We will assess the impact of SFAS 141(R) if and when a future acquisition occurs, however the application of SFAS 141(R) will result in a significant change in accounting for future acquisitions after the effective date.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161). SFAS No. 161 requires companies with derivative instruments to disclose information that would enable financial statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (SFAS No. 133) and how derivative instruments and related hedged items affect a company's financial position, financial performance and cash flows. The new requirements apply to derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under SFAS 133. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008; however, early application is encouraged.

### **Updates to Critical Accounting Estimates**

As discussed below and in Note 11 to the Condensed Consolidated Financial Statements, we have adopted SFAS 157 as of January 1, 2008, with the exception of the application of the statement to nonfinancial assets and nonfinancial liabilities, the deferral of which was permitted under FSP 157-2. Other than this change, there have been no significant changes in our critical accounting estimates during the first three months of 2008.

Substantially all of our financial assets and liabilities are measured at fair value based upon Level 2 inputs, as defined under SFAS 157. The fair value measurement is prepared using the closing mid-market rate/price environment on March 28, 2008, using proprietary models, available market data, and reasonable assumptions.

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

Our primary market risk is the interest rate risk on our bank line of credit, which currently bears interest at a variable rate of LIBOR plus 70 basis points. We have partially hedged this exposure to interest rate risk with an interest rate swap, which has a remaining notional amount of \$60 million, through a well established financial institution.

## Edgar Filing: AVOCENT CORP - Form 10-Q

We also face foreign currency exchange rate risk to the extent that the value of certain foreign currencies relative to the U.S. dollar affects our financial results. Our international operations transact a significant portion of our business in currencies other than the U.S. dollar, predominantly the euro, and changes in exchange rates may positively or negatively affect our revenue, gross margins, operating expenses, and retained earnings since these transactions are reported by us in U.S. dollars. We occasionally purchase foreign currency forwards aimed at limiting the impact of currency fluctuations. These instruments provide only limited protection against currency exchange risks, and there can be no assurance that such an approach will be successful, especially if a significant and sudden decline occurs in the value of local currencies. As of March 28, 2008, we had three open forward contracts with an approximate fair value of \$20,000.

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

(a) *Evaluation of disclosure controls and procedures.* Based on their evaluation as of March 28, 2008, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective.

(b) *Changes in internal control over financial reporting.* There were no changes in our internal controls over financial reporting during the quarter ended March 28, 2008 that materially affected or are reasonably likely to materially affect, our internal controls over financial reporting.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings.

In March 2006, TFS Electronic Manufacturing Services, Inc. (TFS) filed a Third-Party Complaint and an Objection to Claim of Avocent Corporation with the United States Bankruptcy Court, District of Arizona. As a result of the complaint, an adversary proceeding was commenced against us in the TFS bankruptcy case in an effort to disallow our bankruptcy claim against TFS in its entirety. TFS also seeks damages in an undetermined amount for our alleged breach of contract, negligence, negligent misrepresentations, breaches of warranty, unjust enrichment, disparagement of TFS' business, and quantum merit. TFS is seeking recovery of actual damages, punitive damages, attorneys' fees, pre- and post-judgment interest, costs from us. We have entered into a Settlement Agreement with TFS and we are awaiting Bankruptcy Court approval.

In January 2007, we filed a complaint for patent infringement in the United States District Court for the Western District of Washington against Aten Technology, Inc., Aten International Co., Ltd, Belkin Corporation, Rose Electronics and its general partners, and Trippe Manufacturing Company. The defendants filed counterclaims alleging non-infringement, unenforceability, and invalidity. In May 2007, we entered into a Settlement and License Agreement with Trippe Manufacturing, and dismissed Trippe from the lawsuit. In October 2007, the District Court stayed the action pending a re-examination of our patents by the Patent and Trademark Office. That re-examination is currently underway.

In March 2007, KBM Enterprises, formerly a contract manufacturer for Avocent, filed a complaint against us in the Circuit Court of Madison County, Alabama, seeking \$9,500 for costs allegedly incurred by KBM in its manufacturing efforts on behalf of Avocent. We have filed an answer and counterclaims against KBM and one of its principals. Discovery is currently underway.

In April 2007, we filed a complaint for declaratory judgment against Aten International Co., Ltd. in the United States District Court for the Northern District of Alabama. We are seeking a declaratory judgment that two patents owned by Aten and asserted against us are invalid and that certain of products alleged by Aten to infringe do not infringe these patents. In August 2007, Aten's motion to dismiss for lack of personal jurisdiction was granted, and we have appealed that ruling to the Federal Circuit Court of Appeals. Oral arguments were held in February 2008.

In November 2007, Gemini IP, LLC filed a complaint for patent infringement in the United States District Court for the Eastern District of Texas, Sherman Division, against Avocent Corporation and our subsidiary LANDesk Software, Inc. The complaint alleges infringement of a Gemini patent through the sales of a LANDesk product. The complaint seeks injunctive relief, damages, attorneys' fees, and costs. Avocent Corporation was dismissed from the lawsuit in January 2008, and we have made a claim for indemnification against the LANDesk escrow account. In April 2008, the District Court stayed the action pending a review of the Gemini Patent by the Patent and Trademark Office.

We acquired LANDesk Group Limited, a privately-held company, in August 2006, and the acquisition agreements provided for total initial consideration of approximately \$407 million and a potential earn-out payment to the former shareholders of LANDesk of up to \$60 million if LANDesk achieved specified revenue targets for 2006. Based on LANDesk's 2006 revenue results, we concluded that LANDesk did not achieve the minimum revenue target required to cause an earn-out payment and that no earn-out was earned or payable. Accordingly, we did not pay, and have not accrued, for any earn-out payment. The Shareholder Representative for the former LANDesk shareholders instituted the arbitration procedure described in the acquisition agreements and is challenging our conclusion that no earn-out was earned or payable. We intend to vigorously defend our position in such arbitration but can give no assurance relative to the outcome of that proceeding.

**Item 1A. Risk Factors.**

*THIS QUARTERLY REPORT CONTAINS FORWARD-LOOKING STATEMENTS THAT INVOLVE RISKS AND UNCERTAINTIES THAT COULD CAUSE OUR ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE DISCUSSED IN THIS QUARTERLY REPORT. THESE RISKS AND UNCERTAINTIES INCLUDING THE FOLLOWING:*

**We have acquired, and expect to continue to acquire, technologies, and companies and these acquisitions could disrupt our business or expose us to other risks.**

A key component of our engineering and product development strategy and our future growth is the investment in or the acquisition of technologies and companies. We intend to continue to execute our strategy through the acquisition of technologies or companies or through investments in complementary companies, products, personnel, or technologies, and it is likely we will complete such acquisitions or investments in the future. These acquisitions and investments involve many risks and factors outside our control, including the following:



## Edgar Filing: AVOCENT CORP - Form 10-Q

- Difficulty integrating the acquired company's personnel, distribution channels, products, product roadmaps, technologies, systems, processes, and operations, including product delivery, order management, and information systems;
- Difficulty in conforming the acquired company's financial policies and practices to our policies and practices and in implementing and maintaining adequate internal systems and controls over the financial reporting and information systems of the acquired company;
- Diversion of management's attention and disruption of our current business and the challenges associated with managing the resulting larger company following any acquisition;
- Difficulty in combining product and technology offerings and entering into new markets (such as software) or geographical areas in which we have no or limited direct experience and where our competitors may have stronger market positions;
- Loss of management, sales, technical, or other key personnel (at either Avocent or in the acquired company) or the loss of customers, distributors, resellers, vendors, or other business relationships as a result of the acquisition;
- Revenue from the acquired companies not meeting our expectation, and the potential loss of the acquired companies' customers, distributors, resellers, suppliers, or other partners;
- Delays or difficulties and the attendant expense in evaluating, coordinating, and combining administrative, manufacturing, research and development and other operations, facilities, and relationships with third parties in accordance with local laws and other obligations while maintaining adequate standards, controls and procedures, including financial controls and controls over information systems;
- Difficulty in completing projects associated with acquired in-process research and development;
- Incurring amortization expense related to certain intangible assets and recording goodwill and non-amortizable assets that will be subject to impairment testing and possible impairment charges;
- Dilution of existing stockholders as a result of issuing equity securities, including the assumption of any stock options or other stock awards to employees issued by the acquired company;
- Overpayment for any acquisition or investment or unanticipated costs or liabilities;
- Assumption of liabilities of the acquired company, including any potential intellectual property infringement claims or other litigation and any unrecorded tax obligations; and
- Incurring substantial write-offs, restructuring charges, interest expense, amortization, and transactional expenses.

Our integration plans and indemnification and escrow agreements might fail to adequately mitigate these risks and factors, and our failure to manage these risks and challenges could materially harm our business, financial condition, and results of operations. Further, if we do not successfully address these challenges in a timely manner, we may not fully realize all of the anticipated benefits or synergies on which the value of a transaction was based. Future transactions could cause our financial results to differ materially from expectations of market analysts or investors for any given quarter.

**Intense competition from new and existing competitors or consolidation in the server and systems management sectors could impair our ability to grow our business, to sustain our profitability, and to sell our products and technologies.**

The markets for our products and technologies are highly fragmented, rapidly evolving, and intensely competitive, and we expect these characteristics to continue and increase. Aggressive competition from both hardware and software products and technologies could lengthen the customer evaluation process and result in price reductions and loss of sales, which would materially harm our business. Our business is highly sensitive to the introduction of new products and technologies (such as virtualization), price changes, and marketing efforts by numerous and varied competitors. Accordingly, our future success will be highly dependent upon our timely completion and introduction of new products and

## Edgar Filing: AVOCENT CORP - Form 10-Q

technologies and features at competitive prices and performance levels that address changing industry trends and the evolving needs of our customers. We continue to experience aggressive price competition and increased customer sensitivity to product prices, and pricing and margin pressures are likely to increase in the future.

Because of this competition, we may have to continue to lower the prices of many of our products and technologies or offer greater functionality within our products to deliver greater value to customers to stay competitive, while at the same time trying to maintain or improve our revenue and gross margin. Because our business model is based on providing innovative and high quality products, we may spend a proportionately greater amount on research and development than some of our competitors. If we cannot proportionately decrease our cost structure on a timely basis in response to competitive price pressures, our gross margin and profitability could be adversely affected. In addition, if our pricing, functionality, and other factors are not sufficiently competitive, or if there is an adverse reaction to our product decisions, we may lose market share in certain areas, which could adversely affect our revenue and prospects.

We compete for sales of switching systems and extension products with companies such as Raritan Computer, Rose Electronics, Minicom Advanced Systems, Aten International, Belkin, Digi International, and Lantronix. These products also face competition from software providers (such as Microsoft, Computer Associates, Tivoli, Symantec, Novell, AMI, and BMC Software), who may be able to offer software products competitive with our hardware products at a much lower cost or even bundled for free, and from server manufacturers (including our OEM customers), who are able to offer their competitive technologies or products at the time of the server sale. These competitive software and hardware products address many of the problems our switching systems and technologies, extension products, and remote access products are designed to address.

We compete for sales of our systems management and security products with companies such as Microsoft, Computer Associates, BMC Software, Novell, and Symantec, many of whom have greater financial, technical, and marketing resources, a larger customer base, a longer operating history, greater name recognition, and more established relationships in the industry than we do, and may offer their own or third-party competitive software products at a lower cost or bundled for free with their other products. Microsoft, in particular, has delivered competitive products and announced its intention to continue to develop competitive software. If Microsoft is successful in delivering software products that are competitive with our products, our ability to grow our software business may be limited.

Our current and potential competitors may be able to respond more quickly to new or emerging technologies or products and to changes in customer requirements or to devote greater resources to the research, development, promotion, sale, and support of their products and technologies than we do. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties that expand or enhance the ability of their products and technologies to address the needs of our current and prospective customers. Some of these competitors can also bundle hardware, software, and services together, and offer a more complete set of hardware products and services than we are able to offer. We may not be able to compete successfully against current and future competitors and competitive pressure may materially harm our business, financial condition, operating results, and cash flows, or impair our ability to achieve our desired results.

Certain of our customers, such as Dell, Hewlett-Packard, IBM, Symantec, and Microsoft, presently offer competitive hardware and/or software products and technologies that address many of the problems our products and technologies address. These customers could decide to manufacture or enhance their own switching, IPMI or other embedded technologies, or systems management or security products, or offer products or technologies supplied by competitors. Companies with hardware manufacturing experience or network management products, many of which are substantially larger than we are and have significantly more financial resources than we do, also offer products or technologies that compete with us. Established companies with hardware manufacturing or network management experience (such as Intel, Cisco, or EMC) could also offer new products, new technologies (such as virtualization), or new solutions that compete with, or reduce the demand for, our products and technologies.

There has been consolidation in the markets in which we compete, which we believe will continue and could lead to increased price competition and other forms of competition as companies attempt to maintain or extend their market positions in the rapidly changing IT industry. In addition, we may face competition in the future from large established companies or from emerging companies that have not previously entered the market or that do not currently have products that directly compete with our products. This could lead to more variability in our operating results due to lengthening of the customer evaluation process and/or the loss of business to these competitors, which may adversely affect our

business, financial condition, and results of operations.

**Our failure to respond to rapid technological change or to introduce successful new products and technologies may result in reduced revenue or revenue growth.**

The process of developing or acquiring new products, software, and technologies and enhancing existing products, software, and technologies is complex, costly, and uncertain, and any failure by us to anticipate customers' changing needs and emerging technological trends accurately could significantly harm our market share and results of operations. We must make long-term investments, develop or obtain appropriate intellectual property, and commit significant resources before knowing whether our predictions will accurately reflect customer demand for our products and services. After we develop a product, we must then accurately forecast volumes and configurations that meet customer requirements, manufacture appropriate hardware volumes quickly and at low cost and develop cost-effective software solutions, and train our sales force and resellers. Any delay in the development,

production, marketing of, or training for new products or technologies could result in our not being among the first to market, which could further harm our competitive position.

Sales of switching, extension, and remote access products and technologies are characterized by rapid technological advances, frequent new product and technological introductions and enhancements, and significant price competition. If we do not keep pace with these changes, we will lose customers, and our business will be adversely affected. The introduction of products or technologies incorporating superior alternatives such as switching software, the emergence of new industry standards, or changes in pricing structure could render our existing products and technologies and those under development obsolete or unmarketable. New technologies offered by us or our competitors could compete with our existing products at a lower price, which could reduce our revenue.

Our hardware products combine components, such as printed circuit boards, connectors, semiconductors, memory, cable assemblies, power supplies and enclosures that are manufactured by other companies and are generally available to competitors and potential competitors. Our software products combine software or content from third parties, such as open source software or technology, drivers, security, or anti-virus information, which may also be generally available to our competitors and potential competitors. Our future success will depend in large part upon continued innovative application of commercially available components and third-party software or technology, and continued enhancements to our proprietary hardware, software, firmware, and other technologies, the expansion and enhancement of existing products and technologies, and our development and introduction of new products and technologies that address changing industry trends and customer needs on a cost-effective and timely basis. If we fail to respond on a timely basis to technological developments, changes in industry standards, customer requirements, competitive products, product localization, or software innovations, we will lose customers, and our business will be greatly harmed. Similar results could occur if we experience significant delays in the development or introduction of new products or technologies.

Due to our significant reliance on OEM relationships, our hardware development efforts may often be focused on developing new products, technologies, or enhancements for OEM customers. As a result, our OEM relationships may negatively affect our ability to develop new and enhanced products and technologies for our non-OEM customers. Moreover, these new products, technologies, or enhancements for OEM customers may not be available to, or readily marketable to, other customers without significant modification and delay. The expansion, termination, or significant disruption of our relationship with certain OEMs or other customers for whom we devote significant product development resources is likely to result in lost opportunities with respect to the development of products, technologies, or enhancements for our other customers.

**We have limited protection of proprietary rights and face risks of third-party infringements.**

Our future success depends in part upon our ability to protect proprietary rights in our products and technologies. We seek to protect our intellectual property rights by invoking the benefits of the patent, trademark, copyright, trade secret, and unfair competition laws of the United States and other countries and protections provided by confidentiality and nondisclosure agreements and other legal agreements. These laws and practices, however, afford only limited protection. There can be no assurance that the steps we have taken to protect our intellectual property rights, or that the steps we take in the future, will be adequate to prevent or detect misappropriation of our intellectual property or technologies or that our competitors will not independently develop proprietary or other technologies that are substantially equivalent or superior to our products or technologies. In addition, our proprietary information may be misused or improperly disclosed by third parties entrusted with this information. There also can be no assurance that our proprietary rights will not be challenged, invalidated, or avoided.

The U.S. Patent and Trademark Office has issued several patents to us for various aspects of our products. We have various corresponding patent applications pending under the provisions of the Patent Cooperation Treaty, which permits the filing of corresponding foreign patent applications in numerous foreign countries within a limited time period. We also have other United States and foreign patent applications

## Edgar Filing: AVOCENT CORP - Form 10-Q

pending. There can be no assurance that any additional patents will be issued from any of those pending applications or that any patents will be issued in any additional countries where our products can be sold. Claims allowed in our patents or in any pending patent applications may not be of sufficient scope or strength for, or provide meaningful protection or any commercial advantage to us or such claims may not be upheld if challenged. Also, competitors may develop their own intellectual property or technologies, obtain their own patents, or challenge the validity of, or be able to design around, our patents. The laws of certain foreign countries in which our products are or may be developed, manufactured, or sold (particularly certain countries in Asia) may not protect our products or intellectual property rights to the same extent as do the laws of the United States and thus increase the likelihood of piracy of our technologies and products.

We may initiate claims or litigation against other third parties for infringement of proprietary rights or to establish the validity of proprietary rights. Similarly, our competitors or other third parties may initiate claims or litigation against us alleging infringement of their proprietary rights or improper use of their intellectual property, and from time to time, third parties notify us that our products may infringe their intellectual property rights, which regardless of merit, requires our time and resources to evaluate and respond. Existing litigation, and any other litigation relating to intellectual property to which we become a party, is subject to numerous risks

and uncertainties, including the risk of counterclaims or other litigation against us, and we may not be successful in any such litigation. Dealing with adverse claims and litigation is expensive, and the existing litigation or any other litigation by or against us could result in significant additional expense, divert the efforts of technical and management personnel, whether or not such litigation results in a favorable determination, harm our relationships with existing customers, and deter future customers from purchasing or licensing our products. In the event of an adverse result in any such litigation, we could be required to pay substantial damages, suspend or cease the development, manufacture, use, marketing, and sale of any infringing products, expend significant resources to redesign products or develop non-infringing technology, discontinue the use of certain processes, or obtain licenses to the infringing technology. There can be no assurance that we would be successful in such development or that such licenses would be available on reasonable terms, or at all, and any such development or license could require us to expend substantial time and other resources. In the event that any third party makes a successful claim against us, or our customers, and a license is not made available on commercially reasonable terms, our business, financial condition, and results of operations could be adversely affected. In addition, any dispute involving our intellectual property could result in our customers, distributors, or resellers becoming involved in the litigation, which could trigger indemnification obligations in certain of our sales, license, or service agreements.

The IT industry is characterized by vigorous pursuit and protection of intellectual property rights or positions, which has resulted in significant and often protracted and expensive litigation. We have in the past been, and we may from time to time in the future be, a party in litigation or other proceedings alleging infringement of intellectual property rights owned by third parties. If necessary or desirable, we may seek licenses under such intellectual property rights. However, licenses may not be offered on terms acceptable to us, or at all. The failure to obtain a license from a third party for technology used by us could cause us to incur substantial liabilities and to suspend or cease the manufacture of products requiring such technology. Additionally, current or future competitors could obtain patents or other intellectual property rights that may prevent us from developing or selling our products. The result of these litigation matters is difficult to predict and an unfavorable resolution could affect our operating results, business, or financial condition. The resolution of litigation involving the company may impact our operating results or financial condition.

**We are likely to experience fluctuations in operating results.**

We have in the past experienced substantial fluctuations in revenue, bookings, and operating results, on a quarterly and an annual basis, and we expect these fluctuations will continue in the future. Our operating results will be affected by a number of factors, including, but not limited to:

- The volume, timing, pricing, and contractual terms of orders, particularly from OEMs, resellers, and other large customers, a significant portion of which tend to occur late in each quarter;
- The timing of shipments;
- The unpredictable nature of the sales cycle for software products and the timing and completion of delivery of software products;
- The timing of new product introductions, new technologies, and enhancements by us and by our competitors, and the possibility that customers may defer purchases of our products in anticipation of these new products, new technologies, and enhancements;
- Changes in or our failure to accurately predict product or distribution and reseller channel mixes, including changes in the mix of software licenses in which revenue is recognized upfront as opposed to subscription licenses that are deferred over time and changes in the mix of revenue attributable to higher-margin products as opposed to lower-margin sales or services;
- Changes in demand for our products and services;
- Changes in pricing policies or price reductions;
- Changes in laws, regulations, or other government requirements;

## Edgar Filing: AVOCENT CORP - Form 10-Q

- Changes in renewal rates for software upgrade protection or maintenance;
- Competition from new products, technologies, business models, and price reductions by competitors;
- The availability and cost of supplies, components, or third-party code or content on commercially reasonable terms;



## Edgar Filing: AVOCENT CORP - Form 10-Q

- Compatibility or interoperability of our products with third-party systems and applications;
- Sales and marketing expenses related to entering into new markets, introducing new products, new technologies, and retaining current OEMs, resellers, and other large customers;
- Fluctuations in sales of servers and personal computers due to changes in technology (such as virtualization), economic conditions, or capital spending levels;
- The amount and timing of operating expenses and capital expenditures relating to the expansion of our business and operations; and
- Costs associated with legal proceedings, including legal fees and any adverse judgments or settlements.

Our operating results will continue to be affected by seasonal trends, by general conditions in the IT market, and by general economic conditions. We have experienced, and we expect to continue to experience, some degree of seasonality due to customer buying cycles and delays in customer orders during unfavorable economic periods. We believe that the third and fourth quarters will generally have higher net sales levels due to customer budgeting and procurement cycles, which may depress net sales in other quarters. In addition, European sales are often weaker during the summer months. In the past, we have typically seen a sequential decline in revenue from the fourth quarter of a year to the first quarter of the following year, and while it is difficult to predict revenue in any quarter, we expect that this pattern will continue in the future. Many of the factors that create and affect seasonal trends are beyond our control.

Our quarterly sales have also reflected a pattern in which a disproportionate percentage of each quarter's total sales occur toward the end of the quarter, and this trend has become more pronounced in recent periods. Our increased focus on the software market continues this trend with a greater proportion of our software revenue coming from software license and subscriptions booked in the last weeks or days of each quarter. This uneven sales pattern makes prediction of revenue, earnings, and working capital for each financial period difficult, increases the risk of unanticipated variations in quarterly results and financial condition, and places pressure on our hardware inventory management and logistics systems. If predicted demand for hardware is substantially greater than orders, there will be excess inventory. Alternatively, if hardware orders substantially exceed predicted demand, we may not be able to fulfill all of the orders received in the last few weeks of each quarter. Other developments late in a quarter, such as a systems failure, component pricing movements, actions or announcements from our competitors, global logistics disruptions, or large sales opportunities not being completed when predicted, could adversely impact inventory levels and results of operations in a manner that is disproportionate to the number of days in the quarter affected. In addition, accounting requirements associated with satisfying the various elements necessary to recognize software revenue may result in significant fluctuations in our quarterly results.

In order to remain competitive and provide our increasingly sophisticated customers with more options, we have made and expect to continue to make new products and new software purchasing and licensing options available to our customers. These new products and options may result in an increase in contracts where software revenue is deferred or cash is received over time as opposed to recognition of revenue or payment at or about the time of the purchase or license.

We believe that quarter-to-quarter comparisons of our historical financial results are not meaningful indicators of our future operating results, and you should not rely on them as an indication of our future performance. If our quarterly operating results fail to meet the expectations of equity research analysts, the price of our common stock could be negatively affected.

### **Our gross margins are expected to vary and may decline.**

Gross margins may vary or decline from period-to-period and may be adversely affected by a number of factors, including:

## Edgar Filing: AVOCENT CORP - Form 10-Q

- The ratio of OEM sales to branded sales, since OEM sales typically have lower gross margins than branded sales;
- The ratio of sales through indirect channels to direct sales, since indirect sales typically have lower gross margins than direct sales;
- The ratio of sales in established markets to sales in new markets with different pricing and cost structures;
- Changes in product mix, because sales of some of our products and technologies will have lower gross margins than sales of other products or technologies (e.g. our software products tend to have higher gross margins);

- Increased price competition;
- Changes in product costs and sales discounts;
- Changes in raw materials, freight, regulatory, certification, import or export expenses, tariffs, and labor costs;
- Introduction of new products, services, business models, and technologies by us and by our competitors;
- The level of and costs for third-party technology and code used in our software products; and
- The level of and costs for outsourcing of our manufacturing and assembly services for our hardware products.

We expect that our gross margins may vary and may decline in the future primarily due to the factors listed above and to increased competition and the introduction of new products and technologies that may affect product prices and demand for our products.

**A substantial portion of our business consists of sales to a limited number of resellers and distributors that are not obligated to continue doing business with us, and these sales vary considerably from quarter to quarter.**

A substantial portion of our sales consists of sales of our branded products to a limited number of resellers and distributors. Sales to resellers and distributors represented approximately 56% of net sales in 2007, 56% of net sales in 2006, and 48% of net sales in 2005. The loss of significant revenue opportunities with these resellers and distributors could negatively impact our results of operations. In addition, many of these customers also have or distribute competing products. If resellers and distributors elect to increase the marketing of competing products or reduced marketing of our products, our ability to grow our business will be negatively impacted and will impair one of our substantial revenue sources.

Our reseller and distributor business is subject to many risks, including:

- Concentration of business in a limited number of resellers and distributors could result in significant damage to our business upon the termination of a reseller relationship;
- Termination of reseller and distributor agreements or reduced or delayed orders;
- Difficulty in predicting sales to resellers and distributors who do not have long-term commitments to purchase from us, which requires us to maintain sufficient inventory levels to satisfy anticipated demand;
- Lack of visibility of end user customers and revenue recognition and channel inventory issues related to sales by resellers and distributors;
- Resellers and distributors electing to resale or increase their marketing of competing products or technologies or reduced marketing of our products; and
- Changes in corporate ownership, financial condition, credit worthiness, payment patterns, business direction, sales compensation related to our products, or product mix by the resellers and distributors.

Any of these risks could have a material adverse effect on our business, financial condition, and results of operations. We have experienced, and expect to continue to experience, pricing pressures and significant variability in orders from our resellers and distributors, which may in the

future have a material adverse effect on our quarterly sales and operating results.

The loss of one or more large reseller or distributors could materially harm our business. While we have reseller and distributor agreements, none of our resellers or distributors are obligated to purchase products from us. Consequently, any reseller or distributor could cease doing business with us at any time. Our dependence upon a few resellers and distributors could result in a significant concentration of credit risk, thus a substantial portion of our trade receivables outstanding from time to time may be concentrated among a limited number of customers. In addition, the inability to accurately forecast the timing and volume of orders for sales of branded products to resellers and distributors during any given quarter could adversely affect operating results for such quarter and, potentially, for future periods. If we underestimate sales, we will not be able to fill orders on a timely basis. This could cause customer dissatisfaction and loss of future business. If we overestimate sales, we will experience increased costs from inventory storage, waste, and obsolescence.

**We will need to expand sales through distributors and resellers in order to develop our business and increase revenue.**

We expect to rely increasingly on distributors and resellers, VARs (including LANDesk VARs who are also referred to as Expert Service Providers or ESPs), and systems integrators for the distribution and sale of our branded hardware and software products. Our strategy contemplates the expansion of our distributor and reseller network both domestically and internationally, particularly in Asia, and an increase in the number of customers licensing our products through these expanded channels. Our future success will depend in part on our ability to attract, train, and motivate new distributors and resellers and expand our relationships with current distributors and resellers. We may not be successful in expanding our distributor and reseller relationships. We will be required to invest significant additional resources in order to expand these relationships, and the cost of this investment may exceed the margins generated from this investment. Conducting business through indirect sales channels presents a number of risks, including:

- Difficulties in replacing any lost or terminated distributors or resellers;
- Existing or new distributors and resellers may not be able to effectively sell our current or future products or services;
- Potential distributors and resellers deciding not to enter into relationships with us because of our existing relationships with other distributors and resellers with which they compete;
- Our ability to provide proper training and technical support to our distributors and resellers;
- The possibility of damage or impairment to our market position, brands or trademarks as a result of the actions of our distributors and resellers;
- Distributors and resellers electing to place greater emphasis on products or services offered by our competitors; and
- The lack of direct control over the business practices, marketing, sales and services offered by distributors and resellers.

As we expand our distribution and reseller channels, we will also need to expand our sales organization and invest substantial resources toward this expansion. We may experience difficulty recruiting, training, and retaining qualified sales personnel, and any failure to obtain, train, and keep qualified personnel could limit our ability to sell products.

In addition, distributors and resellers of our hardware products often have rights of return, and in the future, these returns from our existing or any new distributors and resellers may have a material adverse effect on our business, financial condition, and results of operations. Our

## Edgar Filing: AVOCENT CORP - Form 10-Q

agreements with our current distributors and resellers are generally nonexclusive and may be terminated on short notice by either party without cause, and any new distributor or reseller agreements are likely to contain similar provisions. Distributors and resellers are not obligated to purchase products from us and frequently offer products from several different companies, including competitors' products, and distributors and resellers may give higher priority to the sale of our competitors' products. A reduction in sales efforts or efficiency by our distributors or resellers could lead to a reduction in our sales and could materially adversely affect our business, financial condition, and results of operations.

**A substantial portion of our business consists of sales to a limited number of OEM customers that are not obligated to continue doing business with us, and these sales vary considerably from quarter to quarter.**

A substantial portion of our sales is concentrated among a limited number of OEM customers. Sales to these OEMs represented approximately 35% of net sales in 2007, 40% of net sales in 2006, and 48% of net sales in 2005. Sales to Hewlett-Packard represented approximately 12% of net sales in 2007, 14% of our net sales in 2006, and 20% of our net sales in 2005. Sales to Dell represent approximately 12% of net sales in 2007, 14% of net sales in 2006, and 15% of our net sales in 2005.

We have experienced, and we expect to continue to experience, period-to-period variability in sales to these OEM customers. Any cancellation, rescheduling, or reduction of orders by OEM customers in the future could materially adversely affect our operating results. Although our OEM customers typically place orders for products up to several months prior to scheduled shipment dates, these orders are subject to cancellation.

Our OEM business is subject to many risks, including:

- Contract termination or reduced or delayed orders;
- Short order cycles and difficulty in predicting sales because our OEM customers do not have long-term commitments to purchase from us;
- Changes in the OEMs' internal product life cycles including the delay of planned new product introductions and uncertainty over product end-of-life decisions;
- Adoption of competing products or technologies developed by third parties for the OEMs, acquisition or internal development of competing products or technologies by the OEMs, or changes in the OEMs' marketing of competing products or reduced marketing of our products; and
- Changes in corporate ownership, financial condition, credit worthiness, payment patterns, business direction, sales compensation related to our products, or product mix by the OEMs.

Any of these risks could have a material adverse effect on our business, financial condition, and results of operations. We have experienced, and expect to continue to experience, pricing pressures and significant variability in orders from our OEM customers, which may in the future have a material adverse effect on our quarterly sales and operating results.

The loss of one or more large OEM customers would materially harm our business. While we have contracts with some of our existing OEM customers, none of our OEM customers is obligated to purchase products from us except pursuant to binding purchase orders. Consequently, any OEM customer could cease doing business with us at any time. Our dependence upon a few OEMs also results in a significant concentration of credit risk, thus a substantial portion of our trade receivables outstanding from time to time may be concentrated among a limited number of customers. In addition, OEM customers have longer payment cycles that increase the likelihood of aged or problem accounts receivable.

We use multiple warehouses for many of our OEM customers to fulfill their hardware orders under a just-in-time inventory management system, which requires us to maintain sufficient inventory levels of our hardware products at each of these warehouses to satisfy our OEMs' anticipated customer demand, and we generally recognize revenue only when these OEM customers take possession of our hardware products. We are required to plan production, order components, and undertake our manufacturing activities prior to the time that these orders become firm or the products are accepted. In addition, our OEM customers have requested, and are likely to continue to request from time to time, that we delay shipment dates or cancel orders for hardware products that are subject to firm orders. As a result, at any time we may be holding a significant amount of OEM-branded hardware products in inventory, and our sales to OEMs for future quarters are difficult to predict. The inability to accurately predict the timing and volume of hardware orders for our OEM customers during any given quarter could adversely affect operating results for that quarter and, potentially, for future quarters. If we underestimate sales, we may not be able to fill orders on a timely basis. This could cause customer dissatisfaction and loss of future business. If we overestimate sales, we may experience increased costs from inventory storage, waste, and obsolescence.

**We are dependent upon third-party suppliers and outsourced manufacturing for our hardware products. Disruption of our access to these supplies and services, or problems with the quality of supplies or services, could prevent us from filling customer orders and harm our business.**

The principal components of our hardware products are electronic components, power supplies, semiconductors, memory, cable assemblies, line filters, enclosures, and printed circuit boards, all of which are purchased from outside vendors. We generally buy components under purchase orders and generally do not have long-term agreements with our suppliers. Also, we generally do not maintain large inventories of components. Any termination of, or significant disruption of, our relationships with the suppliers of our product components may prevent us from filling customer orders in a timely manner which could result in customer dissatisfaction and lost sales.

We have occasionally experienced, and we may in the future experience, shortages or delays in delivery of components. Although alternate suppliers are available for most of the components and services needed to produce our products, the number of suppliers of some components is limited, and qualifying a replacement supplier and receiving components from alternate suppliers could take several months.

We have limited ability to control quality issues (particularly with respect to faulty components manufactured by third parties), and we depend upon suppliers to deliver components that are free from defects, competitive in functionality and cost, and in compliance with specifications and delivery schedules. Disruption in supply, a significant increase in the cost of one or more components, failure of a third-party supplier to remain competitive in functionality or price, or the failure of a supplier to comply with any of our procurement needs could delay or interrupt our ability to manufacture and deliver our products to customers on a timely



basis, thereby delaying our revenue recognition and adversely affecting our business, financial condition, and results of operations.

We rely on third-party manufacturers for subassembly of products and for final assembly, quality assurance, and testing of some of our products. These outsourcing arrangements and any future outsourcing arrangements involve numerous risks, including the economic and financial viability of these manufacturers, reduced control over product quality, delivery schedules, manufacturing yields, and costs. Moreover, although arrangements with such manufacturers may contain provisions for warranty obligations on the part of such manufacturers, we are primarily responsible to our customers for warranty obligations.

**Our hardware products are subject to warranty claims and returns. Increased warranty claims or returns could harm our business.**

We typically offer a 30-day unconditional money-back guarantee on our appliance products sold in North America. We also offer warranties for parts and service on all our hardware products, ranging from one to three years (and, in the case of some of our Equinox branded products, five years). Although our historical return experience has not been significant, our returns may increase in the future. An increase in returns would have an adverse effect on our sales and could negatively affect our financial results.

For our software products, sales are final and we do not generally allow any returns. We provide a 90-day limited warranty on the media used to deliver the software, which is not applicable to electronic downloads, and we generally provide a 90-day limited warranty that our products will function in accordance with the user documentation.

In the future, we may, as a result of competitive pressures, requirements in certain geographies, or customer demands, change our warranty policies or our warranty terms to provide coverage that is greater in scope and duration than the coverage we currently offer. If we were to increase our warranty coverage, our risk of warranty claims, and therefore our warranty expense and reserves, would likely increase.

**We must meet the increased demands on customer service operations or customer satisfaction and sales could suffer.**

Continued growth of our sales is likely to be accompanied by increasing demands on customer service operations. As a result of our commitment to a high level of customer service, we will need to invest significant resources in the maintenance and improvement of our customer service resources. Any failure to maintain adequate customer service could cause customer dissatisfaction, result in reduced sales of products, reductions in the renewals of software maintenance and support agreements, and, accordingly, materially adversely affect our business, financial condition, and results of operations.

**If we are unable to successfully develop our international distribution and reseller networks and international sales efforts, results of operations may suffer.**

We are working to develop, integrate, and expand our international distribution and reseller networks in an effort to increase international sales of our products. We may not be successful in developing or expanding the international distribution and reseller network or in marketing and selling products in foreign markets, particularly Asia. If the revenue generated by our international sales is not adequate to recover the expense

## Edgar Filing: AVOCENT CORP - Form 10-Q

of establishing, expanding, and maintaining an international distribution and reseller network, our business, financial condition, and results of operations could be materially adversely affected. If international sales become a more significant component of net sales, our business could become more vulnerable to the risks inherent in doing business on an international level, including:

- Difficulties in managing foreign distributors and resellers;
- Longer payment cycles and problems in collecting accounts receivable;
- The effects of seasonal customer demand;
- Differing license terms and conditions to meet local requirements;
- Changes in regulatory requirements;
- Difficulties in meeting the requirements of different international product regulations, including import and export requirements, tariffs, and other trade barriers;
- Risks relating to the protection of our intellectual property rights;

## Edgar Filing: AVOCENT CORP - Form 10-Q

- The impact on our marketing expenses and our research and development resources as we localize our product offerings to meet local user requirements such as language translations and hardware compatibility issues;
- Fluctuations in currency exchange rates; and
- Potentially adverse tax consequences and political instability.

The existence or occurrence of any one or more of these factors could have a material adverse effect on our business, financial condition, and results of operations.

**Due to the international nature of our business, political or economic changes or other factors could harm our future revenue, increase our costs and expenses, and impair our financial condition.**

We are a global company with sales, manufacturing, and research and development efforts around the world. Sales outside the United States generate approximately half of our revenue, over half of our manufacturing takes place outside the United States, and we have research and development centers in several locations outside the United States. Accordingly, our business, operating results, future revenue, gross margin, expenses, and financial condition could suffer due to a variety of international factors, including:

- Ongoing instability or changes in a country's or region's economic or political conditions, including inflation, recession, interest rate fluctuations, and actual or anticipated military or political conflicts, particularly in areas where we have offices or other facilities;
- Currency fluctuations, which could contribute to variations in sales of products and technologies and could also affect our reported results expressed in U.S. dollars;
- Longer accounts receivable cycles and financial instability among customers;
- Tax or trade regulations, tariffs, duties, and procedures and actions affecting production, pricing, and marketing of or payments for products;
- Local labor conditions and other regulations;

## Edgar Filing: AVOCENT CORP - Form 10-Q

- Differing technology standards or customer requirements;
- Limited or unfavorable intellectual property protection in certain foreign countries including the loss of proprietary information due to piracy or misappropriation;
- Fluctuations in freight costs and disruptions at important geographic points of exit and entry;
- Natural or manmade disasters, such as earthquakes, tsunamis, flooding, hurricanes, typhoons, fires, power shortages, blackouts, telecommunications failures, terrorism, or computer viruses;
- Medical epidemics, such as avian flu or Severe Acute Respiratory Syndrome (SARS);
- Seasonal reductions in business activity in certain foreign countries, such as the summer months in Europe;
- Compliance with a wide variety of complex laws, treaties, and regulations that increase the risks of doing business in certain foreign countries;
- Restrictions against repatriation of earnings from our international operations;
- Difficulties in staffing and managing international operations, including the difficulty in managing a geographically dispersed workforce;
- Possible non-compliance with our Code of Conduct or other corporate policies due to inconsistent laws, interpretations, and/or application of corporate standards in foreign countries;
- Increased financial accounting and reporting burdens and complexities; and

- The need to localize our products.

The factors described above also could disrupt our product development and manufacturing, key suppliers, and OEMs and resellers located outside of the United States. For example, we rely on manufacturers in Asia and Europe for the assembly and manufacture of many of our hardware products, and we conduct substantial software development and testing operations in China. Accordingly, we are directly affected by economic, political, and military conditions in China. Any interruption or curtailment of trade between China and its present trading partners could materially adversely affect our product development, product releases, support, business, operating results, and financial condition.

Continued or increased international political instability, evidenced by the threat or occurrence of terrorist attacks, enhanced national security measures in the United States, sustained military action or other conflicts, or strained international relations may impair our ability to do business, increase our costs and adversely affect our stock price. Increased international instability may negatively impact our ability to obtain adequate insurance at reasonable rates or require us to take extra security precautions for our domestic and international operations.

**Fluctuations in the value of foreign currencies could result in currency exchange losses.**

Currently, a majority of our international business is conducted in U.S. dollars. However, as we expand our international operations, it is likely that international business will increasingly be conducted in foreign currencies. In particular, the introduction of the euro has led many of our European customers to request or insist that our sales to them be denominated in euros instead of U.S. dollars and sales from our software operations are frequently conducted in foreign currencies. Fluctuations in the value of foreign currencies relative to the U.S. dollar have caused, and are expected to increasingly cause, currency transaction gains and losses. In addition, currency fluctuations could also affect our reported results expressed in U.S. dollars. While we attempt to hedge our foreign currency exposure, we cannot predict the effect of exchange rate fluctuations upon future quarterly and annual operating results, and we may experience currency losses in the future.

**The sales cycle for our software products is unpredictable, making it difficult to forecast operating results for any given period.**

The sales cycle for our software products is typically ninety to one hundred eighty days or longer. This sales cycle is subject to a number of significant risks over which we have little or no control, including:

- Customers' budgetary constraints, fluctuations, or uncertainty, internal acceptance requirements, and procurement procedures;
- Concerns about the actions or announcements of our competitors and their products;
- Concerns about the future or performance of our company; and

- Changes in economic conditions generally and in the technology market specifically.

Moreover, our software revenue is heavily weighted toward the end of each quarter, with as much as sixty percent of LANDesk's revenue recorded in the third month of a quarter, making it difficult to forecast operating results for any quarter or give accurate guidance. For large opportunities, especially for enterprise-wide sales, the sales cycle is often significantly longer than our average sales cycle. In addition, these large opportunities are more difficult to forecast, and if we do not correctly forecast the timing in a given period, the amount of revenue we recognize in a period could be higher or lower than we expect, which could significantly affect our operating results for the then current period and future periods over which revenue would have been recognized. In addition, the terms and conditions of the legal agreements for these large opportunities are often based on our customers' purchase agreements and may contain terms that are generally less favorable to us than our standard terms and conditions. As a result, revenue recognition may be delayed or otherwise negatively affected, and if we fail to meet expectations, the price of our common stock could be negatively affected.

**A significant percentage of our software revenue is dependent on sales to existing customers or the renewal of annual software upgrade protection or maintenance services by existing customers.**

Our LANDesk Division has historically derived, and plans to continue to derive, a significant portion of our total software revenue from existing customers who purchase additional products or annual maintenance or upgrade protection. We depend on our installed base of software customers for future revenue from the purchase of annual software upgrade protection or maintenance services. As we introduce new software products, our current customers may not require or desire the functionality of our new

products and may choose not to license these products or renew their agreements for maintenance or upgrade protection. If our customers do not purchase additional products or increased numbers of products already in use, or renew annual software upgrade protection or maintenance services, our ability to increase or maintain revenue levels could be limited to only new customers.

Maintenance revenue related to the licensing of our software products is a significant part of our current and future operating revenue. In general, maintenance fees increase with the increase in the use of our software. Accordingly, we receive higher maintenance fees with new license agreements and as existing customers install more of our software products on additional systems. Due to increased discounting for larger sales opportunities, maintenance fees on a per unit basis for such large deals can be lower than average. In addition, customers are generally provided reduced annual maintenance percentages for entering into long-term maintenance agreements. Declines in our license bookings, increases in long-term maintenance agreements, customers electing to migrate to competitive products or find alternatives to our products, and/or increased discounting could lead to reduced software maintenance revenue and reduced gross margins.

**Our software products are designed with interoperability or compatibility with many third-party platforms, systems, and applications, the absence of which may harm our business.**

Our software products are designed for use with specific third-party platforms, systems, and applications. We believe the breadth of our integration with such platforms, systems and applications is a significant competitive advantage. Any significant change in these third-party products could result in the loss of interoperability or compatibility with our products, making our products less attractive, increasing our research and development costs in order to modify our products, license new solutions, or develop new products, and potentially harming our future revenue. Our failure to anticipate, manage and adapt to these risks could result in significant delays in our product releases, changes in our product roadmaps, loss of current customers for whom the lost compatibility is an issue, and damage to our operating results.

**Our software products include licensed third-party content or code upon which we rely for the interoperability, integration, development, or updates of our products, and disruption of our access to such code or content could delay product releases, inhibit our compatibility with third-party products, and harm our business.**

The principal components of our software products are proprietary code and content. We do, however, rely on some licensed third-party code, content, or other intellectual property, and we expect to use such third-party code, content, or intellectual property in future products. Although we believe that there are usually adequate alternative sources for the third-party technology licensed to us, any significant interruption in the availability of these third-party software products on commercially acceptable terms or any defects in these products could delay development of future products or enhancement of our future products and harm our revenue. Use of such third-party code, content, or other intellectual property presents risks such as:

- Owners or licensees of third-party systems could adopt more restrictive policies or impose unfavorable or unacceptable terms and conditions for access to their products making it more difficult for us to make our products compatible with their products and resulting in higher research and development costs for us for the enhancement or modification of our existing products and the development of new products;
- Functionality provided by third-party code, content, or other intellectual property in our products may become obsolete, defective, or incompatible with future versions of our products, may not be adequately maintained or updated, and we may be unable to find viable alternatives or develop our own proprietary solution;

- Quality, warranty, and support terms vary dramatically when licensing third-party code, content, or other intellectual property and we have limited ability to control quality issues with third-party code, content, or other intellectual property and must we depend on our own research and development personnel to evaluate and select third-party code, content, or other intellectual property that we believe is of the most value to our customers; and
- Technical difficulties in integrating our products and third-party code, content, or other intellectual property to create a combined solution, and the risk that customers will not perceive the need for such integrated solutions.

Any significant termination of a third-party license, change in third-party license provisions, increase in the cost of such third-party code, content or other intellectual property, failure of a code, content or other intellectual property provider to remain competitive in functionality, or defect in or a quality issue could delay or interrupt our ability to develop and deliver software products to customers on a timely basis. This could delay our revenue recognition and adversely affect our business, financial condition, and results of operations and possibly expose us to claims under license agreements with our customers and possibly increased litigation fees and expenses. Our failure to anticipate, manage, and adapt to these risks could result in significant delays in our products releases, changes in our product roadmaps, and damage to our operating results.



**Software errors or bugs, and possible product liability claims related to such errors or bugs, could result in increased costs, damage to our reputation, and loss of market share.**

Our software products are generally large and intricate programs. As a result, our current software products, updates, upgrades, or future products may contain errors, failures, or bugs, some of which may not become known until after the product has been released by us for use by customers. While we routinely test our products for such errors and identify and correct bugs through our customer support group, these problems are inevitable. Any significant errors may result in, among other things, loss of, or delay in, the market acceptance of our products, lost revenue and sales of our products, reallocation of, or increases in, development and customer support resources, impairment to our reputation, loss of future renewal or maintenance revenue, and increased service and warranty costs. Errors could also result in significant delays in the release of updates, upgrades, or new products while such errors are corrected. Moreover, because our products primarily support other systems and applications, any software errors or bugs in these other systems or applications may affect the performance of our software, and it may be difficult or impossible to determine where the errors reside. As a result, product errors, failures, or bugs could result in significant harm to our business and have a material adverse effect on our results of operations.

We may be subject to legal actions or claims for damages related to product errors which could, whether or not successful, increase costs and distract our management and our development and support teams and could harm our business, result in unexpected expenses and damage our reputation. Our license agreements with our customers typically contain provisions designed to limit exposure to potential product liability claims, and, to the extent permitted by governing law, our standard agreements in many jurisdictions also provide that we will not be liable for indirect or consequential damages caused by the failure of our products. In certain jurisdictions, however, warranty and limitation of liability provisions are not effective.

**Use of free or open source software or technology in our products or in the development of our products may reduce our ability to control the quality and support for products and may result in damage to our operating results.**

Free or open source software is software that is made widely available by its authors or other third parties and is often licensed on an as is basis for a nominal fee or, in some cases, at no charge. We have incorporated some free and open source software into our products, allowing us to enhance certain solutions without incurring substantial additional research and development costs. In addition, we may use free or open source tools in the development of our products. While we have not experienced any material problems as a result of our use of free or open source software, use of free or open source software entails significant risks including:

- Free or open source software or technology becoming competitive with our proprietary technology, which could cause sales of our products to decline or force us to reduce the fees we charge for our products, which could have a material adverse impact on our revenue and operating margins;
- Requiring that we make available the source code for any modifications or derivative works we make to or from the free or open source software, and that we license or contribute such modifications or derivative works under the terms of a particular free or open source license or other license granting third parties certain rights of further use;
- Our proprietary software could be combined with open source software in such a way that we would be required to release the source code of our proprietary software; and

- The lack of any warranty, maintenance, or support for most open source software or technology.

We have established processes to help minimize these risks to the extent within our control, including a review process for screening requests from our development organizations for the use of free or open source, but we cannot be sure that all free or open source software, technology, or tools are submitted for approval prior to use in our products or in the development of our products or that all use is in compliance with our corporate policies. These risks, if not eliminated, could negatively affect our ability to sale and license our products and could materially impact our business.

**Executive officers and other key personnel may depart, which could adversely affect our results of operations and harm our ability to grow the business.**

We are greatly dependent on the ability to retain key management, sales, and technical personnel, and our future success is highly dependent upon the personal efforts of our management, sales, and technical personnel and other key employees. The loss of services of key personnel could have a material adverse effect on our business, financial condition, and results of operations. We have attempted to mitigate these risks by offering key employees retention bonuses (payable only if they continue employment with us for

specified periods) and equity awards, but there is the risk that we could nevertheless lose key management, sales, and technical employees.

We have historically used stock options and are currently using restricted stock units, including both time-based, performance-based and market conditioned-based shares, as a key component in our executive and employee compensation programs in order to align employees' interests with the interests of our stockholders, encourage employee retention, and provide competitive compensation packages. Many of our employee stock options are fully vested, but most of these outstanding and vested options are currently underwater. This could affect our ability to retain present employees. In addition, we are now required to record a charge to earnings for employee stock option grants and other equity incentives. Moreover, applicable stock exchange listing standards relating to obtaining stockholder approval of equity compensation plans could make it more difficult or expensive for us to make equity awards to employees in the future. As a result, we may incur increased compensation costs, change our equity compensation strategy, or find it difficult to attract, retain, and motivate employees, any of which could materially adversely affect our business.

As we expand our international operations, we will be required to recruit and retain experienced management, sales and technical personnel in our international offices, and we expect that the identification, recruitment, training and retention of such personnel will require significant management time and effort and resources. Competition for employees with the skills required, particularly management, engineering and other technical personnel, is intense, and there can be no assurance that we will be able to attract and retain highly skilled employees in sufficient numbers to sustain our current business or to support future growth. We may need to pay recruiting or agency fees and offer additional compensation or incentives to attract and retain these and other employees, resulting in an increase to our operating expenses.

In addition, for the last several years, we have acquired several companies and these acquisitions have resulted in increased responsibilities and placed significant strain on our managerial, operational, and financial resources and resulted in new and increased responsibilities for management personnel. There can be no assurance that our management, personnel, systems, procedures, and controls are, or will be, adequate to support our existing and future operations or that we will continue to grow. If we fail to recruit and retain sufficient and qualified managerial, operational, or financial personnel or to implement or maintain internal systems that enable us to effectively manage our growing business and operations worldwide, our financial results in any given period may be adversely affected and our business and financial condition could be materially harmed.

**Our management changes may disrupt our business or affect our profitability.**

In January 2008, John R. Cooper, our Chief Executive Officer and the Chairman of the Board of Directors, announced his resignation, effective March 31, 2008. His resignation and the transition to a new chief executive officer could create uncertainty and confusion among our employees, customers, and stockholders. In addition, the process of identifying Mr. Cooper's successor could distract us and adversely affect or delay customer purchase decisions or decisions about the strategic direction of our business and raise concerns among our employees, customers, and stockholders, all of which could affect our sales, profitability, or results of operations.

**Difficulties encountered during changing economic conditions could adversely affect our results of operations.**

Our ability to effectively manage during changing economic conditions will require us to continue to implement and improve our operational, financial, and information systems and internal controls and will likely require additional management personnel. In addition, we believe that we must continue to develop improved engineering, financial, marketing, sales, and customer service capabilities in order to develop new products and technologies, secure new customers, and effectively serve the evolving needs of present and future customers. We may not be successful in strengthening these capabilities. Without adequate management, engineering, financial, product development, marketing, sales,

## Edgar Filing: AVOCENT CORP - Form 10-Q

and customer service capabilities, our ability to effectively manage during changing economic conditions, expand and enhance our product lines, further penetrate existing markets, and develop new markets will be significantly limited. If we are unable to effectively manage during changing economic conditions, our business, financial condition, and results of operations could be materially adversely affected.

Because our business and operating results depend to a significant extent on the general conditions in the server market, any adverse change in the server market due to adverse economic conditions, declining capital spending levels, or other factors could have a material adverse effect on our business, financial condition, and results of operations. In addition, we continue to see industry-wide initiatives by OEMs and by distributors and resellers of our hardware products to reduce their inventories and to shorten their lead times, thereby reducing early commitments to firm orders by our major OEM and our distributor and reseller customers.

### **Our line of credit could adversely affect us and our operations.**

In the second quarter of 2006, we obtained a \$250 million unsecured, five-year, revolving, bank line of credit, and we used borrowings under this line of credit to fund a portion of the LANDesk acquisition and the purchase of our shares under our recently-

expanded stock repurchase program. We may increase this line of credit or seek other credit lines in the future. The balance on our line of credit was \$140 million as of March 28, 2008. Interest expense on borrowings and additional future borrowings under the line of credit could adversely affect our future net income, margins, expenses, and financial conditions by:

- Requiring us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, which would reduce the availability of our cash flow to fund internal growth through working capital and capital expenditures and for other general corporate purposes;
- Increasing our vulnerability to economic downturns in our industry;
- Increasing our vulnerability to interest rate increases to the extent any of our variable rate debt is not hedged;
- Placing us at a competitive disadvantage compared to our competitors that have less debt in relation to cash flow;
- Limiting our flexibility in planning for or reacting to changes in our business and our industry;
- Limiting, among other things, our ability to borrow additional funds, refinance the line of credit, or obtain other financing capacity; and
- Subjecting us to a risk of noncompliance with financial and other restrictive covenants in our indebtedness.

**The line of credit contains affirmative and negative covenants, including limitations on our ability to (i) make distributions, investments, and other payments unless we satisfy certain financial tests or other criteria, (ii) incur additional indebtedness, and (iii) make acquisitions and capital expenditures. All of these restrictions could affect our ability to operate our business and may limit our ability to take advantage of potential business opportunities as they arise. The failure to comply with these covenants could result in an event of default which, if not cured or waived, could have a material adverse effect on us.**

Our ability to comply with these provisions of our line of credit may be affected by changes in the economic or business conditions or other events beyond our control. If we do not comply with these covenants and restrictions, we could be in default under our line of credit, and our debt, together with accrued interest, could then be declared immediately due and payable. There can be no assurance that we will be able to obtain sufficient funds to enable us to repay or refinance our debt obligations on commercially reasonable terms or at all. We also face interest rate risk on our bank line of credit which currently bears interest at a variable rate of LIBOR plus 70 basis points. We have partially hedged this exposure to interest rate risk with an interest rate swap, which has a remaining notional amount of \$60 million, through a well established financial institution.

**Unanticipated changes in our tax rates or exposure to additional income tax liabilities could affect our profitability.**

We are subject to income taxes in both the United States and various foreign jurisdictions, and our domestic and international tax liabilities are subject to the allocation of expenses in different jurisdictions. Our effective tax rates could be adversely affected by changes in the mix of earnings in countries with differing statutory tax rates, in the valuation of deferred tax assets and liabilities, in tax laws and treaties, or by material audit assessments, which could affect our profitability. In addition, the amount of income taxes we pay is subject to audit in various jurisdictions, and a material assessment by a governing tax authority could affect our profitability.

**Failure to maintain adequate internal systems and effective internal controls over our financial reporting and information systems could result in our management and auditors being unable to certify the effectiveness of our internal controls over financial reporting and information systems, which could harm our business reputation and cause our stock price to decline.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we implement and maintain adequate internal systems and effective internal controls over financial reporting and information systems. The absence of such controls could have a material adverse effect on our business, financial condition, and results of operations. In addition, correction of any significant deficiencies or material weaknesses (as defined under PCAOB guidelines) could require additional remedial measures including hiring additional personnel, which could be costly and time-consuming. If a significant deficiency or material weakness exists at any year-end (including a material weakness identified prior to year-end for which there is an insufficient period of time to evaluate and confirm the effectiveness of the corrections or related new procedures), our management and our auditors will be unable to report favorably as to the effectiveness of our control over financial reporting or information systems. This could result in a loss of investor confidence in the accuracy and completeness of our financial reports and our management, which could result in a decline of our stock price, damage to our business reputation, and potential litigation.

**Changes in accounting standards or the interpretation of accounting standards, especially changes related to revenue recognition, could cause significant impact on our revenue or earnings.**

Based on our interpretation of current accounting standards, we believe we have properly reported our current sales and license revenue. New accounting standards or regulations, changes to current accounting standards, or different interpretations of existing accounting standards in the future could result in corresponding changes in our revenue recognition or other accounting policies that could have a material adverse effect on our financial condition and operating results.

**Unforeseen environmental costs could negatively affect our future earnings.**

Some of our operations use substances regulated under various federal, state, and international laws governing the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes, and the cleanup of contaminated sites. Many of our products are subject to various federal, state, and international laws governing chemical substances in products, including those regulating the manufacture and distribution of chemical substances and those restricting the presence of certain substances in electronics products. We could incur substantial costs, including cleanup costs, fines, civil or criminal sanctions, third-party property damage, or personal injury claims if we were to violate or become liable under environmental laws or if our products become non-compliant with environmental laws. We also face increasing complexity in our product design and procurement operations as we adjust to new and future requirements relating to the materials composition of our products, including the restrictions on lead and certain other substances that will apply to specified electronics products put on the market in the European Union as of July 1, 2006 (Restriction of Hazardous Substances Directive) and similar legislation in China and other countries. The ultimate costs under environmental laws and the timing of these costs are difficult to predict, and liability under some environmental laws relating to contaminated sites can be imposed retroactively and on a joint and several basis.

We could also face significant costs and liabilities in connection with product take-back legislation. The European Union has finalized the Waste Electrical and Electronic Equipment Directive (WEEE), which makes producers of electrical goods, including computers and peripherals, financially responsible for specified collection, recycling, treatment, and disposal of past and future covered products. This deadline to enact and implement the directive by individual European Union governments generally was August 13, 2004, although extensions were granted to some countries (such legislation, together with the directive, the WEEE Legislation), and producers are financially responsible under the WEEE Legislation beginning in August 2005. Similar legislation has been or may be enacted in other geographies, including in the United States and Japan, the cumulative impact of which could be significant for us. We have incurred some costs and will continue to incur costs under the WEEE legislation but the amount and timing of these costs are difficult to predict.

**Provisions in our charter documents and in Delaware law may discourage potential acquisition bids for us and may prevent changes in management that stockholders may favor.**

Provisions in our charter documents could discourage potential acquisition proposals and could delay or prevent a change in control transaction that stockholders may favor. These provisions could have the effect of discouraging others from making tender offers for shares, and as a result, these provisions may prevent the market price of our common stock from reflecting the effects of actual or rumored takeover attempts and may prevent stockholders from reselling their shares at or above the price at which they purchased their shares. These provisions may also prevent changes in management that stockholders may favor. Our charter documents do not permit stockholders to act by written consent, limit the ability of stockholders to call a stockholders meeting, and provide for a classified Board of Directors, which means stockholders can only elect, or remove, a limited number of directors in any given year. Furthermore, the Board of Directors has the authority to issue up to five million shares of preferred stock in one or more series. The Board of Directors can fix the price, rights, preferences, privileges, and restrictions of such preferred stock without any further vote or action by our stockholders. The issuance of shares of preferred stock may delay or prevent a change

in control transaction without further action by our stockholders.

In addition, Delaware law may inhibit potential acquisition bids for us. Delaware law prevents certain Delaware corporations, including Avocent, from engaging, under certain circumstances, in a business combination with any interested stockholder for three years following the date that such stockholder became an interested stockholder.

**Our stock price may be volatile.**

Our stock has experienced significant volatility in price, in particular whenever there has been a difference between our actual financial results and the published expectations of analysts. We have also experienced changes in our stock price as a result of speculation in the press or investment community about our strategic position, financial position, results of operations, business, or significant transactions or acquisitions. The stock market in general has experienced price and volume fluctuations that have



negatively affected the market price of many publicly-held companies in ways seemingly unrelated to the actual operating performance of these companies. These factors, as well as general economic and political conditions and the announcement of proposed and completed acquisitions or other significant transactions, or any difficulties associated with such transactions, by us or our current or potential competitors, may materially adversely affect the market price of our common stock in the future. Additionally, volatility, lack of positive performance in our stock price or changes to our overall compensation program including our stock incentive program may adversely affect our ability to retain key employees, virtually all of whom are compensated, in part, based on the performance of our stock price.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

In 2004 our Board of Directors approved a stock repurchase program whereby we may purchase shares of our common stock. Our Board has approved a total of 19 million shares to be repurchased under this program, including 4 million additional shares approved by our Board in January 2008. The plan has no expiration date. Details of purchases made during the quarter ended March 28, 2008 are as follows:

Period:	Total Number of Shares Purchased During the Period	Average Price Paid Per Share for Period Presented	Total Cumulative Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares Remaining to Purchase Under the Plan
January 1, 2008 - January 25, 2008	1,587,575	\$ 15.59	14,287,575	4,712,425
January 26, 2008 - February 22, 2008	1,462,425	\$ 16.56	15,750,000	3,250,000
February 23, 2008 - March 28, 2008	862,300	\$ 16.22	16,612,300	2,387,700
Quarter ended March 28, 2008	3,912,300	\$ 16.09		

Approximately 159,000 shares were withheld as payment for employee payroll withholding taxes at the release of vested restricted stock units in the first quarter of 2008 (*see Note 3 to our condensed consolidated financial statements contained in Part I, Item 1 of this quarterly report*). The 159,000 shares were considered to be treasury shares; however, these treasury shares were immediately retired and are not considered in the table above.

During the period from March 26, 2008 through March 28, 2008, we purchased 88,000 additional shares of our common stock under our share repurchase program for a total cost of \$1.5 million. However, as these transactions settled after March 28, 2008, we will record these trades as occurring in the second quarter of 2008.

## Item 6. Exhibits.

(a) Exhibits

**31.2** Sarbanes-Oxley Act of 2002 Section 302(a) Certification of the Chief Financial Officer

32.1 Certification of the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

ITEMS 3, 4, AND 5 ARE NOT APPLICABLE AND HAVE BEEN OMITTED.

**SIGNATURE**

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

AVOCENT CORPORATION  
(Registrant)

Date: May 6, 2008

/s/ Edward H. Blankenship  
Edward H. Blankenship  
Senior Vice President of Finance, Chief Financial  
Officer, and Assistant Secretary (Principal Financial Officer)