

DSP GROUP INC /DE/  
Form 10-Q  
November 10, 2014

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United States  
SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

\_\_\_\_\_  
FORM 10-Q

**(Mark One)**

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

**For the Quarterly Period Ended September 30, 2014**

**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 1-35256**

  

\_\_\_\_\_

DSP GROUP, INC.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of

incorporation or organization)

**2161 S. San Antonio Road, Suite 10**

**San Jose, California**

(Address of Principal Executive Offices) (Zip Code)

**94-2683643**

(I.R.S. employer identification number)

**95131**

Registrant's telephone number, including area code: **(408) 986-4300**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

As of November 5, 2014, there were 21,612,193 shares of Common Stock (\$.001 par value per share) outstanding.



**INDEX**

**DSP GROUP, INC.**

|   | <u>Page<br/>No.</u> |
|---|---------------------|
| <b><i>PART I. FINANCIAL INFORMATION</i></b>   |                     |
| Item 1. Financial Statements (Unaudited)  |                     |
| Condensed consolidated balance sheets—September 30, 2014 and December 31, 2013                                    | 2                   |
| Condensed consolidated statements of income—Three and nine months ended September 30, 2014 and 2013               | 4                   |
| Condensed consolidated statements of cash flows—Nine months ended September 30, 2014 and 2013                     | 7                   |
| Condensed consolidated statements of stockholders' equity—Three and nine months ended September 30, 2014 and 2013 | 8                   |
| Notes to condensed consolidated financial statements—September 30, 2014   | 10                  |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations                     | 23                  |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk  | 34                  |
| Item 4. Controls and Procedures   | 35                  |
| <b><i>PART II. OTHER INFORMATION</i></b>  |                     |
| Item 1. Legal Proceedings   | 35                  |
| Item 1A. Risk Factors   | 35                  |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds   | 52                  |
| Item 3. Defaults Upon Senior Securities   | 53                  |
| Item 4. Mine Safety Disclosure  | 53                  |
| Item 5. Other Information   | 53                  |
| Item 6. Exhibits  | 53                  |
| <b>SIGNATURES</b>   | <b>54</b>           |

**PART 1. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****DSP GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(U.S. dollars in thousands, except share and per share data)**

|  | <b>September<br/>30,<br/><br/>2014<br/>Unaudited</b> | <b>December<br/>31,<br/><br/>2013<br/>Audited</b> |
|--|--|---|
| <b>ASSETS</b>                                  |  |   |
| <b>CURRENT ASSETS:</b>                         |  |   |
| Cash and cash equivalents                      | \$ 14,509  | \$ 23,578   |
| Restricted deposits                            | 394  | 77  |
| Marketable securities and short-term deposits  | 9,275  | 13,895  |
| Trade receivables, net                         | 25,091   | 21,195  |
| Deferred income taxes                          | 97   | 92  |
| Other accounts receivable and prepaid expenses | 1,640  | 2,641   |
| Inventories                                    | 13,908   | 12,334  |
| <b>TOTAL CURRENT ASSETS</b>                    | <b>64,914</b>  | <b>73,812</b>                                     |
| <b>PROPERTY AND EQUIPMENT, NET</b>             | <b>2,865</b>   | <b>2,837</b>                                      |
| <b>LONG-TERM ASSETS:</b>                       |  |   |
| Long-term marketable securities and deposits   | 93,214   | 90,162  |
| Long-term prepaid expenses and lease deposits  | 87   | 100   |
| Severance pay fund                             | 11,456   | 11,168  |
| Investment in other companies                  | 2,200  | 2,200   |
| Intangible assets, net                         | 5,517  | 6,710   |
| Goodwill                                       | 5,276  | 5,276   |
|  | 117,750  | 115,616   |
| <b>TOTAL ASSETS</b>                            | <b>\$ 185,529</b>                                    | <b>\$ 192,265</b>                                 |

Note: The balance sheet at December 31, 2013 has been derived from the audited financial statements on that date.

See notes to condensed consolidated financial statements.

**DSP GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(U.S. dollars in thousands, except share and per share data)

|  | <b>September<br/>30,<br/>2014<br/>Unaudited</b> | <b>December<br/>31, 2013<br/>Audited</b> |
|--|---|--|
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |   |  |
| <b>CURRENT LIABILITIES:</b>  |   |  |
| Trade payables   | \$ 15,468                                       | \$ 14,149                                |
| Accrued compensation and benefits  | 7,579   | 9,845                                    |
| Income tax accruals and payables   | 1,946   | 1,985                                    |
| Accrued expenses and other accounts payable  | 5,565   | 5,532                                    |
| <b>Total current liabilities</b>   | <b>30,558</b>                                   | <b>31,511</b>                            |
| <b>LONG-TERM LIABILITIES:</b>  |   |  |
| Deferred income taxes  | 894   | 1,183                                    |
| Accrued severance pay  | 11,525  | 11,179                                   |
| Accrued pensions   | 927   | 981                                      |
| <b>Total long-term liabilities</b>   | <b>13,346</b>                                   | <b>13,343</b>                            |
| <b>COMMITMENTS AND CONTINGENCIES STOCKHOLDERS' EQUITY:</b>   |   |  |
| Capital stock:   |   |  |
| Preferred stock, \$ 0.001 par value - Authorized shares: 5,000,000 at September 30, 2014 and December 31, 2013; Issued and outstanding shares: none at September 30, 2014 and December 31, 2013  | -   | -  |
| Common stock, \$ 0.001 par value - Authorized shares: 50,000,000 shares at September 30, 2014 and December 31, 2013; Issued and outstanding shares: 21,540,317 and 22,349,780 shares at September 30, 2014 and December 31, 2013, respectively | 22  | 22                                       |
| Additional paid-in capital   | 354,694   | 350,494                                  |
| Treasury stock   | (125,329 )                                      | (118,749 )                               |
| Accumulated other comprehensive loss   | (1,433 )  | (821 )                                   |
| Accumulated deficit  | (86,329 )                                       | (83,535 )                                |
| <b>Total stockholders' equity</b>  | <b>141,625</b>                                  | <b>147,411</b>                           |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$ 185,529</b>                               | <b>\$ 192,265</b>                        |

Note: The balance sheet at December 31, 2013 has been derived from the audited financial statements on that date.

See notes to condensed consolidated financial statements.



**DSP GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)**

(U.S. dollars in thousands, except per share amounts)

|   | <b>Three Months Ended</b> |                           | <b>Nine Months Ended</b>  |                           |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
|   | <b>September 30, 2014</b> | <b>September 30, 2013</b> | <b>September 30, 2014</b> | <b>September 30, 2013</b> |
| Revenues  | \$36,715                  | \$35,381                  | \$105,877                 | \$115,723                 |
| Cost of revenues (1)  | 22,187                    | 21,576                    | 63,554                    | 70,050                    |
| Gross profit  | 14,528                    | 13,805                    | 42,323                    | 45,673                    |
| Operating expenses:   |                           |                           |                           |                           |
| Research and development, net (2)   | 8,083                     | 8,147                     | 24,313                    | 26,481                    |
| Sales and marketing (3)   | 2,892                     | 2,767                     | 8,925                     | 8,492                     |
| General and administrative (4)  | 2,580                     | 2,576                     | 7,941                     | 9,046                     |
| Intangible assets amortization  | 397                       | 418                       | 1,191                     | 1,254                     |
| Total operating expenses  | 13,952                    | 13,908                    | 42,370                    | 45,273                    |
| Operating income (loss)   | 576                       | (103 )                    | (47 )                     | 400                       |
| Financial income, net   | 186                       | 512                       | 895                       | 1,837                     |
| Income before taxes on income   | 762                       | 409                       | 848                       | 2,237                     |
| Taxes on income (income tax benefit)  | (11 )                     | 11                        | (25 )                     | (83 )                     |
| Net income  | \$773                     | \$398                     | \$873                     | \$2,320                   |
| Net income per share:   |                           |                           |                           |                           |
| Basic   | \$0.04                    | \$0.02                    | \$0.04                    | \$0.10                    |
| Diluted   | \$0.03                    | \$0.02                    | \$0.04                    | \$0.10                    |
| Weighted average number of shares used in per share computations of net income: |                           |                           |                           |                           |
| Basic   | 21,830                    | 22,522                    | 22,064                    | 22,159                    |
| Diluted   | 23,073                    | 23,048                    | 22,829                    | 22,723                    |

Includes equity-based compensation expense in the amount of \$71 and \$65 for the three months ended

(1) September 30, 2014 and 2013, respectively, and equity-based compensation expense in the amount of \$237 and \$191 for the nine months ended September 30, 2014 and 2013, respectively.

Includes equity-based compensation expense in the amount of \$568 and \$474 for the three months ended

(2) September 30, 2014 and 2013, respectively, and equity-based compensation expense in the amount of \$1,869 and \$1,412 for the nine months ended September 30, 2014 and 2013, respectively

Includes equity-based compensation expense in the amount of \$150 and \$115 for the three months ended

(3) September 30, 2014 and 2013, respectively, and equity-based compensation expense in the amount of \$481 and \$383 for the nine months ended September 30, 2014 and 2013, respectively.

Includes equity-based compensation expense in the amount of \$507 and \$391 for the three months ended (4) September 30, 2014 and 2013, respectively, and equity-based compensation expense in the amount of \$1,613 and \$1,147 for the nine months ended September 30, 2014 and 2013, respectively.

See notes to condensed consolidated financial statements.

**DSP GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (U.S. dollars in thousands)**

|   | <b>Three<br/>months<br/>ended<br/>September<br/>30,<br/>2014    2013</b> |       |
|---|--|-------|
| Net income:   | \$773  | \$398 |
| Other comprehensive loss:   |  |       |
| Available-for-sale securities:  |  |       |
| Changes in unrealized gains/losses  | (404)  | 459   |
| Reclassification adjustments for losses (gains) included in net income (loss) | 3  | (183) |
| Net change  | (401)  | 276   |
| Cash flow hedges:   |  |       |
| Changes in unrealized gains/losses  | (528)  | 93    |
| Reclassification adjustments for losses (gains) included in net income (loss) | 97   | (292) |
| Net change  | (431)  | (199) |
| Change in unrealized components of defined benefit plans:                     |  |       |
| Amortization of actuarial loss and prior service benefit                      | 3  | 3     |
| Net change  | 3  | 3     |
| Foreign currency translation adjustments, net                                 | 5  | 7     |
| Other comprehensive income (loss)   | (824)  | 87    |
| Comprehensive income (loss)   | \$(51 )  | \$485 |

See notes to condensed consolidated financial statements.

**DSP GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (U.S. dollars in thousands)**

|  | <b>Nine months<br/>ended<br/>September 30,<br/>2014 2013</b> |         |
|--|--|---------|
| Net income:  | \$873  | \$2,320 |
| Other comprehensive income (loss):                                     |  |         |
| Available-for-sale securities:   |  |         |
| Changes in unrealized gains/losses                                     | (134)  | (537 )  |
| Reclassification adjustments for (gains) losses included in net income | (62 )  | (726 )  |
| Net change   | (196)  | (1,263) |
| Cash flow hedges:  |  |         |
| Changes in unrealized gains/losses                                     | (516)  | 355     |
| Reclassification adjustments for losses (gains) included in net income | 92   | (695 )  |
| Net change   | (424)  | (340 )  |
| Change in unrealized components of defined benefit plans:              |  |         |
| Amortization of actuarial loss and prior service benefit               | 9  | 8       |
| Net change   | 9  | 8       |
| Foreign currency translation adjustments, net                          | (1 )   | (19 )   |
| Other comprehensive loss   | (612)  | (1,614) |
| Comprehensive income   | \$261  | \$706   |

See notes to condensed consolidated financial statements.

**DSP GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(U.S. dollars in thousands)

|  | <b>Nine Months<br/>Ended September<br/>30,</b> |             |
|--|--|-------------|
|  | <b>2014</b>                                    | <b>2013</b> |
| <b>Net cash provided by operating activities</b>                   | \$3,734  | \$4,973     |
| <b>Investing activities</b>  |  |             |
| Purchase of marketable securities                                  | (50,205)                                       | (53,331)    |
| Proceeds from maturity of marketable securities                    | 9,896  | 15,180      |
| Proceeds from sales of marketable securities                       | 40,821   | 27,814      |
| Increase in restricted deposits                                    | (327 )   | -           |
| Purchases of property and equipment                                | (1,002 )                                       | (925 )      |
| <b>Net cash provided used in investing activities</b>              | (817 )   | (11,262)    |
| <b>Financial activities</b>  |  |             |
| Purchase of treasury stock   | (12,484)                                       | -           |
| Issuance of treasury stock for cash upon exercise of stock options | 514  | 1,848       |
| <b>Net cash provided by (used in) financing activities</b>         | (11,970)                                       | 1,848       |
| <b>Increase (decrease) in cash and cash equivalents</b>            | \$(9,053 )                                     | \$(4,441 )  |
| <b>Cash (erosion) due to exchange rate differences</b>             | (16 )  | 28          |
| <b>Cash and cash equivalents at the beginning of the period</b>    | \$23,578                                       | \$21,684    |
| <b>Cash and cash equivalents at the end of the period</b>          | \$14,509                                       | \$17,271    |

See notes to condensed consolidated financial statements.

**DSP GROUP, INC.****CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY****(UNAUDITED)****(U.S. dollars and shares in thousands)**

| <b>Three Months Ended</b>  | <b>Number</b> |               | <b>Additional</b> |                    |                     | <b>Other</b>         | <b>Total</b>         |
|--|---------------|---------------|-------------------|--------------------|---------------------|----------------------|----------------------|
| <b>September 30, 2013</b>  | <b>of</b>     | <b>Common</b> | <b>Paid-In</b>    | <b>Treasury</b>    | <b>Accumulated</b>  | <b>Comprehensive</b> | <b>Stockholders'</b> |
|  | <b>Common</b> | <b>Stock</b>  | <b>Capital</b>    | <b>Stock</b>       | <b>deficit</b>      | <b>Income</b>        | <b>Equity</b>        |
|  | <b>Stock</b>  |               |                   |                    |                     | <b>(Loss)</b>        |                      |
| Balance at June 30, 2013   | 22,172        | \$ 22         | \$ 348,423        | \$(120,829)        | \$ (80,297 )        | \$ ( 713 )           | \$ 146,606           |
| Net income   | -             | -             | -                 | -                  | 398                 | -                    | 398                  |
| Change in accumulated other comprehensive income   | -             | -             | -                 | -                  | -                   | 87                   | 87                   |
| Issuance of treasury stock upon purchase of common stock under employee stock purchase plan  | 184           | *)            | -                 | 1,802              | (984 )              | -                    | 818                  |
| Issuance of treasury stock upon exercise of stock options, stock appreciation rights and restricted share units by employees and directors | 202           | 1             | -                 | 1,985              | (1,362 )            | -                    | 624                  |
| Equity-based compensation  | -             | -             | 1,045             | -                  | -                   | -                    | 1,045                |
| <b>Balance at September 30, 2013</b>   | <b>22,558</b> | <b>\$ 23</b>  | <b>\$ 349,468</b> | <b>\$(117,042)</b> | <b>\$ (82,245 )</b> | <b>\$ ( 626 )</b>    | <b>\$ 149,578</b>    |
| <b>Three Months Ended September 30, 2014</b>   |               |               |                   |                    |                     |                      |                      |
| Balance at June 30, 2014   | 21,843        | \$ 22         | \$ 353,398        | \$(122,713)        | \$ (86,092 )        | \$ ( 609 )           | \$ 144,006           |
| Net income   | -             | -             | -                 | -                  | 773                 | -                    | 773                  |
| Change in accumulated other comprehensive income   | -             | -             | -                 | -                  | -                   | (824 )               | (824 )               |
| Purchase of treasury stock   | (505 )        | (1 )          | -                 | (4,588 )           | -                   | -                    | (4,589 )             |
| Issuance of treasury stock upon purchase of common stock under employee stock purchase plan  | 124           | 1             | -                 | 1,217              | (329 )              | -                    | 889                  |
|  | 78            | *)            | -                 | 755                | (681 )              | -                    | 74                   |

Issuance of treasury stock upon exercise of stock options, stock appreciation rights and restricted share units by employees and directors

|                                      |               |              |                   |                    |                     |                    |                   |
|--------------------------------------|---------------|--------------|-------------------|--------------------|---------------------|--------------------|-------------------|
| Equity-based compensation            | -             | -            | 1,296             | -                  | -                   | -                  | 1,296             |
| <b>Balance at September 30, 2014</b> | <b>21,540</b> | <b>\$ 22</b> | <b>\$ 354,694</b> | <b>\$(125,329)</b> | <b>\$ (86,329 )</b> | <b>\$ (1,433 )</b> | <b>\$ 141,625</b> |

(\* ) Represents an amount lower than \$1.

See notes to condensed consolidated financial statements.

**DSP GROUP, INC.****CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY****(UNAUDITED)****(U.S. dollars and shares in thousands)**

|   | Number<br>of<br>Common<br>Stock | Common<br>Stock | Additional<br>Paid-In<br>Capital | Treasury<br>Stock  | Accumulated<br>deficit | Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Stockholders'<br>Equity |
|---|---------------------------------|-----------------|----------------------------------|--------------------|------------------------|--|----------------------------------|
| <b>Nine Months Ended<br/>September 30, 2013</b>   |                                 |                 |                                  |                    |                        |  |                                  |
| Balance at December 31,<br>2012   | 21,674                          | \$ 22           | \$ 346,335                       | \$(125,724)        | \$(79,394)             | \$ 988                                     | \$ 142,227                       |
| Net income  |                                 | -               | -                                | -                  | 2,320                  |  | 2,320                            |
| Change in accumulated other<br>comprehensive income   |                                 | -               | -                                | -                  | -                      | (1,614)                                    | (1,614)                          |
| Issuance of treasury stock<br>upon purchase of common<br>stock under employee stock<br>purchase plan  | 374                             | *)              | -                                | 3,669              | (2,005)                | -  | 1,664                            |
| Issuance of treasury stock<br>upon exercise of stock<br>options, stock appreciation<br>rights and restricted share<br>units by employees and<br>directors | 510                             | 1               | -                                | 5,013              | (3,166)                | -  | 1,848                            |
| Equity-based compensation   | -                               | -               | 3,133                            | -                  | -                      | -  | 3,133                            |
| Balance at September 30,<br>2013  | <b>22,558</b>                   | <b>\$ 23</b>    | <b>\$ 349,468</b>                | <b>\$(117,042)</b> | <b>\$(82,245)</b>      | <b>\$(626)</b>                             | <b>\$ 149,578</b>                |
| <b>Nine Months Ended<br/>September 30, 2014</b>   |                                 |                 |                                  |                    |                        |  |                                  |
| Balance at December 31,<br>2013   | 22,350                          | \$ 22           | \$ 350,494                       | \$(118,749)        | \$(83,535)             | \$(821)                                    | \$ 147,411                       |
| Net income  |                                 | -               | -                                | -                  | 873                    |  | 873                              |
| Change in accumulated other<br>comprehensive income   |                                 | -               | -                                | -                  | -                      | (612)                                      | (612)                            |
| Purchase of treasury stock  | (1,414)                         | (1)             | -                                | (12,483)           | -                      | -  | (12,484)                         |
| Issuance of treasury stock<br>upon purchase of common<br>stock under employee stock<br>purchase plan  | 311                             | 1               | -                                | 3,031              | (1,309)                | -  | 1,723                            |



|  |               |              |                   |                    |                   |          |                  |                     |
|--|---------------|--------------|-------------------|--------------------|-------------------|----------|------------------|---------------------|
| Issuance of treasury stock upon exercise of stock options, stock appreciation rights and restricted share units by employees and directors | 293           | *)           | -                 | 2,872              | (2,358            | )        | -                | 514                 |
| Equity-based compensation  | -             | -            | 4,200             | -                  | -                 | -        | -                | 4,200               |
| Balance at September 30, 2014  | <b>21,540</b> | <b>\$ 22</b> | <b>\$ 354,694</b> | <b>\$(125,329)</b> | <b>\$ (86,329</b> | <b>)</b> | <b>\$ (1,433</b> | <b>) \$ 141,625</b> |

(\*) Represents an amount lower than \$1.

See notes to condensed consolidated financial statements.

**DSP GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(UNAUDITED)****(U.S. dollars in thousands, except share and per share data)****NOTE A—BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. For further information, reference is made to the consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K of DSP Group, Inc. (the “Company”) for the year ended December 31, 2013.

**NOTE b—INVENTORIES**

Inventories are stated at the lower of cost or market value. The Company periodically evaluates the quantities on hand relative to current and historical selling prices, and historical and projected sales volume. Based on these evaluations, provisions are made in each period to write inventory down to its net realizable value. Inventories are composed of the following:

|                 | <b>September<br/>30, 2014</b> | <b>December<br/>31, 2013</b> |
|-----------------|-------------------------------|------------------------------|
|                 | (Unaudited)                   | (Audited)                    |
| Work-in-process | \$ 7,311                      | \$ 5,412                     |
| Finished goods  | 6,597                         | 6,922                        |
|                 | <b>\$ 13,908</b>              | <b>\$ 12,334</b>             |

Inventory write-off amounted to \$48 for the nine months ended September 30, 2014. For the nine months ended September 30, 2013, the Company recorded \$177 of income due to the utilization of inventory that was written off in the past.

**NOTE c—NET income PER SHARE**

Basic net income (loss) per share is computed based on the weighted average number of shares of common stock outstanding during the period. For the same periods, diluted net income (loss) per share further includes the effect of dilutive stock options, stock appreciation rights and restricted share units outstanding during the period, all in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) No. 260 “Earnings per Share.” The following table sets forth the computation of basic and diluted net income (loss) per share:

|   | <b>Three months ended</b> |             | <b>Nine months ended</b>  |             |
|---|---------------------------|-------------|---------------------------|-------------|
|   | <b>September 30, 2014</b> | <b>2013</b> | <b>September 30, 2014</b> | <b>2013</b> |
|   | Unaudited                 |             |                           |             |
| Net income  | \$773                     | \$398       | \$873                     | \$2,320     |
| Net income per share:   |                           |             |                           |             |
| Basic   | \$0.04                    | \$0.02      | \$0.04                    | \$0.10      |
| Diluted   | \$0.03                    | \$0.02      | \$0.04                    | \$0.10      |
| Weighted average number of shares of common stock outstanding during the period used to compute basic net income per share (in thousands)   | 21,830                    | 22,522      | 22,064                    | 22,159      |
| Incremental shares attributable to exercise of outstanding options, stock appreciation rights and restricted shares units (assuming proceeds would be used to purchase treasury stock) (in thousands) | 1,243                     | 526         | 765                       | 564         |
| Weighted average number of shares of common stock used to compute diluted net income per share (in thousands)   | 23,073                    | 23,048      | 22,829                    | 22,723      |

**NOTE d—MARKETABLE SECURITIES and time deposits**

The Company accounts for investments in marketable securities in accordance with FASB ASC No.320-10 “Investments in Debt and Equity Securities.” Management determines the appropriate classification of its investments in government and corporate marketable debt securities at the time of purchase and reevaluates such determinations at each balance sheet date.

The Company classifies marketable securities as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of taxes, reported in other comprehensive income. The amortized cost of marketable securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and interest are included in financial income, net. Interest on securities are included in financial income,

net. The following is a summary of available-for-sale securities and short term deposits at September 30, 2014 and December 31, 2014:

|                       | Amortized cost      |                   | Unrealized gains<br>(losses), net |                   | Estimated fair value |                   |
|-----------------------|---------------------|-------------------|-----------------------------------|-------------------|----------------------|-------------------|
|                       | September<br>30,    | December<br>31,   | September<br>30,                  | December<br>31,   | September<br>30,     | December<br>31,   |
|                       | 2014<br>(Unaudited) | 2013<br>(Audited) | 2014<br>(Unaudited)               | 2013<br>(Audited) | 2014<br>(Unaudited)  | 2013<br>(Audited) |
| Short -term deposits  | \$2,755             | \$2,911           | \$-                               | \$ -              | \$2,755              | \$2,911           |
| U.S. GSE securities   | 4,315               | 3,093             | 2                                 | (11 )             | 4,317                | 3,082             |
| Corporate obligations | 96,006              | 98,444            | (589)                             | (380 )            | 95,417               | 98,064            |
|                       | \$103,076           | \$104,448         | \$(587)                           | \$(391 )          | \$102,489            | \$104,057         |

The amortized cost of short and long-term deposits and available-for-sale debt securities at September 30, 2014, by contractual maturities, is shown below:

|                                  | <b>Amortized</b> | <b>Unrealized</b>     |               | <b>Estimated</b>  |
|----------------------------------|------------------|-----------------------|---------------|-------------------|
|                                  | <b>cost</b>      | <b>gains (losses)</b> |               | <b>fair value</b> |
|                                  |                  | <b>Gains</b>          | <b>Losses</b> |                   |
| Due in one year or less          | \$ 9,266         | \$9                   | \$ -          | \$ 9,275          |
| Due after one year to five years | 93,810           | 125                   | (721 )        | 93,214            |
|                                  | \$ 103,076       | \$ 134                | \$ (721 )     | \$ 102,489        |

The actual maturity dates may differ from the contractual maturities because debtors may have the right to call or prepay obligations without penalties.

Management believes that as of September 30, 2014, the unrealized losses in the Company's investments in all types of marketable securities were temporary and no impairment loss was realized in the Company's condensed consolidated statement of income.

Marketable securities are periodically reviewed for impairment. If management concludes that any marketable security is impaired, management determines whether such impairment is other-than-temporary. Factors considered in making such a determination include the duration and severity of the impairment, the reason for the decline in value and the potential recovery period, and the Company's intent to sell, or whether it is more likely than not that the Company will be required to sell the marketable security before recovery of cost basis. If any impairment is considered other-than-temporary, the marketable security is written down to its fair value through a corresponding charge to financial income, net.

The total fair value of marketable securities with outstanding unrealized losses as of September 30, 2014 amounted to \$68,921. Of the \$721 unrealized losses outstanding as of September 30, 2014 and presented in the table above, a portion of which in the amount of \$149, was related to marketable securities that were in a loss position for more than 12 months and the remaining portion in the amount of \$572 was related to marketable securities that were in a loss position for less than 12 months.

Proceeds from maturity of available-for-sale marketable securities during the nine months ended September 30, 2014 and 2013 were \$9,896 and \$15,180, respectively. Proceeds from sales of available-for-sale marketable securities during the nine months ended September 30, 2014 and 2013 were \$40,821 and \$27,814, respectively. Net realized gains from the sale of available-for-sale marketable securities for the nine months ended September 30, 2014 and 2013 were \$62 and \$726, respectively. The Company determines realized gains or losses on the sale of available-for-sale marketable securities based on a specific identification method.

**NOTE e—TAXES ON Income**

The effective tax rate used in computing the provision for income taxes is based on projected fiscal year income before taxes, including estimated income by tax jurisdiction. Tax provision for the three and nine months ended September 30, 2014 and September 30, 2013 does not include tax benefits associated with equity-based compensation expenses. During the three and nine months ended September 30, 2014, the Company did not record any significant changes to its deferred tax assets due to its current estimation of future taxable income.

The total amount of net unrecognized tax benefits was \$1,833 and \$1,892 at September 30, 2014 and December 31, 2013, respectively. The Company accrues interest and penalties, relating to unrecognized tax benefits, in its provision for income taxes. At September 30, 2014 and December 31, 2013, the Company had accrued interest and penalties relating to unrecognized tax benefits of \$432 and \$408, respectively.

## **NOTE F—SIGNIFICANT CUSTOMERS**

The Company sells its products primarily through distributors and directly to original equipment manufacturers (OEMs) and original design manufacturers (ODMs) who incorporate the Company's products into consumer products. The Company's future performance will depend, in part, on the continued success of its distributors in marketing and selling its products. The loss of the Company's distributors and the Company's inability to obtain satisfactory replacements in a timely manner may harm the Company's sales and results of operations. In addition, the Company expects that a limited number of customers, varying in identity from period-to-period, will account for a substantial portion of its revenues in any period. The loss of, or reduced demand for products from, any of the Company's major customers could have a material adverse effect on the Company's business, financial condition and results of operations.

Sales to Hong Kong-based VTech Holdings Ltd. ("VTech") represented 34% and 35% of the Company's total revenues for the three months ended September 30, 2014 and 2013, respectively. Sales to VTech represented 36% of the Company's total revenues for both the nine months ended September 30, 2014 and 2013.

Revenues derived from sales through one distributor, Tomen Electronics Corporation ("Tomen Electronics"), accounted for 22% and 24% of the Company's total revenues for the three months ended September 30, 2014 and 2013, respectively. Tomen Electronics accounted for 21% and 18% of the Company's total revenues for the nine months ended September 30, 2014 and 2013, respectively. The Japanese market and the OEMs that operate in that market are among the largest suppliers in the world with significant market share in the U.S. market for residential wireless products. Tomen Electronics sells the Company's products to a limited number of customers. One customer, Panasonic Communications Co., Ltd. ("Panasonic"), has continually accounted for a majority of the sales of Tomen Electronics. Sales to Panasonic through Tomen Electronics generated 17% and 18% of the Company's total revenues for the three months ended September 30, 2014 and 2013, respectively. Sales to Panasonic through Tomen Electronics generated 15% and 13% of the Company's total revenues for the nine months ended September 30, 2014 and 2013, respectively.

## **NOTE g—DERIVATIVE INSTRUMENTS**

The Company accounts for derivative instruments in accordance with FASB. ASC No. 815 "Derivatives and Hedging" ("ASC 815"). Due to the Company's global operations, it is exposed to foreign currency exchange rate fluctuations in the normal course of its business. The Company's treasury policy allows it to offset the risks associated with the effects of certain foreign currency exposures through the purchase of foreign exchange forward contracts and put options (collectively, "hedging contracts"). The policy, however, prohibits the Company from speculating on hedging contracts for profit.



To protect against the increase in value of forecasted foreign currency cash flows resulting from salary and lease payments of its Israeli facilities denominated in the Israeli currency, the New Israeli Shekels (“NIS”), during the year, the Company instituted a foreign currency cash flow hedging program. The Company hedges portions of the anticipated payroll and lease payments denominated in NIS for a period of one to twelve months with hedging contracts. Accordingly, when the dollar strengthens against the foreign currencies, the decline in present value of future foreign currency expenses is offset by losses in the fair value of the hedging contracts. Conversely, when the dollar weakens, the increase in the present value of future foreign currency cash flows is offset by gains in the fair value of the hedging contracts. These hedging contracts are designated as cash flow hedges, as defined by ASC 815, and are all effective hedges of these expenses.

In accordance with ASC 815, for derivative instruments that are designated and qualify as a cash flow hedge (i.e. hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Any gain or loss on a derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item is recognized in current earnings during the period of change. As of September 30, 2014, the Company had outstanding foreign exchange forward contracts in the amount of \$3,450 and outstanding option contracts in the amount of \$11,725. These hedging contracts do not contain any credit-risk-related contingency features. See Note K for information on the fair value of these hedging contracts.

The fair value of derivative assets and derivative liabilities were \$32 and \$456, respectively, at September 30, 2014. The Company recorded a net amount of \$424 in accrued expenses and other accounts payable in the condensed consolidated balance sheets at September 30, 2014.

The amount recorded as expense in research and development expenses, sales and marketing expenses and general and administrative expenses in the condensed consolidated statements of income for the nine months ended September 30, 2014 that resulted from the above referenced hedging transactions was \$72, \$7 and \$13, respectively. The amount recorded as expense in research and development expenses, sales and marketing expenses and general and administrative expenses in the condensed consolidated statements of income for the three months ended September 30, 2014 that resulted from the above referenced hedging transactions was \$76, \$8 and \$13, respectively.

The fair value of the outstanding derivative instruments at September 30, 2014 and December 31, 2013 is summarized below:

|  | Balance Sheet Location                          | Fair Value of Derivative Instruments |                         |
|--|---|--------------------------------------|-------------------------|
|  |   | As of September 30, 2014             | As of December 31, 2013 |
| Derivative Assets                                  |   |                                      |                         |
| Foreign exchange forward contracts and put options | Accrued expenses and other accounts payable (*) | \$ 424                               | \$ -                    |
| Total  |   | \$ 424                               | \$ -                    |

\*) Estimated to be reclassified into earnings for the remainder of 2014 and in 2015.

The effect of derivative instruments in cash flow hedging transactions on income and other comprehensive income (“OCI”) for the three and nine months ended September 30, 2013 and 2012 is summarized below:

| Gains (Losses) on Derivatives Recognized in OCI |                     |
|---|---------------------|
| for the three months                            | for the nine months |
|   |                     |

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|                                    | ended       | ended       |             |             |
|------------------------------------|-------------|-------------|-------------|-------------|
|                                    | September   | September   |             |             |
|                                    | 30,         | 30,         |             |             |
|                                    | <b>2014</b> | <b>2013</b> | <b>2014</b> | <b>2013</b> |
| Foreign exchange forward contracts | \$(528)     | \$ 93       | \$(516)     | \$355       |

Gains (Losses) Reclassified from OCI into  
Income

|                                    |                    | for the three | for the nine |             |             |
|------------------------------------|--------------------|---------------|--------------|-------------|-------------|
|                                    |                    | months        | months       |             |             |
|                                    |                    | ended         | ended        |             |             |
|                                    |                    | September     | September    |             |             |
|                                    |                    | 30,           | 30,          |             |             |
| Location                           |                    | <b>2014</b>   | <b>2013</b>  | <b>2014</b> | <b>2013</b> |
| Foreign exchange forward contracts | Operating expenses | \$(97)        | \$292        | \$(92)      | \$695       |

**NOTE h—CONTINGENCIES**

From time to time, the Company may become involved in litigation relating to claims arising from its ordinary course of business. Also, as is typical in the semiconductor industry, the Company has been and may from time to time be notified of claims that the Company may be infringing patents or intellectual property rights owned by third parties. The Company currently believes that there are no claims or actions pending or threatened against it, the ultimate disposition of which would have a material adverse effect on the Company.

**NOTE i—ACCOUNTING FOR EQUITY-BASED COMPENSATION****Grants for Three Months ended September 30, 2013:**

The weighted-average estimated fair value of restricted stock units (“RSUs”) granted during the three months ended September 30, 2014 and September 30, 2013 was \$8.87 and \$7.58 per share with the following weighted-average assumptions (annualized percentages):

|                            | Three<br>months<br>ended<br>September<br>30, 2014 | Three<br>months<br>ended<br>September<br>30, 2013 |
|----------------------------|---|---|
| Pre-vest cancellation rate | 4.57%   | 3.66%   |

**Employee Stock Benefit Plans**

As of September 30, 2013, the Company had two equity incentive plans from which the Company may grant future equity awards and three expired equity incentive plans from which no future equity awards may be granted but had outstanding equity awards granted prior to expiration. The Company also had one employee stock purchase plan. As of September 30, 2014, approximately 404,000 shares of common stock remain available for grant under the Company’s employee stock purchase plan and 566,000 shares of common stock remain available for grant under the Company’s equity incentive plans.

The table below presents a summary of information relating to the Company's stock option, SAR and RSU grants pursuant to its equity incentive plans:

|   | Number of<br>Options/SARs/RSUs | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(years) (3) | Aggregate Value<br>(*)  |
|---|--------------------------------|--|--|-------------------------|
|   | <b>in thousands</b>            |  |  | <b>in<br/>thousands</b> |
| Outstanding at June 30, 2014                    | 6,173                          | \$ 7.20                                  |  |                         |
| RSUs granted                                    | 5                              | -  |  |                         |
| Options / SARs/RSUs cancelled/forfeited/expired | (89                            | ) \$ 17.49                               |  |                         |
| Options / SARs / RSUs exercised                 | (153                           | ) \$ 4.89                                |  |                         |
| Outstanding at September 30, 2014 (1)           | 5,937                          | \$ 7.10                                  | 3.02   | \$ 13,853               |
| Exercisable at September 30, 2014 (2)           | 4,233                          | \$ 8.28                                  | 2.35   | \$ 5,738                |

(\*) Calculation of aggregate intrinsic value is based on the share price of the Company's common stock on September 30, 2014 (\$8.87 per share).

(1) Due to the ceiling imposed on the SAR grants, the outstanding amount equals to a maximum of 4,432 shares of the Company's common stock issuable upon exercise. SAR grants made prior to January 1, 2009 are convertible for a maximum number of shares of the Company's common stock equal to 50% of the SAR units subject to the grant. SAR grants made on or after January 1, 2009 and before January 1, 2010 are convertible for a maximum number of shares of the Company's common stock equal to 75% of the SAR units subject to the grant. SAR grants made on or after January 1, 2010 and before January 1, 2012 are convertible for a maximum number of shares of the Company's common stock equal to 66.67% of the SAR units subject to the grant. SAR grants made on or after January 1, 2012 are convertible for a maximum number of shares of the Company's common stock equal to 50% of the SAR units subject to the grant.

(2) Due to the ceiling imposed on the SAR grants, the currently exercisable amount equals to a maximum of 2,920 shares of the Company's common stock exercisable.

(3) Calculation of weighted average remaining contractual term does not include the RSUs that were granted, which have an indefinite contractual term.

Additional information about stock options, SARs and RSUs outstanding and exercisable at September 30, 2014 with exercise prices above \$8.87 per share (the closing price of the Company's common stock on September 30, 2014) is as follows (in thousands, except per share amounts):

| Exercise Prices  | Exercisable  |  | Unexercisable  |  | Total  |  |
|------------------|--|--|--|--|--|--|
|                  | Number<br>of<br>Options/<br>SARs/<br>(in<br>thousands) | Weighted<br>Average<br>Exercise<br>Price<br>(\$) | Number<br>of<br>Options/<br>SARs/<br>(in<br>thousands) | Weighted<br>Average<br>Exercise<br>Price<br>(\$) | Number<br>of<br>Options/<br>SARs/<br>(in<br>thousands) | Weighted<br>Average<br>Exercise<br>Price<br>(\$) |
| Above \$8.87     | 1,373  | \$ 11.22   | 124  | \$ 9.71  | 1,497  | \$ 11.09   |
| Less than \$8.87 | 2,860  | \$ 6.86  | 1,580  | \$ 3.73  | 4,440  | \$ 5.75  |
| Total            | 4,233  | \$ 8.28  | 1,704  | \$ 4.17  | 5,937  | \$ 7.10  |

The Company's aggregate equity-based compensation expense for the three months ended September 30, 2014 and 2013 totaled \$1,296 and \$1,045, respectively. The Company did not recognize any income tax benefits relating to its equity-based compensation expense for the three months ended September 30, 2014 and 2013.

The Company's aggregate equity-based compensation expenses for the nine months ended September 30, 2014 and 2013 totaled \$4,200 and \$3,133, respectively. The Company did not recognize any income tax benefits relating to its equity-based compensation expense for the nine months ended September 30, 2014 and 2013.

As of September 30, 2014, there was \$3,488 of total unrecognized equity-based compensation expenses related to unvested equity-based compensation awards granted under the Company's equity incentive plans. This amount is expected to be recognized during the period from the remainder of 2014 through 2018.

#### **NOTE j—Pension Liability**

The information in this note represents the net periodic pension and post-retirement benefit costs and related components in accordance with FASB ASC No. 715 "Employers' Disclosures about Pensions and Other Post-Retirement Benefits." The components of net pension and post-retirement periodic benefit cost (income) for the nine months ended September 30, 2014 and 2013 are as follows (in thousands):

|   | September<br>30, 2014 | September<br>30, 2013 |
|---|-----------------------|-----------------------|
| Components of net periodic benefit cost |                       |                       |
| Service cost                            | \$ 12                 | \$ 13                 |
| Interest cost                           | 22                    | 27                    |
| Expected return on plan assets          | (4 )                  | (7 )                  |
| Net periodic benefit cost               | <b>\$ 30</b>          | <b>\$ 33</b>          |

The net pension liability as of September 30, 2014 amounted to \$927.

#### **NOTE K—FAIR VALUE MEASUREMENTS**

##### **Assets and Liabilities Measured at Fair Value on a Recurring Basis:**

The Company measures its cash equivalents, short-term deposits, marketable securities and foreign currency derivative contracts at fair value. Cash equivalents, short-term deposits and marketable securities are classified within Level 1 or Level 2 value hierarchies as they are valued using quoted market prices or alternative pricing sources and models utilizing market observable inputs. Foreign currency derivative contracts are classified within Level 2 value hierarchy as the valuation inputs are based on quoted prices and market observable data of similar instruments.

The following table provides information by value level for assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2014:

| Description  | Balance<br>as of<br>September<br>30,<br>2014 | Fair Value<br>Measurements |           |            |
|--|--|----------------------------|-----------|------------|
|  |  | Level<br>1                 | Level 2   | Level<br>3 |
| <b>Assets:</b>   |  |                            |           |            |
| <b>Cash equivalents:</b>                                   |  |                            |           |            |
| Time deposits  | \$ 572                                       | -                          | \$572     | -          |
| Money market mutual funds                                  | \$ 1,828                                     | \$1,828                    | -         | -          |
| <b>Short-term marketable securities and cash deposits:</b> |  |                            |           |            |
| Corporate debt securities                                  | \$ 6,520                                     | -                          | \$6,520   | -          |
| Time deposits  | \$ 2,755                                     | -                          | \$2,755   | -          |
| <b>Long-term marketable securities:</b>                    |  |                            |           |            |
| U.S. GSE securities  | \$ 4,317                                     | -                          | \$4,317   | -          |
| Corporate debt securities                                  | \$ 88,897                                    | -                          | \$88,897  | -          |
| <b>Derivative liabilities</b>                              | \$ (424 )                                    | -                          | \$ (424 ) | -          |

The following table provides information by value level for assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2013:

| Description               | Balance as<br>of<br>December<br>31,<br>2013 | Fair Value<br>Measurements |         |            |
|---------------------------|---|----------------------------|---------|------------|
|                           |   | Level<br>1                 | Level 2 | Level<br>3 |
| <b>Assets:</b>            |   |                            |         |            |
| <b>Cash equivalents:</b>  |   |                            |         |            |
| Time deposits             | \$ 913                                      | -                          | \$ 913  | -          |
| Money market mutual funds | \$ 3,762                                    | \$3,762                    | -       | -          |



**Short-term marketable securities and time deposits:**

|                           |           |   |           |   |
|---------------------------|-----------|---|-----------|---|
| U.S. GSE securities       | \$ 251    | - | \$ 251    | - |
| Corporate debt securities | \$ 10,733 | - | \$ 10,733 | - |
| Time deposits             | \$ 2,911  | - | \$ 2,911  | - |

**Long-term marketable securities:**

|                           |           |   |           |   |
|---------------------------|-----------|---|-----------|---|
| U.S. GSE securities       | \$ 2,831  | - | \$ 2,831  | - |
| Corporate debt securities | \$ 87,331 | - | \$ 87,331 | - |

In addition to the assets and liabilities described above, the Company's financial instruments also include cash and cash equivalents, restricted and short-term deposits, trade receivables, other accounts receivable, trade payables, accrued expenses and other payables. The fair value of these financial instruments was not materially different from their carrying values at September 30, 2014 due to the short-term maturity of these instruments.

#### **NOTE I—STOCKHOLDERS' EQUITY**

During the first nine months of 2014, the Company repurchased 1,414,226 shares of common stock at an average purchase price of \$8.83 per share for an aggregate purchase price of \$12,484. As of September 30, 2014, 1,203,601 shares of common stock remained authorized for repurchase under the Company's board-authorized share repurchase program.

Repurchases of common stock are accounted for as treasury stock, and result in a reduction of stockholders' equity. When treasury shares are reissued, the Company accounts for the reissuance in accordance with Accounting Principles Board Opinion No. 6, "Status of Accounting Research Bulletins" and charges the excess of the repurchase cost over issuance price using the weighted average method to accumulated deficit. In the case where the repurchase cost over issuance price using the weighted average method is lower than the issuance price, the Company credits the difference to additional paid-in capital.

During the first nine months of 2014, the Company issued approximately 605,000 shares of common stock out of treasury stock to employees who exercised their stock options, SARs or RSUs, or purchased shares from the Company's 1993 Employee Stock Purchase Plan.

#### **note M—SEGMENT INFORMATION**

##### **Description of segments:**

The Company operates under three reportable segments.

The Company's segment information has been prepared in accordance with ASC 280, "Segment Reporting." Operating segments are defined as components of an enterprise engaging in business activities about which separate financial information is available that is evaluated regularly by the Company's chief operating decision-maker

(“CODM”) in deciding how to allocate resources and assess performance. The Company's CODM is its Chief Executive Officer, who evaluates the Company's performance and allocates resources based on segment revenues and operating income.

The Company's operating segments are as follows: Home, Office and Mobile. The classification of the Company's business segments is based on a number of factors that management uses to evaluate, view and run its business operations, which include, but are not limited to, customer base, homogeneity of products and technology.

A description of the types of products provided by each business segment is as follows:

Home - Wireless chipset solutions for converged communication at home. Such solutions include integrated circuits targeted for cordless phones sold in retail or supplied by telecommunication service providers, residential gateway devices supplied by telecommunication service providers which integrate the DECT/CAT-iq functionality and also address home automation applications, as well as fixed-mobile convergence solutions.

Office - Comprehensive solution for Voice-over-IP (VOIP) office products, including office solutions that offer businesses of all size low-cost VOIP terminals with converged voice and data applications.

Mobile - Products for the mobile market that provides voice enhancement and far-end noise elimination targeted for mobile phone and mobile headsets.

**Segment data:**

The Company derives the results of its business segments directly from its internal management reporting system and by using certain allocation methods. The accounting policies the Company uses to derive business segment results are substantially the same as those the Company uses for consolidation of its financial statements. The CODM measures the performance of each business segment based on several metrics, including earnings from operations. The CODM uses these results, in part, to evaluate the performance of, and to assign resources to, each of the business segments. The Company does not allocate to its business segments certain operating expenses, which it manages separately at the corporate level. These unallocated costs include primarily restructuring charges, amortization of purchased intangible assets, equity-based compensation expenses, proxy contest related expenses incurred during the second quarter of 2013 and certain corporate governance costs.

Selected operating results information for each business segment was as follows for the three months ended September 30, 2014 and 2013:

| <b>Three months ended September 30</b> |             |                      |             |
|--|-------------|----------------------|-------------|
|  |             | <b>Income (loss)</b> |             |
| <b>Revenues</b>                        |             | <b>from</b>          |             |
|  |             | <b>operations</b>    |             |
| <b>2014</b>                            | <b>2013</b> | <b>2014</b>          | <b>2013</b> |

|               |          |          |           |           |
|---------------|----------|----------|-----------|-----------|
| <b>Home</b>   | \$32,292 | \$33,492 | \$5,957   | \$5,381   |
| <b>Office</b> | \$4,353  | \$1,889  | \$(252 )  | \$(731 )  |
| <b>Mobile</b> | \$70     | \$-      | \$(2,910) | \$(2,609) |
| <b>Total</b>  | \$36,715 | \$35,381 | \$2,795   | \$2,041   |

Selected operating results information for each business segment was as follows for the nine months ended September 30, 2014 and 2013:

|               | Nine months ended September 30 |           | Income (loss)   |            |
|---------------|--------------------------------|-----------|-----------------|------------|
|               | Revenues                       |           | from operations |            |
|               | 2014                           | 2013      | 2014            | 2013       |
| <b>Home</b>   | \$95,492                       | \$109,146 | \$16,851        | \$19,650   |
| <b>Office</b> | \$10,315                       | \$6,577   | \$(985 )        | \$(4,321 ) |
| <b>Mobile</b> | \$70                           | \$-       | \$(8,865 )      | \$(7,369 ) |
| <b>Total</b>  | \$105,877                      | \$115,723 | \$7,001         | \$7,960    |

The reconciliation of segment operating results information to the Company's consolidated financial information was as follows for the three and nine months ended September 30, 2014:

|  | <b>Three<br/>months</b> | <b>Nine<br/>months</b> |
|--|-------------------------|------------------------|
| Income from operations                                     | \$ 2,795                | \$ 7,001               |
| Unallocated corporate, general and administrative expenses | (526 )                  | (1,657 )               |
| Equity-based compensation expenses                         | (1,296 )                | (4,200 )               |
| Intangible assets amortization expenses                    | (397 )                  | (1,191 )               |
| Financial income, net                                      | 186                     | 895                    |
| Total consolidated income before taxes                     | \$ 762                  | \$ 848                 |

The reconciliation of segment operating results information to the Company's consolidated financial information was as follows for the three and nine months ended September 30, 2013:

|  | <b>Three<br/>months</b> | <b>Nine<br/>months</b> |
|--|-------------------------|------------------------|
| Income from operations   | \$ 2,041                | \$ 7,960               |
| Unallocated corporate, general and administrative expenses                     | (681 )                  | (1,770 )               |
| Proxy contest related expenses included in general and administrative expenses | -                       | (1,403 )               |
| Equity-based compensation expenses   | (1,045 )                | (3,133 )               |
| Intangible assets amortization expenses  | (418 )                  | (1,254 )               |
| Financial income, net  | 512                     | 1,837                  |
| Total consolidated income before taxes   | \$ 409                  | \$ 2,237               |

**NOTE N —ACCUMULATED OTHER COMPREHENSIVE INCOME(LOSS)**

The following table summarizes the changes in accumulated balances of other comprehensive income (loss) for the three months ended September 30, 2014:

|   | Unrealized<br>gains (losses)<br>on<br>available-for-sale<br>marketable<br>securities | Unrealized<br>gains<br>(losses)<br>on<br>Cash<br>Flow<br>Hedges | Unrealized<br>gains<br>(losses)<br>on<br>components<br>of defined<br>benefit<br>plans | Unrealized<br>gains<br>(losses)<br>on<br>foreign<br>currency<br>translation | Total     |
|---|--|---|---|---|-----------|
| Beginning balance   | \$ (186 )  | \$ 7 )  | \$ (232 )   | \$ (198 )   | \$(609 )  |
| Other comprehensive income (loss) before reclassifications              | (404 )   | (528 )  | -   | 5   | (927 )    |
| Amounts reclassified from accumulated other comprehensive income (loss) | 3  | 97  | 3   | -   | 103       |
| Net current period other comprehensive income (loss)                    | (401 )   | (431 )  | 3   | 5   | (824 )    |
| Ending balance  | \$ (587 )  | \$ (424 )   | \$ (229 )   | (193 )  | \$(1,433) |

The following table provides details about reclassifications out of accumulated other comprehensive income for the three months ended September 30, 2014:

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive | Affected Line Item in the<br>Statement of Income (Loss) |
|--|---|---|
|  |   |   |

|  | <b>Income (Loss)</b><br><b>(In millions)</b> |                            |
|--|--|----------------------------|
| Loss on available-for-sale marketable securities | \$ 3   | Financial income, net      |
|  | -  | Provision for income taxes |
|  | 3  | Total, net of income taxes |
| Losses on cash flow hedges -                     |  |                            |
|  | 77   | Research and development   |
|  | 7  | Sales and marketing        |
|  | 13   | General and administrative |
|  | 97   | Total, before income taxes |
|  | -  | Provision for income taxes |
|  | 97   | Total, net of income taxes |
| Losses on components of defined benefit plans    | 2  | Research and development   |
|  | 1  | Sales and marketing        |
|  | 3  | Total, before income taxes |
|  | -  | Provision for income taxes |
|  | 3  | Total, net of income taxes |
| Total reclassifications for the period           | 103  | Total, net of income taxes |



The following table summarizes the changes in accumulated balances of other comprehensive income (loss) for the nine months ended September 30, 2014:

|   | <b>Unrealized gains (losses) on available-for-sale marketable securities</b> | <b>Unrealized gains (losses) on Cash Flow Hedges</b> | <b>Unrealized gains (losses) on components of defined benefit plans</b> | <b>Unrealized gains (losses) on foreign currency translation</b> | <b>Total</b> |
|---|--|--|---|--|--------------|
| Beginning balance   | \$ (391 )  | \$ -   | \$ (237 )   | \$ (193 )  | \$ (821 )    |
| Other comprehensive income (loss) before reclassifications              | (134 )   | (516 )   | -   | (1 )   | (651 )       |
| Amounts reclassified from accumulated other comprehensive income (loss) | (62 )  | 92   | 9   | -  | 39           |
| Net current period other comprehensive income (loss)                    | (196 )   | (424 )   | 9   | (1 )   | (612 )       |
| Ending balance  | \$ (587 )  | \$ (424 )  | \$ (228 )   | (194 )   | \$ (1,433 )  |

The following table provides details about reclassifications out of accumulated other comprehensive income (loss) for the nine months ended September 30, 2014:

| <b>Details about Accumulated Other Comprehensive Income (Loss) Components</b> | <b>Amount</b> | <b>Reclassified from Accumulated Other Comprehensive Income (Loss)</b> | <b>Affected Line Item in the Statement of Income</b> |
|---|---------------|--|--|
| Gains on available-for-sale marketable securities                             | \$ (62 )      |  | Financial income, net                                |
|   | -             |  | Provision for income taxes                           |
|   | (62 )         |  | Total, net of income taxes                           |

|   |    |                            |
|---|----|----------------------------|
| Gains on cash flow hedges                     | 72 | Research and development   |
|   | 7  | Sales and marketing        |
|   | 13 | General and administrative |
|   | 92 | Total, before income taxes |
|   | -  | Provision for income taxes |
|   | 92 | Total, net of income taxes |
| Losses on components of defined benefit plans | 5  | Research and development   |
|   | 4  | Sales and marketing        |
|   | 9  | Total, before income taxes |
|   | -  | Provision for income taxes |
|   | 9  | Total, net of income taxes |
| Total reclassifications for the period        | 39 | Total, net of income taxes |

## NOTE O – GOVERNMENT GRANTS

Government grants received by the Company's Israeli subsidiary relating to categories of operating expenditures are credited to the consolidated statements of income during the period in which the expenditure to which they relate is charged. Royalty and non-royalty-bearing grants from the Israeli Office of the Chief Scientist ("OCS") for funding certain approved research and development projects are recognized at the time when the Company's Israeli subsidiary is entitled to such grants, on the basis of the related costs incurred, and are included as a deduction from research and development expenses, net.

The Company recorded grants in the amount of \$460 and \$1,200 for the three months ended September 30, 2014 and 2013, respectively.

The Company recorded grants in the amount of \$2,500 and \$1,260 for the nine months ended September 30, 2014 and 2013, respectively.

The Company's Israeli subsidiary is obligated to pay royalties amounting to 5% of the sales of certain products the development of which received grants from the OCS in previous years. The obligation to pay these royalties is contingent on actual sales of such products. Grants received from the OCS may become repayable if certain criteria under the grants are not met. In addition, the Company may be required to repay up to six times the amount of the grants if the technology that was developed using those grants is sold directly or indirectly.

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

*This report and certain information incorporated herein by reference contain forward-looking statements, which are provided under the "safe harbor" protection of the Private Securities Litigation Reform Act of 1995. All statements included or incorporated by reference in this report, other than statements that are purely historical in nature, are forward-looking statements. Forward-looking statements are generally written in the future tense and/or are preceded by words such as "will," "may," "should," "could," "expect," "suggest," "believe," "anticipate," "intend," "plan," or other similar words. Forward-looking statements include statements regarding:*

*Our belief that sales of our DECT products will continue to represent a substantial percentage of our revenues for the rest of 2014;*

*Our belief that our past research and development investments in new technologies are beginning to materialize;*

*Our belief that with the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, the traditional cordless telephony market using fixed-line telephony is declining and will continue to decline, which could reduce our revenues derived from, and unit sales of, cordless telephony products;*

*Our belief that the market will remain price sensitive for our traditional cordless telephony products and expect that price erosion and the decrease in the average selling prices of such products to continue;*

*Our intention to leverage our strong technology base and customer relationships to maximize growth and revenue opportunities for our new products;*

*Our anticipation that annual revenues generated from our new products to increase significantly in 2014 as compared to 2013;*

*Our belief that commercial shipments of products incorporating our new products will continue during the rest of 2014;*

*Our belief that we are well positioned to achieve our 2014 key design and financial milestones, as well as return to revenue growth in both the fourth quarter and 2015 fiscal year; and*

*Our belief that our available cash and cash equivalents at September 30, 2014 should be sufficient to finance our operations for the foreseeable future.*

*All forward-looking statements included in this Quarterly Report on Form 10-Q are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement. Many factors may cause actual results to differ materially from those expressed or implied by the forward-looking statements contained in this report. These factors include, but are not limited to, our dependence on one primary distributor, our OEM relationships and competition, as well as those risks described in Part II – Item 1A – “Risk Factors” of this Form 10-Q.*

*This Quarterly Report on Form 10-Q includes trademarks and registered trademarks of DSP Group. Products or service names of other companies mentioned in this Quarterly Report on Form 10-Q may be trademarks or registered trademarks of their respective owners.*

*DSP Group, Inc. is referred to in this Quarterly Report as “DSP Group,” “we,” “us” “our” or “company.”*

## **Overview**

The following discussion and analysis is intended to provide investors with a narrative of our financial results and an evaluation of our financial condition and results of operations. The discussion should be read in conjunction with our condensed consolidated financial statements and notes thereto.

### *Business Overview*

DSP Group is a leading global provider of wireless chipset solutions for converged communications, delivering system solutions that combine semiconductors and software with reference designs. We provide a broad portfolio of wireless chipsets integrating DECT, Wi-Fi, PSTN and VOIP technologies with state-of-the-art application processors. We also enable converged voice, audio and data connectivity across diverse consumer products – from cordless and VOIP phones to home gateways and connected multimedia screens. A majority of our revenues is derived from products targeted for digital cordless telephony. Such revenues currently represent approximately 79% of our total revenues for the first nine months of 2014.

Our total revenues were \$36.7 million for the third quarter of 2014, an increase of 4%, in comparison to \$35.4 million for the same period in 2013. The increase for the third quarter of 2014 was primarily as a result of increased sales of our VoIP, home gateways and home automation products, offset to some extent by the decrease in sales of our DECT and 2.4GHz cordless telephony products. Our revenues were \$105.9 million for the first nine months of 2014, a decrease of 9.0% in comparison to the same period of 2013. The decrease in our revenues for the first nine months of 2014 in comparison to the same period of 2013 was mainly due to a decrease in sales of cordless telephony products for the U.S. and European markets, offset to some extent by an increase in cordless telephony product sales for the Japanese domestic markets and VOIP, home gateways and home automation products sales. Revenues derived from the sale of DECT products represented 82% of our total revenues for the first nine months of 2014, as compared to 83% of our total revenues for the first nine months of 2013. Revenues derived from the sale of cordless telephony products represented 79% of our total revenues for the first nine months of 2014, as compared to 85% of our total revenues for the first nine months of 2013. Our gross margin increased to 40.0% of our total revenues for the first nine months of 2014 from 39.5% for the first nine months of 2013, primary due to (i) an improvement in production yield and direct contribution of certain of our products as a result of lower cost structure for production of such products, and (ii) a change in the mix of products sold and customers. We had no operating income for the first nine months of 2014 as compared to an operating income of \$0.4 million for the first nine months of 2013. The decrease in operating income was mainly as a result of the decrease in total revenues for the first nine months of 2014, as compared to the first nine months of 2013, offset to some extent by a decrease in operating expenses and an increase in gross profit during the first nine months of 2014 as compared to the first nine months of 2013. Our operating expenses decreased by 6% to \$42.4 million for the first nine months of 2014, as compared to \$45.3 million for the first nine months of 2013.

Notwithstanding our return to revenue growth in the third quarter of 2014 and our success in reducing our operating expenses, we expect that our financial condition will continue to be challenged by the steady decline of the cordless telephony market and the continuing decline in the average selling prices of cordless telephony products. The cordless telephony market is undergoing a challenging period. With the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, the traditional cordless telephony market using fixed-line telephony will continue to decline, which will continue to reduce our revenues derived from, and unit sales of, cordless telephony products. Furthermore, our business also may be significantly affected by the outcome of the competition between cellular phone operators and fixed-line operators for the provision of residential communication. A significant majority of our revenues are currently generated from sales of chipsets used in cordless phones that are based on fixed-line telephony. If we are unable to develop new technologies to address alternative connectivity methods, our business could be materially adversely affected.

Therefore, in order to increase our revenues and offset the steady decline in revenues generated from our cordless telephony products, we need to introduce new products and penetrate new markets. We intend to leverage our strong technology base and customer relationships to maximize growth and revenue opportunities for our new products.

We see that our past research and development investments in new technologies are beginning to materialize. We have achieved a number of design wins for our new products. Commercial shipments for some new products have begun with more shipments to occur during the rest of 2014. Aggregate revenues derived from our new products were 21.0% and 14.7% of our total revenues for the first nine months of 2014 and 2013, respectively. Based on a strong pipeline of

design wins, our current mix of new products and anticipated commercialization schedules of customers incorporating our new products, we anticipate annual revenues generated from our new products to increase significantly in 2014 as compared to 2013. Moreover, we believe we are well positioned to achieve our 2014 key design and financial milestones, as well as return to revenue growth in both the fourth quarter and 2015 fiscal year.

However, we can provide no assurances about our success in introducing new products and penetrating new markets, as well as our predictions regarding market trends. For example, although a number of potential customers have expressed interest, we have not yet achieved a design win for our HDClear product for mobile devices. Furthermore, although new products targeted at the home control & automation and enterprise VOIP solutions are gradually being introduced into the market, market adoption of such products is at early stages and may require us to increase our research and development spending to capitalize on opportunities in these markets. As an example, we expect our research and development spending to increase in the fourth quarter of 2014 as compare to the last three quarters of 2014. Although we have achieved a number of design wins with top-tier OEMs for new products, revenue generated from the commercialization of new products is a measured process as there is generally a long lead time from a design win to commercialization. From initial product design win to volume production, many factors could impact the timing and/or amount of sales actually realized from the design win. In addition to general price sensitive and price erosion in the markets we operate, the introduction of new productions may accelerate price erosion of older products. As a result, we expect the market to remain price sensitive for our traditional cordless telephony products and expect that price erosion and the decrease in the average selling prices of such products to continue. Furthermore, various other factors, including increases in the cost of raw materials and commodities and our suppliers passing such increases onto us, increases in silicon wafer costs and increases in production, assembly and testing costs, and shortage of capacity to fulfill our fabrication, assembly and testing needs, all may decrease our gross profit and harm our ability to grow our revenues in future periods.

As of September 30, 2014, our principal source of liquidity consisted of cash and cash equivalents of \$14.5 million and marketable securities and short term deposits of \$102.5 million, totaling \$117.0 million.

## **RESULTS OF OPERATIONS**

**Total Revenues.** Our total revenues were \$36.7 million for the third quarter of 2014, as compared to \$35.4 million for the same period in 2013. Our total revenues were \$105.9 million for the first nine months of 2014, as compared to \$115.7 million for the same period in 2013. The increase for the third quarter of 2014 was primarily as a result of increased sales of our VoIP, home gateways and home automation products, offset to some extent by the decrease in sales of our DECT and 2.4GHz cordless telephony products. The decrease for the first nine months of 2014 was primarily as a result of decreased sales of our DECT and 2.4GHz cordless telephony products, offset to some extent by increased sales of cordless telephony product for the Japanese domestic markets, and increased sales of VoIP, home gateways and home automation products. Sales of DECT products, which include cordless telephony, home gateways and home automation products for the third quarter of 2014 and 2013 were \$29.5 million and \$29.4 million, respectively, representing 80% and 83% of our total revenues for the respective periods. Sales of DECT products, which include cordless telephony, home gateways and home automation products, for the first nine months of 2014 and 2013 were \$86.4 million and \$96.5 million, respectively, representing 82% and 83%, respectively, of our total revenues for the respective periods, representing a decrease of 10% in absolute dollars when comparing sales for the first nine months of 2014 to sales for the first nine months of 2013.



The above mentioned decrease in sales of our cordless telephony products for the third quarter and the first nine months of 2014, as compared to the same period in 2013, was mainly attributable to a decline in market demand. Sales of DECT 6.0 products for the U.S. market decreased to \$35.6 million for the first nine months of 2014 from \$42.9 million for the first nine months of 2013, representing 34% and 37% of our total revenues for the first nine months of 2014 and 2013, respectively. Sales of DECT products for the European market decreased to \$38.5 million for the first nine months of 2014 from \$44.2 million for the first nine months of 2013, representing 36% and 38% of our total revenues for the first nine months of 2014 and 2013, respectively.

The following table shows the breakdown of revenues for all product lines for the periods indicated by geographic location based on the geographic location of our customers (in thousands):

|                | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|----------------|---------------------------|-------------|--------------------------|-------------|
|                | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                | <b>2014</b>               | <b>2013</b> | <b>2014</b>              | <b>2013</b> |
| United States  | \$1,528                   | \$805       | \$3,487                  | \$3,586     |
| Japan          | 8,734                     | 9,237       | 23,742                   | 25,981      |
| Europe         | 1,529                     | 1,334       | 4,552                    | 5,263       |
| Hong-Kong      | 19,140                    | 19,380      | 58,136                   | 66,664      |
| China          | 1,381                     | 1,662       | 4,614                    | 5,349       |
| Taiwan         | 3,155                     | 1,650       | 7,416                    | 5,299       |
| Other          | 1,248                     | 1,313       | 3,930                    | 3,581       |
| Total revenues | \$36,715                  | \$35,381    | \$105,877                | \$115,723   |

Sales to our customers in Hong Kong decreased for the third quarter and the first nine months of 2014, as compared to the same periods of 2013, representing a 1% and 13% decrease in absolute dollars, respectively. The decrease in our sales to Hong Kong for the first nine months of 2014, as compared to the same periods of 2013, resulted mainly from a decrease in sales to VTech Holdings Ltd. (“VTech”), representing a 9% decrease in absolute dollars and a decrease in sales to CCT Telecom Holdings Ltd. (“CCT Telecom”), representing a 23% decrease in absolute dollars. Sales to our customers in Japan decreased for the third quarter and the first nine months of 2014, as compared to the same periods of 2013, representing a 5% and 9% decrease, respectively, in absolute dollars. The decrease in our sales to Japan for the first nine months, as compared to the same period of 2013, resulted from a decrease in sales to Uniden America Corporation, representing a 65% decrease in absolute dollars. The decrease in our sales to Japan for the third quarter of 2014, as compared to the same period of 2013, resulted from a decrease in sales to Panasonic Communications Co., Ltd. (“Panasonic”) and Japan Domestic customers, representing a 3% and 15% decrease in absolute dollars, respectively.

As our products are generally incorporated into consumer electronics products sold by our OEM customers, our revenues are affected by seasonal buying patterns of consumer electronics products sold by our OEM customers that incorporate our products.

**Significant Customers.** VTech is a significant OEM customer based in Hong Kong. Sales to VTech represented 34% and 35% of our total revenues for the three months ended September 30, 2014 and 2013, respectively. Sales to VTech represented 36% of our total revenues for both the nine months ended September 30, 2014 and 2013.

Revenues derived from sales through our largest distributor, Tomen Electronics Corporation (“Tomen Electronics”) accounted for 22% and 24% of our total revenues for the three months ended September 30, 2014 and 2013, respectively. Revenues derived from sales through Tomen Electronics accounted for 21% and 18% of our total revenues for the nine months ended September 30, 2014 and 2013, respectively.

Tomen Electronics sells our products to a limited number of customers. One customer, Panasonic, has continually accounted for a majority of sales through Tomen Electronics. Sales to Panasonic through Tomen Electronics generated 17% and 18% of our total revenues for the three months ended September 30, 2014 and 2013, respectively. Sales to Panasonic through Tomen Electronics generated 15% and 13% of our total revenues for the nine months ended September 30, 2014 and 2013, respectively.

**Significant Products.** Revenues from our DECT products, which include cordless telephony, home gateways and home automation products, represented 80% and 82% of our total revenues for the three and nine months ended September 30, 2014, respectively. Revenues from our DECT products represented 83% of our total revenues for both the three and nine months ended September 30, 2013. We believe that sales of DECT products will continue to represent a substantial percentage of our revenues for the remainder of 2014. We believe that the rapid deployment of new communication access methods, as well as the lack of growth in fixed-line telephony, will reduce our total revenues derived from, and unit sales of, cordless telephony products, for the short and long term. Revenues from our VoIP products represented 12% and 10% of our total revenues for the three and nine months ended September 30, 2014, respectively. Revenues from our VoIP products represented 5% of our total revenues for the both three and nine months ended September 30, 2013.

**Gross Profit.** Gross profit as a percentage of revenues was 39.6% for the third quarter of 2014 and 39.0% for the third quarter of 2013. Gross profit as a percentage of revenues was 40.0% for the first nine months of 2014 and 39.5% for the first nine months of 2013. The increase in our gross profit for the third quarter of 2014 as compared to the third quarter of 2013 was mainly due to (i) an increase in total revenues, (ii) an improvement in the production yield and direct contribution of certain of our products as a result of lower cost structure for production of such products, and (iii) a change in the mix of products sold and customers. The increase in our gross profit for the first nine months of 2014 as compared to the first nine months of 2013 was mainly due to (i) an improvement in the production yield and direct contribution of certain of our products as a result of lower cost structure for production of such products, and (ii) a change in the mix of products sold and customers, offset to some extent by the decrease in total revenues for the first nine months of 2014 as compared to the first nine months of 2013.

As gross profit reflects the sale of chips and chipsets that have different margins, changes in the mix of products sold and customers have impacted and will continue to impact our gross profit in future periods. Our gross profit may decrease in the future due to a variety of factors, including the continued decline in the average selling prices of our products, changes in the mix of products sold and customers, our failure to achieve cost reductions, roll-out of new products in any given period, our success in introducing new engineering processes to reduce manufacturing costs, increases in the cost of raw materials such as gold, oil and silicon wafers, and increases in production, assembly and testing costs. Moreover, our suppliers may pass the increase in the cost of raw materials and commodities onto us which would further reduce the gross margins of our products. There are no guarantees that our ongoing efforts in cost reduction and yield improvements will keep pace with the anticipated continuing decline in average selling prices of our products.

Cost of goods sold consists primarily of costs of wafer manufacturing and fabrication, assembly and testing of integrated circuit devices and related overhead costs, and compensation and associated expenses related to manufacturing and testing support, inventory obsolescence and logistics personnel.

***Research and Development Expenses, net.*** Our research and development expenses, net, were \$8.1 million for both the third quarter of 2014 and 2013. Research and development expenses, net, decreased to \$24.3 million for the first nine months of 2014 from \$26.5 million for the first nine months of 2013. The decrease for the first nine months of 2014 in research and development expenses, net, as compared to the comparable period of 2013, was mainly due to (i) funding received from the Israeli Office of the Chief Scientist (“OCS”) in the amount of \$2.5 million for the first nine months of 2014, following the receipt of an approval from the OCS during the first quarter of 2014 for the current year research and development programs and some residual funding that was approved in respect to 2013 programs. During the first nine months of 2013, such funding recognized in research and development expenses amounted to \$1.3 million. Additionally, the decrease was attributable to: (i) a decrease in projects-related expenses (mainly tape out and IP expenses) in the amount of \$1.4 million, and (ii) a decrease in depreciation expenses in the amount of \$0.4 million.

The above mentioned decreases were offset to some extent by (i) an increase in labor and employee-related expenses in the amount of \$0.4 million for the first nine months of 2014, as compared to the same period in 2013, mainly as a result of the devaluation of the U.S. dollar against the NIS, which increased our Israeli employee labor expenses, and (ii) an increase in equity-based compensation expenses in the amount of \$0.5 million for the first nine months of 2014, as compared to the same period in 2013.

Our research and development expenses, net, as a percentage of our total revenues were 22% and 23% for the three months ended September 30, 2014 and 2013, respectively, and 23% for both the nine months ended September 30, 2014 and 2013. The decrease in research and development expenses, net, as a percentage of our total revenues for the three months ended September 30, 2014 as compared to 2013 was mainly due to the decrease in research and development expenses, net, for the comparable periods, as well as the increase in absolute dollars of our total revenues for the three months ended September 30, 2014 as compared to the three months ended September 30, 2013. Research and development expenses consist mainly of payroll expenses to employees involved in research and development activities, expenses related to tape out and mask work, subcontracting, labor contractors and engineering expenses, depreciation and maintenance fees related to equipment and software tools used in research and development, and facilities expenses associated with and allocated to research and development activities.

***Sales and Marketing Expenses.*** Our sales and marketing expenses increased to \$2.9 million for the third quarter of 2014 from \$2.8 million for the third quarter of 2013. Sales and marketing expenses increased to \$8.9 million for the first nine months of 2014 from \$8.5 million for the first nine months of 2013. The increase in sales and marketing expenses for the third quarter and the first nine months of 2014, as compared to the comparable periods during 2013, was mainly attributable to an increase in labor and employee-related expenses, mainly due to an increase in employee's sales commissions and the devaluation of the U.S. dollar against the NIS, which increased our Israeli employee labor expenses.

Our sales and marketing expenses as a percentage of total revenues were 8% for both the three months ended September 30, 2014 and 2013, and 8% and 7% for the nine months ended September 30, 2014 and 2013, respectively. The increase in sales and marketing expenses as a percentage of our total revenues for the nine months ended September 30, 2014 as compared to the same period in 2013 was due to the decrease in total revenues and an increase in absolute dollars of sales and marketing expenses for the first nine months of 2014 as compared to 2013.

Sales and marketing expenses consist mainly of sales commissions, payroll expenses to direct sales and marketing employees, travel, trade show expenses, and facilities expenses associated with and allocated to sales and marketing activities.

***General and Administrative Expenses.*** Our general and administrative expenses were \$2.6 million for both the third quarter of 2014 and 2013. General and administrative expenses decreased to \$7.9 million for the first nine months of 2014 from \$9.0 million for the first nine months of 2013. The decrease in general and administrative expenses for the

first nine months of 2014, as compared to the comparable period of 2013, was mainly due to (i) proxy contest related expenses (mainly legal and shareholder relations related expenses) we incurred during the second quarter of 2013, in the amount of \$1.4 million as compared to no such expenses in 2014. The decrease in general and administrative expenses for the first nine months of 2014, as compared to the comparable periods of 2013, was offset to some extent by an increase in equity-based compensation expenses of \$0.5 million.

General and administrative expenses as a percentage of our total revenues were 7% for both the three months ended September 30, 2014 and 2013, and 8% for both the nine months ended September 30, 2014 and 2013.

Our general and administrative expenses consist mainly of payroll expenses for management and administrative employees, accounting and legal fees, expenses related to investor relations as well as facilities expenses associated with general and administrative activities.

**Description of Segments.** We operate under three reportable segments. Our segment information has been prepared in accordance with ASC 280, "Segment Reporting." Operating segments are defined as components of an enterprise engaging in business activities about which separate financial information is available that is evaluated regularly by the company's chief operating decision-maker ("CODM") in deciding how to allocate resources and assess performance. Our CODM is our Chief Executive Officer, who evaluates the Company's performance and allocates resources based on segment revenues and operating income.

Our operating segments are as follows: Home, Office and Mobile. The classification of our business segments is based on a number of factors that management uses to evaluate, view and run its business operations, which include, but are not limited to, customer base, homogeneity of products and technology.

A description of the types of products provided by each business segment is as follows:

Home - Wireless chipset solutions for converged communication at home. Such solutions include integrated circuits targeted for cordless phones sold in retail or supplied by telecommunication service providers, residential gateway devices supplied by telecommunication service providers which integrate the DECT/CAT-iq functionality and also address home automation applications, as well as fixed-mobile convergence solutions.

Office - Comprehensive solution for Voice-over-IP (VOIP) office products, including office solutions that offer businesses of all size low-cost VOIP terminals with converged voice and data applications.

Mobile - Products for the mobile market that provides voice enhancement and far-end noise elimination targeted for mobile phone and mobile headsets.

**Segment Data.** We derive the results of our business segments directly from our internal management reporting system and by using certain allocation methods. The accounting policies we use to derive business segment results are substantially the same as those the Company uses for consolidation of our financial statements. The CODM measures the performance of each business segment based on several metrics, including earnings from operations. CODM uses



these results, in part, to evaluate the performance of, and to assign resources to, each of the business segments. We do not allocate to our business segments certain operating expenses, which are managed separately at the corporate level. These unallocated costs include primarily restructuring charges, amortization of purchased intangible assets, equity-based compensation expenses, and certain corporate governance costs.

Selected operating results information for each business segment was as follows for the three months ended September 30, 2014 and 2013:

|               | <b>Three months ended September 30</b> |             |  |             |
|---------------|--|-------------|--|-------------|
|               | <b>Revenues</b>                        |             | <b>Income (loss)<br/>from<br/>operations</b> |             |
|               | <b>2014</b>                            | <b>2013</b> | <b>2014</b>                                  | <b>2013</b> |
| <b>Home</b>   | \$32,292                               | \$33,492    | \$5,957                                      | \$5,381     |
| <b>Office</b> | \$4,353                                | \$1,889     | \$(252 )                                     | \$(731 )    |
| <b>Mobile</b> | \$70                                   | \$-         | \$(2,910)                                    | \$(2,609)   |
| <b>Total</b>  | \$36,715                               | \$35,381    | \$2,795                                      | \$2,041     |

Selected operating results information for each business segment was as follows for the nine months ended September 30, 2014 and 2013:

|               | <b>Nine months ended September 30</b> |             |  |             |
|---------------|---------------------------------------|-------------|--|-------------|
|               | <b>Revenues</b>                       |             | <b>Income (loss)<br/>from<br/>operations</b> |             |
|               | <b>2014</b>                           | <b>2013</b> | <b>2014</b>                                  | <b>2013</b> |
| <b>Home</b>   | \$95,492                              | \$109,146   | \$16,851                                     | \$19,650    |
| <b>Office</b> | \$10,315                              | \$6,577     | \$(985 )                                     | \$(4,321 )  |
| <b>Mobile</b> | \$70                                  | \$-         | \$(8,865 )                                   | \$(7,369 )  |
| <b>Total</b>  | \$105,877                             | \$115,723   | \$7,001                                      | \$7,960     |

Sales to our customers in the home segment decreased for the third quarter and first nine months of 2014, as compared to the third quarter and first nine months of 2013, representing a decrease of 4% and 13% in absolute dollars, respectively. The decrease in our sales in the home segment for the comparable periods was mainly attributable to a decline in market demands for and a decrease in the average selling prices of, cordless phones over the comparative periods, offset to some extent by an increase in the sales of home gateways and home automation products.

Sales to our customers in the office segment increased for the third quarter and first nine months of 2014, as compared to the third quarter and first nine months of 2013, representing an increase of 130% and 57% in absolute dollars,

respectively. The increase in our sales in the office segment for the comparable periods was mainly due to an increase in our market share of VoIP products and a general increase in market demand for VoIP products.

The reconciliation of segment operating results information to our consolidated financial information is included in Note M to our financial statements.

***Amortization of Intangible Assets.*** During both the third quarter of 2014 and 2013, we recorded an expense of \$0.4 million, relating to the amortization of intangible assets associated with the acquisition of the CIPT business of NXP B.V. and the acquisition of BoneTone Communications (“BoneTone”) in 2011. During the nine months ended September 30, 2014, we recorded an expense of \$1.2 million, as compared to \$1.3 million for the nine months ended September 30, 2013, relating to the amortization of intangible assets associated with the acquisition of the CIPT business of NXP B.V. and the acquisition of BoneTone in 2011.

**Financial Income, net.** Financial income, net, for the three months ended September 30, 2014 decreased to \$0.2 million from \$0.5 million for the three months ended September 30, 2013. Financial income, net, for the nine months ended September 30, 2014 decreased to \$0.9 million from \$1.8 million for the nine months ended September 30, 2013. The decrease in financial income, net, for the first nine months of 2014, as compared to the same period in 2013, was mainly due to (i) fewer gains realized from sales of certain of our marketable securities, and (ii) a lower yield on marketable securities. The decrease in financial income, net, for the third quarter of 2014, as compared to the same period in 2013, was mainly due to (i) fewer gains realized from sales of certain of our marketable securities, (ii) a lower yield on marketable securities, and (iii) exchange rate expenses as a result of the devaluation of the NIS and all other currencies against the U.S. dollar in the third quarter of 2014.

Our total cash, cash equivalents, deposits and marketable securities were \$117.0 million as of September 30, 2014, compared to \$125.1 million as of September 30, 2013. The decrease was mainly due to the repurchase of our common stock in an aggregate amount of \$16.0 million since September 30, 2013, offset to some extent by cash generated from operating activities during the period from September 30, 2013 to September 30, 2014.

**Provision for Income Taxes.** During the first nine months of 2014, no tax expenses were recorded, as compared to an income tax benefit of \$0.1 million recorded for the first nine months of 2013. The income tax benefit for the first nine months of 2013 was mainly attributed to (i) a reversal of an income tax contingency reserve that was determined to be no longer needed due to the expiration of the applicable statute of limitations in the amount of \$0.1 million, and (ii) the amortization of deferred tax liability related to the intangible assets acquired in connection with the BoneTone acquisition in the amount of \$0.3 million, offset to some extent by the creation of a provision for current income taxes. In the first nine months of 2014, we recorded income tax benefit in the amount of \$0.3 million, which was attributed to the amortization of deferred tax liability related to the intangible assets acquired in connection with the BoneTone acquisition. The above mentioned income tax benefit was fully offset by the creation of a provision for current income taxes.

During the three and nine months ended September 30, 2014, we did not record any significant changes to the net deferred tax assets due to our current estimation of future taxable income.

## **LIQUIDITY AND CAPITAL RESOURCES**

**Operating Activities.** For the first nine months of 2014, we generated \$3.7 million of cash and cash equivalents from our operating activities. Cash generated from operating activities amounted to \$5.0 million for the first nine months of 2013. The decrease in cash generated from operating activities for the first nine months of 2014, as compared to the same period in 2013, was mainly as a result of (i) an increase in accounts receivable during the first nine months of 2014 in the amount of \$4.0 million, as compared to an increase in the amount of \$2.3 million in accounts receivable during the first nine months of 2013, (ii) an increase in inventories in the amount of \$1.6 million during the first nine months of 2014, as compared to an increase in inventories in the amount of \$0.2 million during the first nine months

of 2013, and (iii) a decrease in accrued compensation and benefits during the first nine months of 2014 in the amount of \$0.5 million as compared to an increase in the amount of \$1.9 million in accrued compensation and benefits during the first nine months of 2013.

The above mentioned decreases in cash used for our operating activities during the first nine months of 2014 compared to the first nine months 2013 was offset to some extent by (i) a decrease in other accounts receivable and prepaid expenses of \$1.0 million during the first nine months of 2014, as compared to an increase of \$0.6 million during the first nine months of 2013, and (ii) an increase in trade payables of \$1.3 million during the first nine months of 2014, as compared to a decrease of \$0.9 million during the first nine months of 2013.

**Investing Activities.** We invest excess cash in marketable securities of varying maturity, depending on our projected cash needs for operations, capital expenditures and other business purposes. During the first nine months of 2014, we purchased \$50.2 million of marketable securities, as compared to \$53.3 million purchase of marketable securities during the first nine months of 2013. During the first nine months of 2014 and 2013, \$9.9 million and \$15.2 million, respectively, of marketable securities matured and were called by the issuers. During the first nine months of 2014 and 2013, \$40.8 million and \$27.8 million, respectively, of marketable securities were sold.

As of September 30, 2014, the amortized cost of our marketable securities and short term deposits was \$103.1 million and their stated market value was \$102.5 million, representing an unrealized loss of \$0.6 million.

Our capital equipment purchases for the first nine months of 2014, consisting primarily of research and development software tools, computers and other peripheral equipment, engineering test and lab equipment, leasehold improvements, furniture and fixtures, totaled \$1.0 million, as compared to \$0.9 million for the first nine months of 2013.

**Financing Activities.** During the first nine months of 2014, we repurchased 1,414,226 shares of our common stock at an average purchase price of \$8.83 per share for approximately \$12.5 million. During the first nine months of 2013, we did not repurchase any shares of common stock. In addition, during the first nine months of 2014 and 2013, we received \$0.5 and \$1.8 million upon the exercise of employee stock options, respectively.

In November 2013, we entered into a share repurchase plan, in accordance with Rule 10b5-1 of the Securities Exchange Act of 1934, for the repurchase of our common stock for up to 2.7 million shares. This was in addition to the approximately 308,000 shares that were available for repurchase pursuant to the Board's prior authorizations.

At September 30, 2014, 1,203,601 shares of our common stock are available for repurchase under our board authorized share repurchase program.

As of September 30, 2014, we had cash and cash equivalents totaling approximately \$14.5 million and marketable securities and short term deposits of approximately \$102.5 million.

Our working capital at September 30, 2014 was approximately \$34.4 million, as compared to \$45.5 million as of September 30, 2013. The decrease in working capital was mainly due to the repurchase of our common stock in the amount of \$16.0 million since September 30, 2013 and the replacement of short term marketable securities and deposits with long term marketable securities. We believe that our current cash, cash equivalents, cash deposits and

marketable securities will be sufficient to meet our cash requirements for both the short and long term.

In addition, as part of our business strategy, we may evaluate potential acquisitions of businesses, products and technologies. Accordingly, a portion of our available cash may be used at any time for the acquisition of complementary products or businesses. Such potential transactions may require substantial capital resources, which may require us to seek additional debt or equity financing. We cannot assure you that we will be able to successfully identify suitable acquisition candidates, complete acquisitions, integrate acquired businesses into our current operations, or expand into new markets. Furthermore, we cannot assure you that additional financing will be available to us in any required time frame and on commercially reasonable terms, if at all. See the section of the risk factors entitled “We may engage in future acquisitions that could dilute our stockholders’ equity and harm our business, results of operations and financial condition.” for more detailed information.

### *Off-Balance Sheet Arrangements*

We do not have any off-balance sheet arrangements, as such term is defined in recently enacted rules by the Securities and Exchange Commission, that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Interest Rate Risk.** It is our policy not to enter into interest rate derivative financial instruments, except for hedging of foreign currency exposures discussed below. We do not currently have any significant interest rate risk since we do not have any financial obligations.

The majority of our cash and cash equivalents are invested in high grade certificates of deposits with major U.S., European and Israeli banks. Generally, cash and cash equivalents and short term deposits may be redeemed and therefore minimal credit risk exists with respect to them. Nonetheless, cash deposits with these banks exceed the Federal Deposit Insurance Corporation ("FDIC") insurance limits in the U.S. or similar limits in foreign jurisdictions, to the extent such deposits are even insured in such foreign jurisdictions. While we monitor on a systematic basis the cash balances and adjust the balances as appropriate, these balances could be impacted if one or more of the financial institutions with which we deposit our funds fails or is subject to other adverse conditions in the financial or credit markets. To date we have experienced no loss of principal or lack of access to our cash; however, we can provide no assurances that access to our cash will not be affected if the financial institutions that we hold our cash fail or the financial and credit markets fail to recover fully.

We hold an investment portfolio of marketable securities consisting principally of debentures of U.S. corporations, and state and political subdivisions of the U.S. government. We intend, and have the ability, to hold such investments until recovery of any temporary declines in market value or maturity.

Interest rate fluctuations relating to our cash and cash equivalents and within our investment portfolio have not had, and are not currently anticipated to have, a material effect on our financial position on an annual or quarterly basis.

**Foreign Currency Exchange Rate Risk.** A significant part of our sales and expenses are denominated in U.S. dollars. Part of our expenses in Israel is paid in NIS, which subjects us to the risks of foreign currency fluctuations between the U.S. dollar and the NIS. Our primary expenses paid in NIS are employee salaries and lease payments on our Israeli



facilities. Furthermore, due to the Acquisition, a portion of our expenses for our European operations are paid in the Euro, which subjects us to the risks of foreign currency fluctuations between the U.S. dollar and the Euro. Our primary expenses paid in Euro are employee salaries, lease and operational payments on our European facilities. To partially protect the company against an increase in value of forecasted foreign currency cash flows resulting from salary and lease payments denominated in NIS during 2014, we instituted a foreign currency cash flow hedging program. The option and forward contracts used are designated as cash flow hedges, as defined by FASB ASC No. 815, "Derivatives and Hedging," and are all effective as hedges of these expenses. For more information about our hedging activity, see Note G to the attached Notes to the Condensed Consolidated Financial Statement for the period ended September 30, 2014. An increase in the value of the NIS and the Euro in comparison to the U.S. dollar could increase the cost of our research and development expenses and general and administrative expenses, all of which could harm our operating profit. Although we currently are using a hedging program to minimize the effects of currency fluctuations relating to the NIS, our hedging position is partial, may not exist at all in the future and may not succeed in minimizing our foreign currency fluctuation risks.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Quantitative and Qualitative Disclosures about Market Risk.”

### ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2014.

There has been no change in our internal control over financial reporting that occurred during our most recent fiscal quarter that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS.

From time to time, we may become involved in litigation relating to claims arising from our ordinary course of business. Also, as is typical in the semiconductor industry, we have been and may from time to time be notified of claims that we may be infringing patents or intellectual property rights owned by third parties. We currently believe that there are no claims or actions pending or threatened against us, the ultimate disposition of which would have a material adverse effect on our company.

### ITEM 1A. RISK FACTORS

There are no material changes to the Risk Factors described under the title “Factors That May Affect Future Performance” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 other than (1) changes

to the Risk Factor below entitled “We generate a significant amount of our total revenues from the sale of digital cordless telephony products and our business and operating results may be materially adversely affected if we do not continue to succeed in this highly competitive market or if sales within the overall cordless digital market decreases;” (2) changes to the Risk Factor below entitled “We rely significantly on revenue derived from a limited number of customers;” (3) changes to the Risk Factor below entitled “We rely on a primary distributor for a significant portion of our total revenues and the failure of this distributor to perform as expected would materially reduce our future sales and revenues;” (4) changes to the Risk Factor below entitled “Because we have significant international operations, we may be subject to political, economic and other conditions relating to our international operations that could increase our operating expenses and disrupt our business;” (5) changes to the Risk Factor below entitled “We are exposed to fluctuations in currency exchange rates;” (6) changes to the Risk Factor below entitled “Because we have significant operations in Israel, we may be subject to political, economic and other conditions affecting Israel that could increase our operating expenses and disrupt our business;” (7) changes to the Risk Factor below entitled “We may have exposure to additional tax liabilities as a result of our foreign operations;” (8) changes to the Risk Factor below entitled “Because the markets in which we compete are highly competitive, and many of our competitors have greater resources than we do, we cannot be certain that our products will be accepted in the marketplace or capture market share;” and (9) deletion of the Risk Factor entitled “New regulations related to “conflict minerals” may cause us to incur additional expenses and could limit the supply and increase the cost of certain metals used in manufacturing our products.”

***We generate a significant amount of our total revenues from the sale of digital cordless telephony products and our business and operating results may be materially adversely affected if we do not continue to succeed in this highly competitive market or if sales within the overall cordless digital market decreased.***

Sales of our digital cordless telephony products comprised a significant majority of our total revenues for the first nine months of 2014 and 2013. . Revenues from digital cordless telephony products represented 79% and 85% of our total revenues for the first nine months of 2014 and 2013, respectively.

Any adverse change in the digital cordless market or in our ability to compete and maintain our competitive position in that market would harm our business, financial condition and results of operations. The digital cordless telephony market is extremely competitive and is facing intense pricing pressures, and we expect that competition and pricing pressures may increase. Our existing and potential competitors in this market include large and emerging domestic and foreign companies, many of whom have significantly greater financial, technical, manufacturing, marketing, sales and distribution resources and management expertise than we do. It is possible that we may one day be unable to respond to increased pricing competition for digital cordless telephony processors or other products through the introduction of new products or reduction of manufacturing costs. This inability to compete would have a material adverse effect on our business, financial condition and results of operations. Likewise, any significant delays by us in developing, manufacturing or shipping new or enhanced products in this market also would have a material adverse effect on our business, financial condition and results of operations.

In addition to general market competitiveness, the digital cordless telephony market is undergoing a challenging period. With the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, the traditional cordless telephony market using fixed-line telephony is declining and will continue to decline, which reduces our revenues derived from, and unit sales of, cordless telephony products. Moreover, macro-economic trends in the consumer electronics industry may adversely impact our future revenues.

Furthermore, the decline in fixed line telephony together with the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity will decrease sales of products using fixed-line telephony. Our business also may be affected by the outcome of the competition between cellular phone operators and fixed-line operators for the provision of residential communication. A significant majority of our revenues are currently generated from sales of chipsets used in cordless phones that are based on fixed-line telephony, and the continued decline in fixed-line telephony would reduce our revenues derived from, and unit sales of, our digital cordless telephony products.

***We rely significantly on revenue derived from a limited number of customers.***

We expect that a limited number of customers, varying in identity from period-to-period, will account for a substantial portion of our revenues in any period. Our four largest customers – VTech, Panasonic (through Tomen), CCT Telecom and Shenzhen Guo Wei Electronics Ltd. accounted for approximately 65% and 66% of our total revenues for the first nine months of 2014 and 2013, respectively. Sales to VTech represented 36% of our total revenues for both the first nine months of 2014 and 2013. Sales to Panasonic represented 15% and 13% of our total revenues for the first nine months of 2014 and 2013, respectively. Typically, our sales are made on a purchase order basis, and none of our customers has entered into a long-term agreement requiring it to purchase our products. Moreover, we do not typically require our customers to purchase a minimum quantity of our products, and our customers can generally reschedule the delivery date of their orders on short notice without significant penalties. A significant amount of our revenues will continue to be derived from a limited number of large customers. Furthermore, the primary customers for our products are original equipment manufacturers (OEMs) and original design manufacturers (ODMs) in the cordless digital market. This industry is highly cyclical and has been subject to significant economic downturns at various times, particularly in recent periods. These downturns are characterized by production overcapacity and reduced revenues, which at times may affect the financial stability of our customers. Therefore, the loss of one of our major customers, or reduced demand for products from, or the reduction in purchasing capability of, one of our major customers, could have a material adverse effect on our business, financial condition and results of operations.

***Our future success is dependent on market acceptance of our HDClear product family targeted for the mobile device market, which is an intensively competitive market with dominant and established players.***

Our ability to increase our revenues and offset declining revenues from our cordless product family are substantially dependent on our ability to gain market share for our HDClear product family, a comprehensive voice enhancement and noise cancellation product targeted for mobile devices. Although a number of potential customers have expressed interest, we do not currently have any design wins for this product family, which is the initial step to incorporating this product with an OEM, and we cannot assure you that we will be successful in doing so. Even if we achieve design wins, the design-in process is labor intensive, long and often delayed. Therefore, the period from design-in to revenue generation may be long, and during the interim period, we would be expending significant time and resources through our sales and development cycles, potentially without achieving any economic return. Moreover, we are targeting a new market with our HDClear product family, a market with dominant and established players selling to OEM customers with whom they have established relationships. We will need to win over such customers, with whom we do not have established relationships, to gain market share. If we are unable to generate revenues from our HDClear product family and gain significant market share in the mobile device market, our operating results would be adversely affected.

***The market for mobile device components is highly competitive and we expect competition to intensify in the future.***

The market for mobile device components is highly competitive and characterized by the presence of large companies with significantly greater resources than we have. Our HDClear product family relates only to the voice and audio subsystem of a mobile device and there are only a limited number of OEMs targeted for this market. Our main competitors include Audience and Cirrus Logic. We also face competition from smaller, privately held companies and could face competition from new market entrants. We also compete against solutions internally developed by OEMs, as well as combined third-party software and hardware systems. If we are unable to compete effectively, we may not succeed in achieving any design wins and may have to lower our pricing to gain design wins, both of which would adversely impact our operating results.

***Because our products are components of end products, if OEMs do not incorporate our products into their end products or if the end products of our OEM customers do not achieve market acceptance, we may not be able to generate adequate sales of our products.***

Our products are not sold directly to the end-user; rather, they are components of end products. As a result, we rely upon OEMs to incorporate our products into their end products at the design stage. Once an OEM designs a competitor's product into its end product, it becomes significantly more difficult for us to sell our products to that customer because changing suppliers involves significant cost, time, effort and risk for the customer. As a result, we may incur significant expenditures on the development of a new product without any assurance that an OEM will

select our product for design into its own product and without this “design win” it becomes significantly difficult to sell our products. This is especially the case for our HDClear product family. Moreover, even after an OEM agrees to design our products into its end products, the design cycle is long and may be delayed due to factors beyond our control which may result in the end product incorporating our products not to reach the market until long after the initial “design win” with the OEM. From initial product design-in to volume production, many factors could impact the timing and/or amount of sales actually realized from the design-in. These factors include, but are not limited to, changes in the competitive position of our technology, our customers’ financial stability, and our ability to ship products according to our customers’ schedule. Moreover, the continued uncertainty about the sustainability of the global economic recovery and outlook may further prolong an OEM customer’s decision-making process and design cycle.

Furthermore, we rely on the end products of our OEM customers that incorporate our products to achieve market acceptance. Many of our OEM customers face intense competition in their markets. If end products that incorporate our products are not accepted in the marketplace, we may not achieve adequate sales volume of our products, which would have a negative effect on our results of operations.

***We rely on a primary distributor for a significant portion of our total revenues and the failure of this distributor to perform as expected would materially reduce our future sales and revenues.***

In addition to direct sales, we use a network of distributors to sell our products. Particularly, revenues derived from sales through our Japanese distributor, Tomen Electronics, accounted for 21% and 18% of our total revenues for the first nine months of 2014 and 2013, respectively. Our future performance will depend, in part, on this distributor to continue to successfully market and sell our products. Furthermore, Tomen Electronics sells our products to a limited number of customers. One customer, Panasonic, has continually accounted for a majority of the sales through Tomen Electronics. Sales to Panasonic through Tomen Electronics generated 15% and 13% of our total revenues for the first nine months of 2014 and 2013, respectively. The loss of Tomen Electronics as our distributor and our inability to obtain a satisfactory replacement in a timely manner would materially harm our sales and results of operations. Additionally, the loss of Panasonic and Tomen Electronics' inability to thereafter effectively market our products would also materially harm our sales.

***Because our quarterly operating results may fluctuate significantly, the price of our common stock may decline.***

Our quarterly results of operations may vary significantly in the future for a variety of reasons, many of which are outside our control, including the following:

fluctuations in volume and timing of product orders;

timing, rescheduling or cancellation of significant customer orders and our ability, as well as the ability of our customers, to manage inventory;

changes in demand for our products due to seasonal consumer buying patterns and other factors;

timing of new product introductions by us and by our customers or competitors;

changes in the mix of products sold by us or our competitors;



fluctuations in the level of sales by our OEM customers and other vendors of end products incorporating our products;

timing and size of expenses, including expenses to develop new products and product improvements, and expenses resulting from restructuring activities;

entry into new markets, including China, Korea and South America;

our ability to scale our operations in response to changes in demand for our existing products and services or demand for new products requested by our customers;

mergers and acquisitions by us, our competitors and our existing and potential customers; and

general economic conditions, including current economic conditions in the United States and worldwide, and the adverse effects on the semiconductor and consumer electronics industries.

Each of the above factors is difficult to forecast and could harm our business, financial condition and results of operations. Also, we sell our products to OEM customers that operate in consumer markets. As a result, our revenues are affected by seasonal buying patterns of consumer products sold by our OEM customers that incorporate our products and the market acceptance of such products supplied by our OEM customers.

***Our revenues, gross margins and profitability may be materially adversely affected by the continued decline in average selling prices of our products and other factors, including increases in assembly and testing expenses, and raw material and commodity costs.***

We have experienced and will continue to experience a decrease in the average selling prices of our products. Decreasing average selling prices could result in decreased revenues even if the volume of products sold increases. Decreasing average selling prices may also require us to sell our products at much lower gross margin than in the past and reduce profitability. Although we have to date been able to partially offset on an annual basis the declining average selling prices of our products through general operational efficiencies and manufacturing cost reductions by achieving a higher level of product integration and improving our yield percentages, there is no guarantee that our ongoing efforts will be successful or that they will keep pace with the anticipated, continued decline in average selling prices of our products.

Moreover, we believe there are significant pressures in the supply chain as a result principally of the uncertainty relating to the sustainability of the global economic recovery, which has negatively affected the consumer electronics industry. The pressures in the supply chain make it very difficult for us to increase or even maintain our product pricing, which further adversely affects our gross margins.

In addition to the continued decline in the average selling prices of our products, our gross profit may decrease in the future due to other factors, including the roll-out of new products in any given period and the penetration of new markets which may require us to sell products at a lower margin, our failure to introduce new engineering processes and mix of products sold.

Our gross margins also are affected by the product mix. For example, DECT products have lower average gross margins than other products. The DECT product line represented 82% of our total revenues for the first nine months of 2014. Therefore, increased sales of our DECT products would lower our gross margins.

Furthermore, increases in the price of silicon wafers, testing costs and commodities such as gold and oil, which may result in increased production costs, mainly assembly and packaging costs, may result in a decrease in our gross margins. Moreover, our suppliers may pass the increase in raw materials and commodity costs onto us which would further reduce the gross margin of our products. In addition, as we are a fabless company, global market trends such as

“over-capacity” problems so that there is a shortage of capacity to fulfill our fabrication needs also may increase our raw material costs and thus decrease our gross margin.

***There are several emerging market trends that may challenge our ability to continue to grow our business.***

New technological developments in the home connectivity market may adversely affect our operating results. For example, the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, as well as the lack of growth in products using fixed-line telephony would reduce our total revenues derived from, and unit sales of, cordless fixed-line telephony products. Our ability to maintain our growth will depend on the expansion of our product lines to capitalize on the emerging access methods and on our success in developing and selling a portfolio of “system-on-a-chip” solutions targeted at wider markets, including the intensively competitive mobile devices market. We cannot assure you that we will succeed in expanding our product lines or portfolio of “system-on-a-chip” solutions, or that they would receive market acceptance.

Furthermore, there is a growing threat from alternative technologies accelerating the decline of the fixed-line telephony market. This competition comes from mobile telephony, including emerging dual-mode mobile Wi Fi phones and other innovative applications, such as Skype and iChat. Given that we derive a significant amount of revenues from chipsets incorporated into fixed-line telephony products, if we are unable to develop new technologies in the face of the decline of this market, our business could be materially adversely affected.

***Our future business growth depends on the growth in demand for mobile devices with improved sound quality.***

Our HDClear product family is designed to enhance the sound quality and eliminate background voices for mobile device users. OEMs and ODMs may decide that the costs of improving sound quality outweigh the benefits which could limit demand for our HDClear product family. Moreover, users may also be satisfied with existing sound quality or blame poor quality on their phone carriers. The market that we are targeting is evolving rapidly and is technologically challenging. New mobile devices with different components or software may be introduced that provide the same functionality as HDClear product family. Alternatively, wireless network technology may be improved to serve the same functionality. Our future business growth will depend on the growth of this market and our ability to adapt to technological changes, user preferences and OEM demands. Our business could be materially adversely affected if we fail to do so.

***Because we have significant international operations, we may be subject to political, economic and other conditions relating to our international operations that could increase our operating expenses and disrupt our business.***

Although the majority of end users of the consumer products that incorporate our products are located in the U.S., we are dependent on sales to OEM customers, located outside of the U.S., that manufacture these consumer products. Also, we depend on a network of distributors to sell our products that also are primarily located outside of the U.S.

Export sales, primarily consisting of digital cordless telephony products shipped to manufacturers in Europe and Asia, including Japan and Asia Pacific, represented 97% of our total revenues for both the first nine months of 2014 and 2013. Furthermore, pursuant to the acquisition of the CIPT business from NXP, we established new foreign subsidiaries, and currently have material operations in Germany, the U.K., Hong Kong and India and employ a number of individuals within those foreign operations. As a result, the occurrence of any negative international political, economic or geographic events, as well as our failure to mitigate the challenges in managing an organization operating in various countries, could result in significant revenue shortfalls and disrupt our workforce within our foreign operations. These shortfalls and disruptions could cause our business, financial condition and results of operations to be harmed. Some of the risks of doing business internationally include:

unexpected changes in foreign government regulatory requirements;

fluctuations in the exchange rate for the United States dollar;

import and export license requirements;

imposition of tariffs and other barriers and restrictions;

burdens of complying with a variety of foreign laws, treaties and technical standards;

uncertainty of laws and enforcement in certain countries relating to the protection of intellectual property;

difficulty in collecting accounts receivable and longer payment cycles for international customers than existing customers;

difficulty in staffing and managing foreign operations and maintaining the morale and productivity of employees within foreign operations;

multiple and possibly overlapping tax structures and potentially adverse tax consequences;

political and economic instability; and

changes in diplomatic and trade relationships.

One or more of these factors may have a material adverse effect on our future operations and consequently, on our business, financial conditions and operating results.

***In order to sustain the future growth of our business, we must penetrate new markets and our new products must achieve widespread market acceptance.***

In order to increase our sales volume and expand our business, we must penetrate new markets and introduce new products, especially our HDClear product family. We are exploring opportunities to expand sales of our products in China, Japan, Korea and South America. However, there are no assurances that we will gain significant market share in those competitive markets. In addition, due to the cyclical nature of manufacturing capacity issues, the increasing cost of silicon integrated circuits, the continued decline of average selling prices of chipsets and other industry-wide factors, many North American, European and Japanese OEMs are moving their manufacturing sites to Asia. This trend may cause the mix of our OEM customers to change in the future, thereby further necessitating our need to penetrate new markets. Furthermore, to sustain the future growth of our business, we need to introduce new products as sales of our older products taper off. Moreover, the penetration of new competitive markets and introduction of new products could require us to reduce the sale prices of our products or increase the cost per product and thus reducing our total gross profit in future periods. Our future growth is dependent on market acceptance and penetration of our new products, especially our HDClear product family, for which we can provide no assurances. Our revenue growth is also dependent on the successful deployment of our new VOIP and BoneTone products. Our inability to penetrate the market or lack of customer acceptance of these products may harm our business and potential growth.

***Because the markets in which we compete are subject to rapid changes, our products may become obsolete or unmarketable.***

The markets for our products and services are characterized by rapidly changing technology, short product life cycles, evolving industry standards, changes in customer needs, demand for higher levels of integration, growing competition and new product introductions. This is especially the case for the mobile device market. Our future growth is dependent not only on the continued success of our existing products but also successful introduction of new products. Our ability to adapt to changing technology and anticipate future standards, and the rate of adoption and acceptance of those standards, will be a significant factor in maintaining or improving our competitive position and prospects for growth. If new industry standards emerge, our products or our customers' products could become unmarketable or obsolete, and we could lose market share. We may also have to incur substantial unanticipated costs to comply with these new standards. If our product development and improvements take longer than planned, the availability of our products would be delayed. Any such delay may render our products obsolete or unmarketable, which would have a negative impact on our ability to sell our products and our results of operations.



Because of changing customer requirements and emerging industry standards, we may not be able to achieve broad market acceptance of our products. Our success is dependent, in part, on our ability to:

successfully develop, introduce and market new and enhanced products at competitive prices and in a timely manner in order to meet changing customer needs;

convince leading OEMs to select our new and enhanced products for design into their own new products;

respond effectively to new technological changes or new product announcements by others;

effectively use and offer leading technologies; and

maintain close working relationships with our key customers.

There are no assurances that we will be successful in these pursuits, that the demand for our products will continue or that our products will achieve market acceptance. Our failure to develop and introduce new products that are compatible with industry standards and that satisfy customer requirements, and the failure of our products to achieve broad market acceptance, could have a negative impact on our ability to sell our products and our results of operations.

***Because we depend on independent foundries and other third party suppliers to manufacture and test all of our integrated circuit products, we are subject to additional risks that may materially disrupt our business.***

All of our integrated circuit products are manufactured and tested by independent foundries and other third party suppliers. While these foundries and other third party suppliers have been able to adequately meet the demands of our increasing business, we are and will continue to be dependent upon these foundries and third party suppliers to achieve acceptable manufacturing yields, quality levels and costs, and to allocate to us a sufficient portion of their foundry, assembly and test capacity to meet our needs in a timely manner.

While we currently believe we have adequate capacity to support our current sales levels pursuant to our arrangement with our foundries and other third party suppliers, we may encounter capacity shortage issues in the future. In the event of a worldwide shortage in foundry, assembly and/or test capacity, we may not be able to obtain a sufficient allocation of such capacity to meet our product needs or we may incur additional costs to ensure specified quantities of products and services. Over-capacity at the current foundries and other third party suppliers we use, or future foundries or other third party suppliers we may use, to manufacture and test our integrated circuit products may lead



to increased operating costs and lower gross margins. In addition, such a shortage could lengthen our products' manufacturing and testing cycle and cause a delay in the shipment of our products to our customers. This could ultimately lead to a loss of sales of our products, harm our reputation and competitive position, and our revenues could be materially reduced. Our business could also be harmed if our current foundries or other third party suppliers terminate their relationship with us and we are unable to obtain satisfactory replacements to fulfill customer orders on a timely basis and in a cost-effective manner. Moreover, we do not have long term capacity guarantee agreements with our foundries and with other third party suppliers.

In addition, as TSMC produces a significant portion of our integrated circuit products and ASE tests and assembles a significant portion of them, earthquakes, aftershocks or other natural disasters in Asia, or adverse changes in the political situation in Taiwan, could preclude us from obtaining an adequate supply of wafers to fill customer orders. Such events could harm our reputation, business, financial condition, and results of operations.

***Because NXP still manufactures certain of the CIPT business products, we are subject to additional risks that may materially disrupt our business.***

As part of the Acquisition of the CIPT business, we entered into a Manufacturing Services Collaboration Agreement (“MSCA”), as amended, with NXP pursuant to which NXP agreed to provide us with specified manufacturing, pre-testing, assembling and final-testing services relating to the CIPT business products. The services under the MSCA were to be provided by NXP at agreed upon prices initially for up to seven years following the closing of the acquisition and will expire by the end of 2014. Our business could be harmed if NXP, or third parties NXP has contracted, fails to achieve acceptable manufacturing yields, quality levels or allocate to us a sufficient portion of its foundry, and assembly and testing capacities to meet our needs for the CIPT business products.

***Our operating results are affected by general economic conditions and the highly cyclical nature of the semiconductor industry.***

Notwithstanding improvements in business conditions since the global downturn in 2008 and 2009, recovery is slow and general worldwide economic conditions remain uncertain which continues to make it difficult for our customers, the end-product customers, our vendors and us to accurately forecast and plan future business activities and make reliable projections. Moreover, we operate within the semiconductor industry which experiences significant fluctuations in sales and profitability. Downturns in the semiconductor industry are characterized by diminished product demand, excess customer inventories, accelerated erosion of prices and excess production capacity. These factors could cause substantial fluctuations in our revenues and in our results of operations. If global economic and market conditions remain uncertain or deteriorate, we could experience a material adverse impact on our business and results of operations.

***Because the manufacture of our products is complex, the foundries on which we depend may not achieve the necessary yields or product reliability that our business requires.***

The manufacture of our products is a highly complex and precise process, requiring production in a highly controlled environment. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by a foundry could adversely affect the foundry’s ability to achieve acceptable manufacturing yields and product reliability. If the foundries we currently use do not achieve the necessary yields or product reliability, our ability to fulfill our customers’ needs could suffer. This could ultimately lead to a loss of sales of our products and have a negative effect on our gross margins and results of operations.

Furthermore, there are other significant risks associated with relying on these third-party foundries, including:

risks due to the fact that we have reduced control over production cost, delivery schedules and product quality;

less recourse if problems occur as the warranties on wafers or products supplied to us are limited; and

increased exposure to potential misappropriation of our intellectual property.

***As we depend on independent subcontractors, located in Asia, to assemble and test our semiconductor products, we are subject to additional risks that may materially disrupt our business.***

Independent subcontractors, located in Asia, assemble and test our semiconductor products. Because we rely on independent subcontractors to perform these services, we cannot directly control our product delivery schedules or quality levels. We are dependent on these subcontractors to allocate to us a sufficient portion of their capacity to meet our needs in a timely manner. Our future success also depends on the financial viability of our independent subcontractors. If the capital structures of our independent subcontractors weaken, we may experience product shortages, production delays, quality assurance problems, increased manufacturing costs, and/or supply chain disruption. All of this could ultimately lead to a loss of sales of our products, harm our reputation and competitive position, and our revenues could be materially harmed.

Moreover, the economic, market, social, and political situations in countries where some of our independent subcontractors are located are unpredictable, can be volatile, and can have a significant impact on our business because we may not be able to obtain product in a timely manner. Market and political conditions, including currency fluctuation, terrorism, political strife, war, labor disruption, and other factors, including natural or man-made disasters, adverse changes in tax laws, tariff, import or export quotas, power and water shortages, or interruption in air transportation, in areas where our independent subcontractors are located also could have a severe negative impact on our operating capabilities.

***We are subject to order and shipment uncertainties and if we are unable to accurately predict customer demand, our business may be harmed.***

We typically sell products pursuant to purchase orders rather than long-term purchase commitments. Customers can generally change or defer purchase orders on short notice without incurring a significant penalty. Given current market conditions, we have less ability to accurately predict what or how many products our customers will need in the future. In addition, we have little visibility into and no control of the demand by our customer's customers – generally consumer electronics retailers. Furthermore, based on discussions with our customers, we understand that our customers also have less visibility into their product demands. A decrease in the consumer electronics retailers' demand or a build-up of their inventory, both of which are out of the control of our customers and us, may cause a cancellation, change or deferral of purchase orders on short notice by our customers. Anticipating demand is difficult because our customers and their customers face volatile pricing and unpredictable demand for their own products, and are increasingly focused on cash preservation and tighter inventory management. Based on these trends, our customers are reluctant to place orders with normal lead times, and we are seeing a shift to shorter lead-times and rush orders. However, we place orders with our suppliers based on forecasts of our customers' demand and, in some instances, may establish buffer inventories to accommodate anticipated demand. Our forecasts are based on multiple assumptions, each of which may introduce error into our estimates. If we overestimate our customers' demand or our customers overestimate their demand, we may allocate resources to manufacturing products that we may not be able to sell when we expect to, if at all. As a result, we could hold excess or obsolete inventory, which would reduce our profit margins and adversely affect our financial results. Conversely, if we underestimate our customers' demand or our customers

underestimate their demand and insufficient manufacturing capacity is available, we could forego revenue opportunities and potentially lose market share and damage our customer relationships.

As a result of the acquisition of the CIPT business, we now maintain inventory, or hubbing, arrangements with certain of our customers. Pursuant to these arrangements, we deliver products to a customer or a designated third party warehouse based upon the customer's projected needs, but do not recognize product revenue unless and until the customer reports that it has removed our product from the warehouse to incorporate into its end products. Since we own inventory that is physically located in a third party's warehouse, our ability to effectively manage inventory levels may be impaired, causing our total inventory turns to decrease, which could increase expenses associated with excess and obsolete product and negatively impact our cash flow.

***We are dependent on a small number of OEM customers, and our business could be harmed by the loss of any of these customers or reductions in their purchasing volumes.***

We sell our products to a limited number of OEM customers directly or through a network of distributors. Moreover, many North American, European and Japanese OEMs are moving their manufacturing sites to Southeast Asia, as a result of the cyclical nature of manufacturing capacity issues and cost of silicon integrated circuits, the continued decline of average selling prices of chipsets and other industry-wide factors. In addition, OEMs located in Southeast Asia are growing and gaining competitive strength. As a result, the mix of our OEM customers may change in the future. However, we may not succeed in attracting new customers as these potential customers may have pre-existing relationships with our current or potential competitors. This trend also may promote the consolidation of OEMs located in North America, Europe and Japan with OEMs located in Southeast Asia, which may reduce the number of our potential customers and reduce the volume of chipsets the combined OEM customer may purchase from us. However, as is common in our industry, we typically do not enter into long term contracts with our customers in which they commit to purchase products from us. The loss of any of our OEM customers may have a material adverse effect on our results of operations. To attract new customers, we may be faced with intense price competition, which may affect our revenues and gross margins.

***The possible emerging trend of our OEM customers outsourcing their production may cause our revenue to decline.***

We believe there may be an emerging trend of our OEM customers outsourcing their production to third parties. We have invested substantial resources to build relationships with our OEM customers. However the outsourcing companies whom our OEM customers may choose to outsource production may not have prior business relationship with us or may instead have prior or ongoing relationships with our competitors. The emergence of this trend may require us to expend substantial additional resources to build relationships with these outsourcing companies, which would increase our operating expenses. Even if we do expend such resources, there are no assurances that these outsourcing companies will choose to incorporate our chipsets rather than chipsets of our competitors. Our inability to retain an OEM customer once such customer chooses to outsource production would have a material adverse effect on our future revenue.

***Third party claims of infringement or other claims against us could adversely affect our ability to market our products, require us to redesign our products or seek licenses from third parties, and seriously harm our operating results and disrupt our business.***

As is typical in the semiconductor industry, we and our customers have been and may from time to time be notified of claims that we may be infringing patents or intellectual property rights owned by third parties. In addition, patent infringement claims are increasingly being asserted by patent holding companies (so-called patent “trolls”), which do not use technology and whose sole business is to enforce patents against companies, such as us, for monetary gain. Because such patent holding companies do not provide services or use technology, the assertion of our own patents by way of counter-claim may be ineffective. We have received claims that our products infringe upon the proprietary rights of such patent holding companies. In addition, third parties have asserted and may in the future assert intellectual property infringement claims against our customers, which we have agreed in certain circumstances to indemnify and defend against such claims. If litigation becomes necessary to determine the validity of any third party claims, it could result in significant expense to us and could divert the efforts of our technical and management personnel, whether or not the claim has merit and notwithstanding that the litigation is determined in our favor.

If it appears necessary or desirable, we may try to obtain licenses for those patents or intellectual property rights that we are allegedly infringing. Although holders of these types of intellectual property rights commonly offer these licenses, we cannot assure you that licenses will be offered or that the terms of any offered licenses will be acceptable to us. Our failure to obtain a license for key intellectual property rights from a third party for technology used by us could cause us to incur substantial liabilities, suspend the manufacturing of products utilizing the technology or damage the relationship with our customers. Alternatively, we could be required to expend significant resources to develop non-infringing technology. We cannot assure you that we would be successful in developing non-infringing technology. The occurrence of any of these events could harm our business, financial condition or results of operations.

***Because we have significant operations in Israel, we may be subject to political, economic and other conditions affecting Israel that could increase our operating expenses and disrupt our business.***

Our principal research and development facilities are located in the State of Israel and, as a result, at September 30, 2014, 202 of our 304 employees were located in Israel, including 134 out of 186 of our research and development personnel. In addition, although we are incorporated in Delaware, a majority of our directors and executive officers are residents of Israel. Although substantially all of our sales currently are being made to customers outside of Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel, or the interruption or curtailment of trade between Israel and its present trading partners, could significantly harm our business, operating results and financial condition.



Israel's economy has been subject to numerous destabilizing factors, including a period of rampant inflation in the early to mid-1980s, low foreign exchange reserves, fluctuations in world commodity prices, military conflicts and civil unrest. In addition, Israel and companies doing business with Israel have been the subject of an economic boycott by the Arab countries since Israel's establishment. Although they have not done so to date, these restrictive laws and policies may have an adverse impact on our operating results, financial condition or expansion of our business.

Since the establishment of the State of Israel in 1948, a state of hostility has existed, varying in degree and intensity, between Israel and the Arab countries. Although Israel has entered into various agreements with certain Arab countries and the Palestinian Authority, and various declarations have been signed in connection with efforts to resolve some of the economic and political problems in the Middle East, hostilities between Israel and some of its Arab neighbors have recently escalated and intensified. We cannot predict whether or in what manner these conflicts will be resolved. Our results of operations may be negatively affected by the obligation of key personnel to perform military service. In addition, certain of our officers and employees are currently obligated to perform annual reserve duty in the Israel Defense Forces and are subject to being called for active military duty at any time. Although we have operated effectively under these requirements since our inception, we cannot predict the effect of these obligations on the company in the future. Our operations could be disrupted by the absence, for a significant period, of one or more of our officers or key employees due to military service.

***The tax benefits available to us under Israeli law require us to meet several conditions, and may be terminated or reduced in the future, which would increase our taxes.***

Our facilities in Israel have been granted Approved Enterprise and Beneficiary Enterprise status under the Law for the Encouragement of Capital Investments, 1959, commonly referred to as the "Investment Law," as amended. The Investment Law provides that capital investments in a production facility (or other eligible assets) designated as an Approved Enterprise or Beneficiary Enterprise receive certain tax benefits in Israel. Our investment programs that generate taxable income are currently subject to an average tax rate of up to approximately 10% based on a variety of factors, including percentage of foreign ownership and approvals for the erosion of the tax basis of our investment programs. To be eligible for tax benefits, we must meet certain conditions, relating principally to adherence to the investment program filed with the Investment Center of the Israeli Ministry of Economy and periodic reporting obligations. Although we believe we have met such conditions in the past, should we fail to meet such conditions in the future, we would be subject to corporate tax in Israel at the standard corporate tax rate (26.5% for 2014) and could be required to refund tax benefits (including with interest and adjustments for inflation based on the Israeli consumer price index) already received. Our average tax rate for our investment programs also may change in the future due to circumstances outside of our control, including changes to legislation. For example, on July 2013, the Investment Law was amended whereby the reduction of corporate tax rate for preferred enterprises was eliminated such that such enterprises, which are subject to the new law, would be subject to a 16% tax rate. Therefore, we cannot provide any assurances that our average tax rate for our investment programs will continue in the future at their current levels, if at all. The termination or reduction of certain programs and tax benefits or a requirement to refund tax benefits (including with interest and adjustments for inflation based on the Israeli consumer price index) already received may have a material adverse effect on our business, operating results and financial condition.

***We may engage in future acquisitions that could dilute our stockholders' equity and harm our business, results of operations and financial condition.***

We have pursued, and will continue to pursue, growth opportunities through internal development and acquisition of complementary businesses, products and technologies. We are unable to predict whether or when any other prospective acquisition will be completed. The process of integrating an acquired business may be prolonged due to unforeseen difficulties and may require a disproportionate amount of our resources and management's attention. We cannot assure you that we will be able to successfully identify suitable acquisition candidates, complete acquisitions, integrate acquired businesses into our operations, or expand into new markets. Further, once integrated, acquisitions may not achieve comparable levels of revenues, profitability or productivity as our existing business or otherwise perform as expected. The occurrence of any of these events could harm our business, financial condition or results of operations. Future acquisitions may require substantial capital resources, which may require us to seek additional debt or equity financing.

Future acquisitions by us could result in the following, any of which could seriously harm our results of operations or the price of our stock:

issuance of equity securities that would dilute our current stockholders' percentages of ownership;

large one-time write-offs;

the incurrence of debt and contingent liabilities;

difficulties in the assimilation and integration of operations, personnel, technologies, products and information systems of the acquired companies;

diversion of management's attention from other business concerns;

contractual disputes;

risks of entering geographic and business markets in which we have no or only limited prior experience; and

potential loss of key employees of acquired organizations.

***We may not be able to adequately protect or enforce our intellectual property rights, which could harm our competitive position.***

Our success and ability to compete is in part dependent upon our internally-developed technology and other proprietary rights, which we protect through a combination of copyright, trademark and trade secret laws, as well as through confidentiality agreements and licensing arrangements with our customers, suppliers, employees and consultants. In addition, we have filed a number of patents in the United States and in other foreign countries with respect to new or improved technology that we have developed. However, the status of any patent involves complex legal and factual questions, and the breadth of claims allowed is uncertain. Accordingly, we cannot assure you that any patent application filed by us will result in a patent being issued, or that the patents issued to us will not be infringed by others. Also, our competitors and potential competitors may develop products with similar technology or functionality as our products, or they may attempt to copy or reverse engineer aspects of our product line or to obtain and use information that we regard as proprietary. Moreover, the laws of certain countries in which our products are or may be developed, manufactured or sold, including Hong Kong, Japan, Korea and Taiwan, may not protect our products and intellectual property rights to the same extent as the laws of the United States. Policing the unauthorized use of our products is difficult and may result in significant expense to us and could divert the efforts of our technical

and management personnel. Even if we spend significant resources and efforts to protect our intellectual property, we cannot assure you that we will be able to prevent misappropriation of our technology. Use by others of our proprietary rights could materially harm our business and expensive litigation may be necessary in the future to enforce our intellectual property rights.

***Because our products are complex, the detection of errors in our products may be delayed, and if we deliver products with material defects, our credibility will be harmed, the sales and market acceptance of our products may decrease and product liability claims may be made against us.***

Our products are complex and may contain errors, defects and bugs when introduced. If we deliver products with material errors, defects or bugs, our credibility and the market acceptance and sales of our products could be significantly harmed. Furthermore, the nature of our products may also delay the detection of any such error or defect. If our products contain material errors, defects and bugs, then we may be required to expend significant capital and resources to alleviate these problems. This could result in the diversion of technical and other resources from our other development efforts. Any actual or perceived problems or delays may also adversely affect our ability to attract or retain customers. Furthermore, the existence of any defects, errors or failures in our products could lead to product liability claims or lawsuits against us or against our customers. We generally provide our customers with a standard warranty for our products, generally lasting one year from the date of purchase. Although we attempt to limit our liability for product defects to product replacements, we may not be successful, and customers may sue us or claim liability for the defective products. A successful product liability claim could result in substantial cost and divert management's attention and resources, which would have a negative impact on our financial condition and results of operations.

***We are exposed to the credit risk of our customers and to credit exposures in weakened markets, which could result in material losses.***

Most of our sales are on an open credit basis. Because of current conditions in the global economy, our exposure to credit risks relating to sales on an open credit basis has increased. We expect demand for enhanced open credit terms, for example, longer payment terms, to continue and believe that such arrangements are a competitive factor in obtaining business. Although we monitor and attempt to mitigate credit risks, including through insurance coverage from time to time, there can be no assurance that our efforts will be effective. Moreover, even if we attempt to mitigate credit risks through insurance coverage, such coverage may not be sufficient to cover all of our losses and we would be subject to a deductible under any insurance coverage. As a result, our future credit risk exposure may increase. Although any losses to date relating to credit exposure of our customers have not been material, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition. Moreover, the loss of a customer due to its financial default also could harm our future business and potential growth.

***Our executive officers and key personnel are critical to our business, and because there is significant competition for personnel in our industry, we may not be able to attract and retain such qualified personnel.***

Our success depends to a significant degree upon the continued contributions of our executive management team, and our technical, marketing, sales customer support and product development personnel. The loss of significant numbers

of such personnel could significantly harm our business, financial condition and results of operations. We do not have any life insurance or other insurance covering the loss of any of our key employees. Because our products are specialized and complex, our success depends upon our ability to attract, train and retain qualified personnel, including qualified technical, marketing and sales personnel. However, the competition for personnel is intense and we may have difficulty attracting and retaining such personnel.

*We may have exposure to additional tax liabilities as a result of our foreign operations.*

We are subject to income taxes in the United States and various foreign jurisdictions. In addition to our significant operations in Israel, pursuant to the Acquisition, we currently have operations in Germany, the U.K., Hong Kong and India. Significant judgment is required in determining our worldwide provision for income taxes and other tax liabilities. In the ordinary course of a global business, there are many intercompany transactions and calculations where the ultimate tax determination is uncertain. We are regularly under audit by tax authorities and as an example, we are now under audit in both Israel and Germany, the outcome of which could have material adverse impact on our financial condition. Our intercompany transfer pricing may be reviewed by the U.S. Internal Revenue Service and by foreign tax jurisdictions. Although we believe that our tax estimates are reasonable, due to the complexity of our corporate structure, the multiple intercompany transactions and the various tax regimes, we cannot assure you that a tax audit or tax dispute to which we may be subject will result in a favorable outcome for us. If taxing authorities do not accept our tax positions and impose higher tax rates on our foreign operations, our overall tax expenses could increase.

*We are exposed to fluctuations in currency exchange rates.*

A significant portion of our business is conducted outside the United States. Export sales to manufacturers in Europe and Asia, including Japan and Asia Pacific, represented 97% of our total revenues for both the first nine months of 2014 and 2013. Although most of our revenue and expenses are transacted in U.S. dollars, we may be exposed to currency exchange fluctuations in the future as business practices evolve and we are forced to transact business in local currencies. Moreover, part of our expenses in Israel are paid in Israeli currency, which subjects us to the risks of foreign currency fluctuations between the U.S. dollar and the New Israeli Shekel (NIS) and to economic pressures resulting from Israel's general rate of inflation. Our primary expenses paid in NIS are employee salaries and lease payments on our Israeli facilities. Furthermore, a portion of our expenses for our European operations are paid in the Euro, which subjects us to the risks of foreign currency fluctuations between the U.S. dollar and the Euro. Our primary expenses paid in the Euro are employee salaries, lease and operational payments on our European facilities. As a result, an increase in the value of the NIS and Euro in comparison to the U.S. dollar could increase the cost of our technology development, research and development expenses and general and administrative expenses, all of which could harm our operating profit. From time to time, we use derivative instruments in order to minimize the effects of currency fluctuations, but our hedging positions may be partial, may not exist at all in the future or may not succeed in minimizing our foreign currency fluctuation risks.

*Because the markets in which we compete are highly competitive, and many of our competitors have greater resources than we do, we cannot be certain that our products will be accepted in the marketplace or capture market share.*

The markets in which we operate are extremely competitive and characterized by rapid technological change, evolving standards, short product life cycles and price erosion. We expect competition to intensify as current competitors expand their product offerings and new competitors enter the market. Given the highly competitive environment in which we operate, we cannot be sure that any competitive advantages enjoyed by our current products would be sufficient to establish and sustain our new products in the market. Any increase in price or competition could result in the erosion of our market share, to the extent we have obtained market share, and would have a negative impact on our financial condition and results of operations.

In each of our business activities, we face current and potential competition from competitors that have significantly greater financial, technical, manufacturing, marketing, sales and distribution resources and management expertise than we do. These competitors may also have pre-existing relationships with our customers or potential customers. Further, in the event of a manufacturing capacity shortage, these competitors may be able to manufacture products when we are unable to do so. Our principal competitors in the cordless market include Lantiq and Dialog Semiconductors, and we have also noted efforts by Beken, a Chinese supplier of basebands for analog cordless phones, to penetrate the DECT market. Our principal competitors in the VOIP market include Dialog Semiconductors, Infineon, Texas Instruments and new Taiwanese IC vendors. Our principal competitors in the multimedia market include Wi-Fi and multimedia application processor IC vendors like Atheros, Broadcom, CSR, Freescale, Intel, Marvel, Ralink, Samsung and Texas Instruments.



As discussed above, various new developments in the home residential market may require us to enter into new markets with competitors that have more established presence, and significantly greater financial, technical, manufacturing, marketing, sales and distribution resources and management expertise than we do. The expenditure of greater resources to expand our current product lines and develop a portfolio of “system-on-a-chip” solutions that integrate video, voice, data and communication technologies in a wider multimedia market may increase our operating expenses and reduce our gross profit. We cannot assure you that we will succeed in developing and introducing new products that are responsive to market demands.

***An unfavorable government review of our federal income tax returns or changes in our effective tax rates could adversely affect our operating results.***

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws, regulations, accounting principles or interpretations thereof. In addition, we are subject to the periodic examination of our income tax returns by the IRS and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes, as an example, we are now under audit in both Israel and Germany. The outcomes from these examinations may have an adverse effect on our operating results and financial condition.

***Our business operations would be disrupted if the information technology systems we rely on fail to function properly.***

We rely on complex information technology systems to manage our business which operates in many geographical locations. For example, to achieve short delivery lead times and superior levels of customer service while maintaining low levels of inventory, we constantly adjust our production schedules with manufacturers and subcontractors. We develop and adjust these schedules based on end customer demand as communicated by our customers and distributors and based on our inventory levels, manufacturing cycle times, component lead times, and projected production yields. We combine and distribute all of this information electronically over a complex global communications network. Our ability to estimate demand and to adjust our production schedules is highly dependent on this network. Any delay in the implementation of, or disruption in the transition to, new or enhanced processes, systems or controls, could adversely affect our ability to manage customer orders and manufacturing schedules, as well as generate accurate financial and management information in a timely manner. These systems are also susceptible to power and telecommunication disruptions and other system failures. Failure of our IT systems or difficulties in managing them could result in business disruption. Our business could be significantly disrupted and we could be subject to third party claims associated with such disruptions.

*We may experience difficulties in transitioning to smaller geometry process technologies or in achieving higher levels of design integration, which may result in reduced manufacturing yields, delays in product deliveries and increased expenses.*

A growing trend in our industry is the integration of greater semiconductor content into a single chip to achieve higher levels of functionality. In order to remain competitive, we must achieve higher levels of design integration and deliver new integrated products on a timely basis. This will require us to expend greater research and development resources, and may require us to modify the manufacturing processes for some of our products, to achieve greater integration. We periodically evaluate the benefits, on a product-by-product basis, of migrating to smaller geometry process technologies to reduce our costs. Although this migration to smaller geometry process technologies has helped us to offset the declining average selling prices of our products, this effort may not continue to be successful. Also, because we are a fabless semiconductor company, we depend on our foundries to transition to smaller geometry processes successfully. We cannot assure you that our foundries will be able to effectively manage the transition. In case our foundries or we experience significant delays in this transition or fail to efficiently implement this transition, our business, financial condition and results of operations could be materially and adversely affected.

*The anti-takeover provisions in our certificate of incorporation and bylaws could prevent or discourage a third party from acquiring us.*

Our certificate of incorporation and bylaws contain provisions that may prevent or discourage a third party from acquiring us, even if the acquisition would be beneficial to our stockholders. Our board of directors also has the authority to fix the rights and preferences of shares of our preferred stock and to issue such shares without a stockholder vote. Our bylaws also place limitations on the authority to call a special meeting of stockholders. Our stockholders may take action only at a meeting of stockholders and not by written consent. We have advance notice procedures for stockholders desiring to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders. In addition, these factors may also adversely affect the market price of our common stock, and the voting and other rights of the holders of our common stock.

*Our stock price may be volatile so you may not be able to resell your shares of our common stock at or above the price you paid for them.*

Announcements of developments related to our business, announcements by competitors, quarterly fluctuations in our financial results, changes in the general conditions of the highly dynamic industry in which we compete or the national economies in which we do business, and other factors could cause the price of our common stock to fluctuate, perhaps substantially. In addition, in recent years, the stock market has experienced extreme price fluctuations, which have often been unrelated to the operating performance of affected companies. These factors and fluctuations could have a material adverse effect on the market price of our common stock.

## **ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

During the third quarter of 2014, we repurchased 505,312 shares of common stock at an average purchase price of \$9.08 per share for approximately \$4,589,000. The table below sets forth the information with respect to repurchases of our common stock during the three months ended September 30, 2014:

| <b>Period</b> | <b>(a) Total<br/>Number<br/>of<br/>Shares<br/>Purchased</b> | <b>(b)<br/>Average<br/>Price<br/>Paid per<br/>Share</b> | <b>(c) Total<br/>Number of<br/>Shares<br/>Purchased<br/>as</b> | <b>(d)<br/>Maximum<br/>Number of<br/>Shares that<br/>May</b> |
|---------------|---|---|--|--|
|---------------|---|---|--|--|

|  |         |      | <b>Part of<br/>Publicly<br/>Announced<br/>Plans or<br/>Programs</b> | <b>Yet Be<br/>Purchased<br/>Under<br/>the Plans<br/>or<br/>Programs)<br/>(1)</b> |
|--|---------|------|---|--|
| Month #1 (July 1, 2014 to July 31, 2014)           | 5,312   | 8.49 | 5,312   | 1,703,601  |
| Month #2 (August 1, 2014 to August 31, 2014)       | 213,443 | 9.21 | 213,443   | 1,490,158  |
| Month #3 (September 1, 2014 to September 30, 2014) | 286,557 | 8.99 | 286,557   | 1,203,601 (1)  |

(1) The number represents the number of shares of our common stock that remain available for repurchase pursuant to our board's authorizations as of September 30, 2014.

In November 2013, we entered into a share repurchase plan, in accordance with Rule 10b5-1 of the Securities Exchange Act of 1934, for the repurchase of our common stock for up to 2,700,000 shares. This was in addition to the approximately 308,000 shares that were available for repurchase pursuant to our Board of Directors' prior authorizations. The Rule 10b5-1 plan was amended within its original terms and extended by the board in July 2014 to the end of February 2015.

At September 30, 2014, 1,203,601 shares of our common stock are available for repurchase under our board authorized share repurchase program. The repurchase program is being affected from time to time, depending on market conditions and other factors, through open market purchases and privately negotiated transactions.

**ITEM 3. defaults upon senior securities.**

Not applicable.

**ITEM 4. mine safety disclosure.**

Not applicable.

**ITEM 5. other information,**

Not applicable.

**ITEM 6. EXHIBITS.**

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- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Labels Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

**SIGNATURES**

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

DSP GROUP, INC.

(Registrant)

/s/ Dror Levy

Date: November 10, 2014 By:

Dror Levy, Chief Financial Officer and Secretary

(Principal Financial Officer and Principal Accounting Officer)