

AVOCENT CORP  
Form 10-Q  
May 09, 2005

# U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-Q

(Mark One)

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

For the quarterly period ended April 1, 2005 or

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

For the transition period from to

Commission file number: 000-30575

## AVOCENT CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or Organization)

91-2032368

(I.R.S. Employer Identification Number)

4991 Corporate Drive

Huntsville, Alabama

(Address of Principal Executive Offices)

35805

(Zip Code)

256-430-4000

(Registrant's Telephone Number, Including Area Code)

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

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☐ Yes ☐ No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934, as amended).

☐ Yes ☐ No

As of May 2, 2005, the number of outstanding shares of the Registrant's Common Stock was 49,662,945.

AVOCENT CORPORATION

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**PART I FINANCIAL INFORMATION****Item 1. Financial Statements**

**AVOCENT CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited, in thousands, except per share data)

|   | For the three months ended |                  |
|---|----------------------------|------------------|
|   | April 1,<br>2005           | April 2,<br>2004 |
| Net sales   | \$ 76,805                  | \$ 86,085        |
| Cost of sales   | 33,223                     | 35,983           |
| Gross profit  | 43,582                     | 50,102           |
| Research and development expenses                             | 14,467                     | 9,428            |
| Acquired in-process research and development expense          |                            | 6,490            |
| Selling, general and administrative expenses                  | 22,280                     | 20,335           |
| Amortization of intangible assets                             | 6,622                      | 4,762            |
| Total operating expenses                                      | 43,369                     | 41,015           |
| Income from operations  | 213                        | 9,087            |
| Net investment income   | 2,056                      | 1,251            |
| Net realized investment losses                                | (177)                      | (64)             |
| Other income (expense), net                                   | 61                         | (50)             |
| Income before provision for income taxes                      | 2,153                      | 10,224           |
| Provision for income taxes                                    | 319                        | 1,681            |
| Net income  | \$ 1,834                   | \$ 8,543         |
| Earnings per share:   |                            |                  |
| Basic   | \$ 0.04                    | \$ 0.18          |
| Diluted   | \$ 0.04                    | \$ 0.17          |
| Weighted average shares used in computing earnings per share: |                            |                  |
| Basic   | 50,208                     | 47,650           |
| Diluted   | 51,452                     | 49,513           |

See notes accompanying these condensed consolidated financial statements.

## AVOCENT CORPORATION

## CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands, except per share data)

|  | April 1,<br>2005 | December 31,<br>2004 |
|--|------------------|----------------------|
| <b>ASSETS</b>  |                  |                      |
| Current assets:  |                  |                      |
| Cash and cash equivalents  | \$ 47,786        | \$ 44,724            |
| Investments maturing within one year   | 193,560          | 195,075              |
| Accounts receivable, net   | 50,034           | 60,948               |
| Inventories, net   | 24,316           | 21,232               |
| Other current assets   | 7,541            | 5,923                |
| Deferred tax assets, net   | 5,778            | 6,720                |
| Total current assets   | 329,015          | 334,622              |
| Investments  | 82,846           | 90,217               |
| Property held for lease, net   | 1,281            | 1,330                |
| Property and equipment, net  | 39,328           | 39,896               |
| Goodwill   | 270,001          | 269,892              |
| Other intangible assets, net   | 27,421           | 33,981               |
| Other assets   | 887              | 843                  |
| Total assets   | \$ 750,779       | \$ 770,781           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                  |                      |
| Current liabilities:   |                  |                      |
| Accounts payable   | \$ 6,664         | \$ 9,171             |
| Accrued wages and commissions  | 8,536            | 12,197               |
| Accrued liabilities  | 15,020           | 15,661               |
| Income taxes payable   | 8,356            | 8,494                |
| Other current liabilities  | 1,495            | 1,106                |
| Total current liabilities  | 40,071           | 46,629               |
| Deferred tax liabilities, net  | 6,004            | 8,985                |
| Other non-current liabilities  | 1,708            | 1,870                |
| Total liabilities  | 47,783           | 57,484               |
| <b>Commitments and contingencies</b>   |                  |                      |
| <b>Stockholders' equity:</b>   |                  |                      |
| Preferred stock, \$0.001 par value; 5,000 shares authorized, no shares issued and outstanding as of April 1, 2005 and December 31, 2004, respectively                                |                  |                      |
| Common stock, \$0.001 par value; 200,000 shares authorized, April 1, 2005 50,733 shares issued and 49,933 outstanding; December 31, 2004 50,332 shares issued and 50,232 outstanding | 51               | 50                   |
| Additional paid-in capital   | 1,085,139        | 1,075,171            |
| Accumulated other comprehensive loss   | (807)            | (56)                 |
| Deferred compensation  | (1,529)          | (2,038)              |
| Accumulated deficit  | (354,018)        | (355,852)            |
| Treasury stock, at cost; April 1, 2005 800 shares; December 31, 2004 100 shares  | (25,840)         | (3,978)              |
| Total stockholders' equity   | 702,996          | 713,297              |
| Total liabilities and stockholders' equity   | \$ 750,779       | \$ 770,781           |

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See notes accompanying these condensed consolidated financial statements.

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

(Unaudited, in thousands)

|   | For the three months ended |                  |
|---|----------------------------|------------------|
|   | April 1,<br>2005           | April 2,<br>2004 |
| Cash flows from operating activities:   |                            |                  |
| Net income  | \$ 1,834                   | \$ 8,543         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                            |                  |
| Depreciation  | 1,576                      | 1,594            |
| Amortization of intangible assets   | 6,622                      | 4,762            |
| Stock-based compensation  | 509                        | 722              |
| Acquired in-process research and development expenses                             |                            | 6,490            |
| Amortization of premiums on investments   | 431                        | 1,495            |
| Net loss on sales of investments  | 177                        | 64               |
| Income tax benefit from exercise of stock options                                 | 1,904                      | 1,238            |
| Changes in operating assets and liabilities (net of effects of acquisition):      |                            |                  |
| Accounts receivable, net  | 10,912                     | (4,204)          |
| Inventories, net  | (3,084)                    | (1,178)          |
| Other assets  | (1,860)                    | 331              |
| Accounts payable  | (2,504)                    | (972)            |
| Accrued wages and commissions   | (3,661)                    | (3,464)          |
| Accrued liabilities   | (287)                      | (2,290)          |
| Income taxes, current and deferred  | (2,415)                    | 252              |
| Net cash provided by operating activities   | 10,154                     | 13,383           |
| Cash flows from investing activities:   |                            |                  |
| Purchase of Crystal Link, net of cash received (1)                                |                            | (3,311)          |
| Purchases of property and equipment   | (1,008)                    | (1,370)          |
| Purchases of investments  | (67,898)                   | (52,751)         |
| Maturities and proceeds from sales of investments                                 | 75,663                     | 75,232           |
| Net cash provided by investing activities   | 6,757                      | 17,800           |
| Cash flows from financing activities:   |                            |                  |
| Repayment of debt assumed at the acquisition of Crystal Link                      |                            | (1,798)          |
| Proceeds from employee stock option exercises                                     | 5,956                      | 5,148            |
| Proceeds from employee stock purchase plan  | 2,107                      | 1,371            |
| Purchases of treasury stock   | (21,862)                   |                  |
| Net cash provided by (used in) financing activities                               | (13,799)                   | 4,721            |
| Effect of exchange rate changes on cash and cash equivalents                      | (50)                       | 135              |
| Net increase in cash and cash equivalents   | 3,062                      | 36,039           |
| Cash and cash equivalents at beginning of period                                  | 44,724                     | 76,492           |
| Cash and cash equivalents at end of period  | \$ 47,786                  | \$ 112,531       |

(1) Supplemental disclosure In addition to the cash paid to Crystal Link shareholders, we issued 106 shares of our common stock valued at \$3,500. The issuance of common stock was recorded as non-cash consideration for the acquisition.

See notes accompanying these condensed consolidated financial statements.



**AVOCENT CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited, in thousands, except per share data)

**Note 1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with generally accepted accounting principles and reflect all adjustments consisting of normal recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the results for the periods shown. The results of operations for these periods are not necessarily indicative of the results expected for the full fiscal year or for any future periods. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the related notes contained in our Annual Report on Form 10-K for the year ended December 31, 2004, which is on file with the Securities and Exchange Commission and is available at our website, [www.avocent.com](http://www.avocent.com). The balance sheet presented in the accompanying financial statements for December 31, 2004, was derived from the audited financial statements filed in our 10-K for the period ended December 31, 2004.

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

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

**Note 2. Inventories**

Inventories consisted of the following at:

|                  | <b>April 1,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|------------------|--------------------------|------------------------------|
| Raw materials    | \$ 4,976                 | \$ 4,411                     |
| Work-in-process  | 620                      | 356                          |
| Finished goods   | 18,720                   | 16,465                       |
| Inventories, net | \$ 24,316                | \$ 21,232                    |

Inventories above have been reduced by reserves for excess and obsolete inventories of \$4,134 and \$3,785 as of April 1, 2005 and December 31, 2004, respectively.

Note 3. Stock Options, Deferred Compensation and Treasury Stock

**Deferred compensation** We recorded \$41,165 of deferred compensation related to Cybex employee stock options at the time of the merger of Apex and Cybex on July 1, 2000, \$2,752 of deferred compensation related to the Equinox employee stock options at the time of the acquisition on January 3, 2001 and \$6,350 of deferred compensation related to the OSA employee stock options at the time of the acquisition on April 6, 2004. The deferred compensation is being amortized over the vesting period of the options for which it was recorded. Amortization of deferred compensation totaled \$509 and \$722 for the quarters ended April 1, 2005 and April 2, 2004, respectively.

**Stock option exercises** Shares of our common stock issued as a result of option exercises totaled 314 shares during the quarter ended April 1, 2005 and 254 shares during the quarter ended April 2, 2004. Total proceeds received from these option exercises were \$5,956 for the quarter ended April 1, 2005 and \$5,148 for the quarter ended April 2, 2004. Additionally, common stock issued under our Employee Stock Purchase Plan totaled 87 shares during the quarter ended April 1, 2005 and 89 shares during the quarter ended April 2, 2004. Total proceeds received from the shares issued under the ESPP were \$2,107 for the quarter ended April 1, 2005 and \$1,371 for the quarter ended April 2, 2004.

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**Stock repurchases** We repurchased 700 shares of our common stock during the quarter ended April 1, 2005 at a cost totaling \$21,862. These treasury shares were purchased on the open market through various brokers under the stock re-purchase plan approved by our Board of Directors during the fourth quarter of 2004.

## Note 4. Accumulated Other Comprehensive Income (Loss)

We record unrealized gains and losses on our foreign currency translation adjustments and unrealized holding gains or losses on our available-for-sale securities, net of tax, as accumulated other comprehensive income (loss), which is included as a separate component of stockholders' equity. Comprehensive income in the first quarter of 2005 of \$1,083 consists of \$1,834 of net income, \$513 of unrealized losses on investments (net of deferred income taxes) and \$238 of foreign currency translation adjustments. Comprehensive income in the first quarter of 2004 of \$8,359 consists of \$8,543 of net income, \$49 of unrealized losses on investments (net of deferred income taxes) and \$135 of foreign currency translation adjustments. As of April 1, 2005 and December 31, 2004, total accumulated other comprehensive income (loss) was \$(807) and \$(56), respectively.

## Note 5. Earnings Per Share

|   | Income (Numerator) | Shares<br>(Denominator) | Per-Share<br>Amount |
|---|--------------------|-------------------------|---------------------|
| <b>For the three months ended April 1, 2005</b>                     |                    |                         |                     |
| <b>Basic EPS</b>  |                    |                         |                     |
| Net income available to common stockholders                         | \$ 1,834           | 50,208                  | \$ 0.04             |
| <b>Effect of Dilutive Securities</b>                                |                    |                         |                     |
| Stock options   |                    | 1,244                   |                     |
| <b>Diluted EPS</b>  |                    |                         |                     |
| Net income available to common stockholders and assumed conversions | \$ 1,834           | 51,452                  | \$ 0.04             |
| <b>For the three months ended April 2, 2004</b>                     |                    |                         |                     |
| <b>Basic EPS</b>  |                    |                         |                     |
| Net income available to common stockholders                         | \$ 8,543           | 47,650                  | \$ 0.18             |
| <b>Effect of Dilutive Securities</b>                                |                    |                         |                     |
| Stock options   |                    | 1,863                   |                     |
| <b>Diluted EPS</b>  |                    |                         |                     |
| Net income available to common stockholders and assumed conversions | \$ 8,543           | 49,513                  | \$ 0.17             |

## Note 6. Sales by Geographic Region and Customer Type

We have evaluated, and will periodically re-evaluate, our business in light of the segment reporting requirements prescribed by SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. We have determined that we should report our operations as a single operating segment. However, we supplementally report net sales by geographic region, as well as by customer type. Following is a presentation of net sales by geographic region and by customer type for the three months ended April 1, 2005 and April 2, 2004:

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|                   | For the three months ended |                  |
|-------------------|----------------------------|------------------|
|                   | April 1,<br>2005           | April 2,<br>2004 |
| Net sales:        |                            |                  |
| United States     | \$ 39,964                  | \$ 51,190        |
| Rest of the World | 36,841                     | 34,895           |
|                   | \$ 76,805                  | \$ 86,085        |

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|            | For the three months ended |        |                  |        |
|------------|----------------------------|--------|------------------|--------|
|            | April 1,<br>2005           |        | April 2,<br>2004 |        |
| Net sales: |                            |        |                  |        |
| Branded    | \$                         | 36,727 | \$               | 50,710 |
| OEM        |                            | 40,078 |                  | 35,375 |
|            | \$                         | 76,805 | \$               | 86,085 |

We sell our products internationally to customers in several countries. Sales to customers in the Netherlands, including the European distribution facility for one of our OEM customers, accounted for 11% and 10% of sales in the first quarter of 2005 and 2004, respectively. No other country accounted for more than 10% of sales in the first quarter of either 2005 or 2004.

As of April 1, 2005, long-lived assets totaled \$338,031, which includes \$317,043 held in the U.S. and \$20,988 held outside of the U.S. As of December 31, 2004, long-lived assets totaled \$345,099, which includes \$324,417 held in the U.S. and \$20,682 held outside of the U.S.

#### Note 7. Forward Contracts

We use forward contracts to reduce our foreign currency exposure related to the net cash flows from our international operations. The majority of these contracts are short-term contracts (three months or less) and are marked-to-market each quarter and included in trade payables, with the offsetting gain or loss included in other income (expense) in the accompanying consolidated statements of operations. As of April 1, 2005, and December 31, 2004, we had one open forward contract with a fair value of zero.

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

Acquired other intangible assets subject to amortization were as follows:

|                                  | April 1, 2005                |                             | December 31, 2004            |                             |
|----------------------------------|------------------------------|-----------------------------|------------------------------|-----------------------------|
|                                  | Gross<br>Carrying<br>Amounts | Accumulated<br>Amortization | Gross<br>Carrying<br>Amounts | Accumulated<br>Amortization |
| Developed technology             | \$ 80,560                    | \$ 66,715                   | \$ 80,560                    | \$ 62,293                   |
| Patents and trademarks           | 21,617                       | 15,523                      | 21,508                       | 14,318                      |
| Customer base and certifications | 6,483                        | 2,360                       | 6,483                        | 1,961                       |
| Non-compete agreements           | 5,793                        | 3,553                       | 5,793                        | 3,070                       |
| Other                            | 1,814                        | 695                         | 1,814                        | 535                         |
|                                  | \$ 116,267                   | \$ 88,846                   | \$ 116,158                   | \$ 82,177                   |

For the three months ended April 1, 2005 and April 2, 2004, amortization expense for other intangible assets was \$6,622 and \$4,762, respectively. The approximate estimated annual amortization for other intangibles is as follows:

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**Years ending December 31:**

|      |    |        |
|------|----|--------|
| 2005 | \$ | 19,600 |
| 2006 | \$ | 9,400  |
| 2007 | \$ | 3,500  |
| 2008 | \$ | 1,100  |
| 2009 | \$ | 381    |

**For the three months ended April 1, 2005, we recorded \$109 of additional goodwill related to the Crystal Link Technologies acquisition.**

**Note 9. Product Warranties**

The activity within the liability for warranty returns for the quarter ended April 1, 2005:

|  | 2005     |
|--|----------|
| Balance, January 1, 2005                                 | \$ 2,760 |
| Accruals for product warranties issued during the period | 39       |
| Settlements made during the period                       | (32)     |
| Balance, April 1, 2005                                   | \$ 2,767 |

Deferred revenue related to our extended warranty program was \$1,714 for the three months ended April 1, 2005. We recorded earned revenue from the amortization of deferred revenue related to extended warranties of \$173 for the three months ended April 1, 2005. In addition, we recorded new extended warranties of \$222 during the three months ended April 1, 2005.

**Note 10. Effective Tax Rate**

The effective tax rate in the first quarter of 2005 was approximately 14.8% compared to an effective tax rate of approximately 16.4% in the first quarter of 2004. The provision for income taxes was approximately \$319 for the first quarter of 2005, compared to \$1.7 million in the first quarter of 2004. The reduction in provision for income taxes was partly the result of the change in mix of our pre-tax profit among our U.S. and international companies. As a result of lower than expected earnings in the U.S. in the first quarter of 2005, the pre-tax profit attributable to our international operations was higher than that experienced in recent quarters. In addition, the provision for income taxes for the first quarter of 2005 was reduced by approximately \$133 related to a tax benefit expected to be realized from the settlement of a tax contingency.

**Note 11. Patent Dispute**

In May 2001, we filed a complaint for patent infringement in the United States District Court for the Southern District of New York against Raritan Computer Inc. The Raritan complaint sought injunctive relief, damages, attorneys' fees and costs under three patents. After a seven day bench trial in New York in January of 2002, U.S. District Judge Milton Pollack found that there was no infringement of these patents by Raritan and ordered that judgment be entered in favor of Raritan.

In April 2003, the United States Court of Appeals for the Federal Circuit issued its ruling on our appeal in this patent litigation. The Court of Appeals ruled in our favor by vacating the non-infringement decision of the District Court for the Southern District of New York and remanding the case for further proceedings consistent with the Court of Appeals' opinion.

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In September 2003, Raritan petitioned the United States Supreme Court for a Writ of Certiorari to review the Court of Appeals decision. The Supreme Court declined to review Raritan's petition in December 2003, and the case was sent back to the United States District Court for the Southern District of New York. A Markman hearing on claims construction was held in February 2005. This case is currently scheduled for a new trial in May 2005.

In October 2003, we filed a complaint for patent infringement in the United States District Court for the Northern District of Alabama against ClearCube Technology, Inc. The ClearCube complaint seeks injunctive relief, damages, attorneys' fees, and costs under three of our patents. ClearCube has filed counterclaims alleging non-infringement, unenforceability, invalidity, and misuse of the Avocent patents. A Markman hearing on claims construction was originally set for February 2005, but in response to an inquiry from the Court, we agreed that the hearing should be postponed until the



United States Court of Appeals for the Federal Circuit issues its ruling on certain similar issues raised in an unrelated patent case.

## Note 12. Stock Based Compensation

We apply Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for our stock plans. Had compensation cost for our stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method prescribed in SFAS No. 123, *Accounting for Stock-Based Compensation*, our net income and earnings per share would have been reduced to the pro forma amounts indicated below for the three months ended April 1, 2005 and April 2, 2004.

|   | 2005       | 2004     |
|---|------------|----------|
| Net income as reported  | \$ 1,834   | \$ 8,543 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects                            | 509        | 677      |
| Deduct: Total stock based employee compensation expense determined under fair value method for all awards, net of related tax effects | 5,019      | 7,060    |
| Net income (loss) pro forma   | \$ (2,676) | \$ 2,160 |
| Basic earnings per share as reported  | \$ 0.04    | \$ 0.18  |
| Basic earnings (loss) per share pro forma   | \$ (0.05)  | \$ 0.05  |
| Diluted earnings per share as reported  | \$ 0.04    | \$ 0.17  |
| Diluted earnings (loss) per share pro forma   | \$ (0.05)  | \$ 0.04  |

The pro forma amounts reflected above are not representative of the effects on reported net income in future years because, in general, the options granted typically do not vest for several years and additional awards are made each year. The fair value of each option grant is estimated on the grant date using the Black-Scholes option-pricing model using the following weighted-average assumptions:

|                         | 2005  | 2004  |
|-------------------------|-------|-------|
| Dividend yield          | 0.0%  | 0.0%  |
| Expected life (years)   | 4.5   | 4.5   |
| Expected volatility     | 47.0% | 55.0% |
| Risk-free interest rate | 3.81% | 2.79% |

## Note 13. Recently Issued Accounting Standards and Regulatory Standards

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share based Payment*, which replaces SFAS No. 123, *Accounting for Stock Based Compensation* and APB Opinion No 25 *Accounting for Stock Issued to Employees*. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair-values beginning with the first annual period after June 15, 2005. The pro-forma disclosures previously permitted under SFAS No. 123 no longer will be an alternative to inclusion of the expense in the financial statements. We are required to adopt SFAS 123R beginning January 1, 2006. Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. We expect to utilize the prospective method which requires that compensation expense begin being recorded for all unvested stock options and

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restricted stock at the beginning of the first quarter of adoption of SFAS 123R. We are evaluating the requirements of SFAS 123R and expect the adoption of SFAS 123R will have a material impact on our consolidated results of operations and earnings per share. We have not determined the effect of adopting SFAS 123R and we have not determined whether the adoption will result in amounts similar to the current pro-forma disclosures under SFAS 123. Under the current approach of SFAS 123 we would have unamortized fair value of unvested stock options of

approximately \$15,000 for currently outstanding stock options to be recognized as expense in our income statements after 2005, prior to the acceleration of vesting discussed in note 14. Following this acceleration we believe the balance to be expensed in future periods would be reduced to approximately \$2,000 for currently outstanding stock options under the SFAS 123 methodology.

On October 22, 2004, the American Jobs Creation Act of 2004 became law. This legislation repeals export tax benefits, which have historically reduced our effective tax rate. This legislation phases in the repealed export tax benefits by allowing 100 percent of the repealed export benefits in 2004, 80 percent in 2005 and 60 percent in 2006. We do not expect this change to have a material impact on our effective tax rate or provision for taxes.

The legislation also transitions in a new tax deduction for qualifying U.S. manufacturing activities. Under the guidance in FASB Staff Position No. FAS 109-1 which articulates the application of SFAS 109, Accounting for Income Taxes, to the tax deduction on qualified production activities provided by this Act, the deduction will be treated as a special deduction as described in SFAS 109. As such, we expect the new manufacturing activities deduction provision of the new legislation will reduce our effective rate in future periods as the deduction is taken on our tax returns.

The legislation also provides for the optional repatriation of earnings from foreign subsidiaries allowing an 85 percent dividends received deduction. The deduction is subject to a number of limitations. We have not yet initiated an analysis nor determined if we will repatriate any overseas earnings pursuant to this provision. If our intention to permanently reinvest overseas earnings in our overseas operations changes and we decide to repatriate any of the earnings to the U.S., we would incur additional income tax expense equal to the incremental U.S. income tax in excess of the credits available for taxes already paid overseas.

#### **Note 14. Subsequent Events**

During the period from April 2, 2005 through May 2, 2005, we repurchased 275 additional shares of our common stock on the open market under our Board approved stock repurchase program, for a total cost of \$6,852. On April 29, 2005 our Board of Directors authorized the repurchase of an additional 2,000 shares of our common stock to be repurchased under the stock repurchase program. A total of 4,000 shares is authorized to be repurchased under the board approved program, 1,075 of which had been repurchased as of May 2, 2005.

On April 29, 2005, our Board of Directors approved a plan to accelerate vesting of all currently outstanding stock options with an exercise price of greater than \$25.00 which are unvested on December 25, 2005. Under the provisions of APB 25, we estimate that there will be no compensation expense related to accelerating these options as the options affected by the acceleration had exercise prices higher than the closing price of our common stock as of the modification date. As a result of the Board's action, stock options to purchase approximately 1,100 shares of our common stock will become exercisable effective December 25, 2005. The exercise prices of the affected stock options range from \$25.17 to \$41.57 per share. The closing price of Avocent's common stock on April 29, 2005 was \$25.14.

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

*THE INFORMATION IN THIS ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS CONTAINS FORWARD-LOOKING STATEMENTS, INCLUDING, WITHOUT LIMITATION, STATEMENTS RELATING TO OUR FUTURE BUSINESS PROSPECTS AND ECONOMIC CONDITIONS IN GENERAL; STATEMENTS REGARDING OUR ABILITY TO PREDICT FUTURE SALES AND MANAGE INVENTORY LEVELS; STATEMENTS REGARDING PRICING PRESSURE; STATEMENTS REGARDING THE FLUCTUATION OF OUR REVENUE GROWTH IN RELATION TO ECONOMIC CONDITIONS AND IT RELATED SPENDING TRENDS; STATEMENTS REGARDING OUR PRODUCT PLATFORMS AND OUR ABILITY TO RESUME GROWTH IN OUR OVERALL BUSINESS; STATEMENTS REGARDING INCREASED SALES OF OUR DIGITAL PRODUCTS AND EMBEDDED SOLUTIONS AND THEIR ABILITY TO OFFSET PRICE DECLINES AND COMPETITIVE FACTORS; STATEMENTS REGARDING OUR GROSS MARGINS, OUR RESEARCH AND DEVELOPMENT EXPENSES AND OUR SELLING, GENERAL AND ADMINISTRATIVE EXPENSES IN THE SECOND QUARTER OF 2005; STATEMENTS REGARDING OUR SARBANES-OXLEY COMPLIANCE COSTS; STATEMENTS REGARDING OUR LEGAL COSTS FOR PATENT LITIGATION CASES; AND STATEMENTS REGARDING THE IMPACT OF SFAS 123R ON OUR RESULTS OF OPERATIONS AND EARNINGS PER SHARE.*

*THESE FORWARD-LOOKING STATEMENTS ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE OUR ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE, BUT ARE NOT LIMITED TO, THE RISKS ASSOCIATED WITH GENERAL ECONOMIC CONDITIONS, RISKS ASSOCIATED WITH THE INTRODUCTION OF NEW PRODUCTS, RISKS ATTRIBUTABLE TO FUTURE PRODUCT DEMAND, SALES, AND EXPENSES, RISKS ASSOCIATED WITH PRODUCT DESIGN EFFORTS, RISKS ASSOCIATED WITH RELIANCE ON A LIMITED NUMBER OF COMPONENT SUPPLIERS AND SINGLE SOURCE COMPONENTS, THE LOSS OF ONE OF OUR OEM CUSTOMERS, A REDUCTION OR FLUCTUATIONS IN SALES OF OUR OEM OR BRANDED PRODUCTS, INTENSE COMPETITION AND NEW PRODUCTS AND TECHNOLOGIES FROM EXISTING AND NEW COMPETITORS, RISKS RELATED TO OBTAINING AND PROTECTING OUR INTELLECTUAL PROPERTY RIGHTS, FLUCTUATIONS IN FOREIGN CURRENCIES, RISKS RELATED TO ACQUISITIONS AND THEIR SUBSEQUENT INTEGRATION, AND OTHER RISKS DETAILED IN OUR ANNUAL REPORT ON FORM 10-K, WHICH WAS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON MARCH 14, 2005.*

## Overview

Avocent designs, manufactures, licenses, and sells solutions that provide connectivity and centralized management of IT infrastructure. We provide connectivity and management products and technologies that centralize control of servers, mobile devices, and network appliances, increasing the efficiency of IT personnel. Server manufacturers rely on Avocent KVM switches and embedded technology in their systems, and companies large and small depend on our products and technologies for managing their growing IT infrastructure.

Our innovations include IP-based switching, centralized management, and intuitive software interfaces. Our products and technologies manage servers, serial devices, wireless devices, mobile devices, and embedded infrastructure. With more than two decades of experience, we have grown through product innovations, global expansion, and strategic acquisitions. Formed as a result of the merger in 2000 between Apex Inc. and Cybex Computer Products Corporation, we subsequently acquired Equinix Systems Inc. in 2001, 2C Computing, Inc. in 2002, Soronti, Inc. in 2003, and Crystal Link Technologies, OSA Technologies, Inc., and Sonic Mobility, Inc. in 2004.

Our KVM switching systems eliminate the need for extra keyboards, monitors, and mice and allow businesses to save critical space in their data centers. Our KVM over IP switching systems eliminate distance limitations and provide 24/7 access and control of an almost unlimited number of servers, even when the servers are dispersed in different physical locations. Our DSVIEW software management and KVM over IP switching systems allow IT managers to use a single console to gain secure, local and remote access and control of servers and other network data center devices from any location.

Our innovative advances for the data center include multi-platform switching, analog matrix switching, KVM extension over CAT 5, PCI bus extension, a proprietary on-screen menu switching system, remote KVM over IP connectivity, digital serial over IP, digital-analog integrated access to multiple servers, intelligent platform management interface (IPMI) solutions, wireless KVM, PDA and hand-held management solutions, and centralized management software for access and control of network infrastructure.

Our DSSeries® switches are revolutionary in the industry. They combine analog and digital connections, serial connectivity, and external modem support in one switch. These appliances integrate our KVM over IP switching technology and CAT 5 connectivity. IT managers and network administrators gain worldwide access and control of their servers and serial devices and can track them all from a single computer screen. In addition, we provide plug and play switching systems for the many network administration, management, and storage problems faced by corporate customers, data centers, and mid-size businesses. Our connectivity solutions include products and technologies sold or licensed under the Avocent, Cybex, and Equinox brands, including our *AMX*, *AutoView*, *Cstation*, *DSView®*, *DS Series*, *LongView*, *OutLook®*, *SuperSerial*, *SwitchView®*, *Emerge*, *SonicAdmin*, and *SonicSentinel* products.

We market and sell our products around the world to a diversified group of original equipment manufacturers (OEMs) dealers, distributors, resellers, and end users, primarily through our sales and customer support staff, advertisements in trade publications, and participation in major industry trade shows.

A substantial portion of our revenue is derived from sales to major server OEMs who purchase our switching systems on a private-label or branded basis for integration and sale with their own products, sales through our reseller and distributor network, and sales to a limited number of direct customers. Sales to our OEM customers accounted for 52% of sales in the first quarter of 2005 and 41% of sales in the first quarter of 2004. Sales to our branded customers accounted for 48% of sales in the first quarter of 2005 and 59% of sales in the first quarter of 2004. We do not have contracts with many of our branded customers, and in general, our OEM and branded business customers are obligated to purchase products from us only pursuant to binding purchase orders. The loss of, or material decline in orders from, these customers would have a material adverse effect on our business, financial condition, results of operations, and cash flows. Our top five customers include both OEM and branded customers, and accounted for 65% of sales in the first quarter of 2005 and 64% of sales in the first quarter of 2004.

We sell products to dealers, end-users, and OEMs in the United States, Canada, Europe, and Asia as well as in other foreign markets. Sales within the United States accounted for approximately 52% of first quarter sales in 2005 and 59% of first quarter sales in 2004. Sales outside of the United States accounted for 48% of first quarter sales in 2005 and 41% of first quarter sales in 2004. Sales to customers in the Netherlands, including the European distribution facility for one of our OEM customers, accounted for 11% of our first quarter sales in 2005 and 10% of our first quarter sales in 2004. No other country accounted for more than 10% of sales in the first quarter of either 2005 or 2004.

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

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

Many of our executive officers and directors are vested in significant amounts of options to purchase shares of our common stock and continue to vest in additional shares on a regular basis. These officers and directors have informed us that they have sold, and may sell additional, shares of our common stock to provide liquidity and diversify their portfolios.

## Results of Operations

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

**Three Months Ended**

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|   | April 1,<br>2005 | April 2,<br>2004 |
|---|------------------|------------------|
| Net sales   | 100.0%           | 100.0%           |
| Cost of sales   | 43.3             | 41.8             |
| Gross profit  | 56.7             | 58.2             |
| Operating expenses:                                   |                  |                  |
| Research and development expenses                     | 18.8             | 11.0             |
| Acquired in-process research and development expenses |                  | 7.5              |
| Selling, general and administrative expenses          | 29.0             | 23.6             |
| Amortization of intangible assets                     | 8.6              | 5.5              |
| Total operating expenses                              | 56.4             | 47.6             |
| Income from operations                                | 0.3              | 10.6             |
| Net investment income                                 | 2.6              | 1.5              |
| Net realized investment losses                        | (0.2)            | (0.1)            |
| Other income (expense), net                           | 0.1              | (0.1)            |
| Income before provision for income taxes              | 2.8              | 11.9             |
| Provision for income taxes                            | 0.4              | 2.0              |
| Net income  | 2.4%             | 9.9%             |

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*Net sales.* Our net sales consist of sales of keyboard, video, and mouse console switching systems, digital connectivity solutions, serial connectivity devices, wireless extension products, IPMI, extension and remote access and management solutions. Net sales decreased 11% to \$76.8 million for the first quarter of 2005 from \$86.1 million for the first quarter of 2004. The decrease in sales resulted primarily from the decline experienced in our U.S. branded sales in the first quarter of 2005 as compared to the first quarter of 2004. Overall, branded sales declined 28% from \$50.7 million in the first quarter of 2004 to \$36.7 million in the first quarter of 2005. As a percentage of sales, branded revenue accounted for 48% of sales in the first quarter of 2005 and 59% of revenue in the first quarter of 2004. Partially offsetting the disappointing branded results in the U.S., OEM sales grew 13% from \$35.4 million in the first quarter of 2004 to \$40.1 million in the first quarter of 2005. OEM sales were 52% of sales for the first quarter of 2005, compared to 41% of sales for the first quarter of 2004. The reasons for our disappointing branded results were varied. The most significant factor was the launch of our DSView3 management software and several new appliance products that kept our sales and reseller forces in training and away from our customers for much of January and created some confusion in the marketplace. In addition, an order for a large customer that we had anticipated to occur in the first quarter of 2005 was deferred. Finally, we experienced greater than expected seasonal softness in the OEM market, with a substantial portion of the softness attributable to one customer. These factors, when combined with increased competition in the marketplace, worked together to cause the decline in revenue. Sales of our digital products represented 50% of our revenue in the first quarter of 2005 as compared to 44% of our revenue in the first quarter of 2004, with this shift coming in large part from our OEM customers. Additionally, our embedded KVM offerings and our IPMI management solutions contributed \$3.8 million in revenue in the first quarter of 2005 as compared to less than \$100,000 of revenue in the first quarter of 2004.

International sales increased 6%, to \$36.8 million in the first quarter of 2005 from \$34.9 million in the first quarter of 2004. Primarily as a result of the reduction in US branded sales, sales within the United States decreased 22% to \$40.0 million in the first quarter of 2005 from \$51.2 million in the first quarter of 2004. Sales within the United States were 52% of sales in the first quarter of 2005, compared to 59% of sales for the first quarter of 2004. International sales were 48% of sales in the first quarter of 2005 and 41% of sales for the first quarter of 2004.

Revenue for the first quarter of 2005 was lower than anticipated. We have seen mixed economic indicators during the past quarter, which adds to uncertainty regarding our ability to predict the results for all of 2005. However, we believe our product platforms position us to grow our overall business from present levels. We have re-launched our DSView3 software with a simplified pricing and packaging structure and increased product training for our reseller network. Early feed-back from the re-launch has been positive. Based on feedback from our sales force, the continuing positive contribution of our digital products and expected increased contributions from our embedded solutions should improve our revenue for the second quarter of 2005. Accordingly, for the second quarter of 2005, we expect revenue to be in the \$84 to \$87 million range.

*Gross profit.* Gross profit may be affected by a variety of factors, including: the ratio of sales among our distribution channels, as OEM sales have lower gross margins than our branded sales; absorption of fixed costs as sales levels fluctuate; product mix, raw materials, and labor costs; new product introductions by us and by our competitors; and the level of our outsourcing of manufacturing and assembly services. Gross profit decreased to 56.7% in the first quarter 2005 as compared to 58.2% in the first quarter of 2004. The primary reason for reduced margins in 2005 relates to the effect of lower revenue in the first quarter of 2005. The lower level of revenue affected the ability to cover the fixed costs related to procurement, warehousing, and shipping. Offsetting the impact of lowered revenue was the increased sales as a percentage of total sales of our digital solutions in the first quarter of 2005 as compared to the first quarter of 2004. Our digital solutions carry higher margins than our analog solutions.

We expect continued positive contributions from our digital products and higher revenues from our embedded solutions in the second quarter of 2005. We expect the combination of these two factors to offset expected price declines, the additional costs expected from complying with new environmental regulations and competitive factors in the second quarter of 2005. Accordingly, we expect gross margins to average between 56% and 57% in the second quarter of 2005.



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*Research and development expenses.* Research and development expenses include compensation for engineers, support personnel, outside contracted services and materials costs, and are expensed as they are incurred. Research and development expenses were \$14.5 million, or 18.8% of net sales, in the first quarter of 2005 compared to \$9.4 million, or 11.0% of net sales, for the first quarter of 2004. The increase in the amount spent on research and development is due to increased labor costs and costs of certification and testing as we continued to develop product enhancements and updates to our digital, analog and embedded products lines. In certain instances, contracted labor was utilized to supplement our engineering staff to meet deadlines. Increases in labor expenses were also caused by annual pay increases that took effect on January 1 as well as additional headcount as a result of the three acquisitions completed in 2004. We believe that the timely development of innovative products and enhancements to existing products is essential to maintaining our competitive position.

We anticipate implementing plans to slow down growth in research and development spending in the second quarter of 2005. However, due to the timing of these changes, most of the benefit will not be apparent until the third quarter of 2005. Considering commitments already in place, research and development expenses in the second quarter of 2005 are expected to be up to \$500,000

higher than the first quarter of 2005

*Acquired in-process research and development expense.* Acquisition related expenses in 2004 are comprised solely of the non-recurring write-off of \$6.5 million of in-process research and development expense related to the acquisition of Crystal Link. There were no such charges in the first quarter of 2005.

*Selling, general and administrative expenses.* Selling, general and administrative expenses include personnel costs for administration, finance, information systems, human resources, sales and marketing and general management, as well as some merger and acquisition related expenses, rent, utilities, legal and accounting expenses, bad debts, advertising, promotional material, trade show expenses and related travel costs. Selling, general and administrative expenses were \$22.3 million, or 29.0% of net sales, for the first quarter of 2005 compared to \$20.3 million, or 23.6% of net sales, for the first quarter of 2004. The increase in selling, general and administrative expenses is attributed to higher costs associated with Sarbanes-Oxley Act of 2002 compliance and higher legal fees associated with obtaining and protecting our intellectual property rights. We experienced higher advertising and promotion costs as we continue to promote DSView3 and other products introduced in late Q4 2004 and Q1 2005.

**We expect our selling, general and administrative expenses to be flat in the second quarter of 2005 as compared to the first quarter of 2005. We expect costs of Sarbanes-Oxley compliance to decline in the second quarter of 2005; however we plan to continue to invest more in promoting our brand and our new products. In addition, legal costs are expected to rise in the second quarter of 2005 as one of our patent protection cases is scheduled for trial during the second quarter of 2005.**

*Amortization of intangible assets.* Amortization of \$6.6 million in the first quarter of 2005 is comprised of the amortization of the identifiable intangible assets created as a result of the merger transaction between Apex and Cybex and the acquisitions of Equinox, 2C, Soronti, Crystal Link, OSA, and Sonic Mobility. Amortization of \$4.8 million in the first quarter of 2004 is comprised of the amortization of the identifiable intangible assets created as a result of the merger transaction between Apex and Cybex and the acquisitions of Equinox, 2C, Soronti and Crystal Link. The increase in amortization expense relates primarily to the addition of intangibles from the three acquisitions completed during 2004.

*Net investment income.* Net investment income increased to \$2.1 million in the first quarter of 2005 as compared to \$1.2 million in the first quarter of 2004. The improved results were the result of higher interest rates on investments resulting in higher returns for the first quarter of 2005.

*Net realized investment losses.* Net realized investment losses increased from \$64,000 in the first quarter of 2004 to \$177,000 in first quarter of 2005.

*Other expense, net.* Net other expense improved from an expense of \$50,000 in the first quarter of 2004, to income of \$61,000 in the first quarter of 2005.

*Provision for income taxes.* The provision for income taxes was approximately \$319,000 for the first quarter of 2005, compared to \$1.7 million in the first quarter of 2004. The effective tax rate in the first quarter of 2005 was approximately 14.8% compared to an effective tax rate of

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approximately 16.4% in the first quarter of 2004. The reduction in our effective tax rate was partly the result of the change in mix of our pre-tax profit among our U.S. and international companies. As a result of lower than expected earnings in the U.S. in the first quarter, the pre-tax profit attributable to the International operations was higher than that experienced in recent quarters. Our international operations in Ireland are generally taxed at lower income tax rates than our U.S. operations. In addition, the provision for income taxes for the first quarter of 2005 was reduced by approximately \$133,000 related to a tax benefit expected to be realized from the settlement of a tax contingency.

*Net income.* Net income for the first quarter of 2005 was \$1.8 million compared to \$8.5 million for the first quarter of 2004, as a result of the above factors, including the decrease in our revenues and our margins, increases in selling, general and administrative charges and research and development expenses and the increase in intangible amortization expense as a result of our latest acquisitions. Net income as a percentage of sales for the first quarter of 2005 was 2.4%, compared to 9.9% for the first quarter of 2004.

### **Liquidity and Capital Resources**

As of April 1, 2005, our principal sources of liquidity consisted of \$324 million in cash, cash equivalents, and investments. We have no outstanding debt or available credit facilities as of this filing.

Our operating activities generated cash of over \$10 million in the first three months of 2005, compared to approximately \$13 million in the first three months of 2004. The reduction in positive cash flow is the result of a decrease in earnings combined with an increase in inventories. Inventories increased from \$21.2 million at December 31, 2004 to \$24.3 million at April 1, 2005. The increase in

inventory was primarily the result of adding inventory related to our recent product introductions and in anticipation of expected higher sales. Accordingly, as a result of the lower sales volume and the increased inventories, our inventory turns declined to 5.5 for the first quarter of 2005 from 6.2 in the first quarter of 2004. We will continue to monitor our inventory closely and expect our inventory turns to return to a more normal level as sales volume increases. Our decrease in receivables positively impacted cash flows for the quarter as accounts receivable decreased from \$60.9 million at December 31, 2004 to \$50.0 million at April 1, 2005. Although our receivables balance declined, our DSOs increased to 59 days, slightly better than our goal of 60 days. DSOs increased as a result of the increasing sales that occurred late in the first quarter of 2005. However, our accounts receivable aging remains strong, with only 1% of the balance greater than 30 days past due. A decline in accrued compensation and accounts payable also affected cash flow from operations for the first quarter of 2005.

In the ordinary course of our business, we may at any point in time have a significant amount of contractual commitments not yet recognized in our financial statements. These commitments relate primarily to our need to schedule the purchase of inventories in advance of the related forecasted sales to customers. We have longer lead times for the products we purchase from suppliers based in Asia than those for our U.S. based and European suppliers. Our actual contractual commitments are typically limited to products needed for one to three months of forecasted sales. The liabilities for these inventory purchases along with the related inventory assets are typically recognized upon our receipt of the products. We also have at any point in time a variety of short term contractual commitments for services such as advertising, marketing, accounting, legal, and research and development activities. The liabilities for these services and the related expenses are typically recognized upon our receipt of the related services. As of April 1, 2005, we had approximately \$22.5 million of such commitments. None of our expected purchase commitments require payment beyond the next year.

We intend to use a portion of our cash and investments for strategic acquisitions of technologies and companies that will enhance and complement our existing technologies and help increase our sales.

We repurchased 700,000 shares of our common stock for a total cost of approximately \$21.9 million during first quarter of 2005 under the stock repurchase program approved by our Board of Directors during the fourth quarter of 2004. During the period April 2, 2005 through May 2, 2005 we repurchased an additional 275,000 shares under this program at a total cost of approximately \$6.9 million. On April 29, 2005, our Board of Directors authorized the repurchase of an additional two million shares of our common stock to be repurchased under the stock repurchase program. A total of four million shares have been authorized for repurchase under the program, of which approximately 1.1 million shares had been repurchased as of May 2, 2005.

On April 29, 2005, our Board of Directors approved a plan to accelerate vesting of all currently outstanding stock options with an exercise price of greater than \$25.00 which are unvested on December 25, 2005. Under the provisions of APB 25, we estimate that there will be no compensation expense related to accelerating these options as the options affected by the acceleration had exercise prices higher than the closing price of our common stock as of the modification date. As a result of the Board's action, stock options to purchase approximately 1.1 million shares of our common stock will become exercisable effective December 25, 2005. The exercise prices of the affected stock options range from \$25.17 to \$41.57 per share. The closing price of Avocent's common stock on April 29, 2005 was \$25.14. We expect the acceleration of these stock options to reduce compensation expense that would have been recorded in future periods following the adoption of SFAS 123R on January 1, 2006. We estimate that we will save approximately \$13 million in future compensation expense based on our plan to accelerate the vesting of stock options.

## Investments

Our investments consist of corporate bonds, municipal bonds, commercial paper, mortgage backed securities guaranteed by U.S. government agencies, and common stock. We classify our debt and equity securities as available-for-sale securities and report them at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity. We periodically review our investment portfolio for investments considered to have sustained an other-than-temporary decline in value. Upon review of our investment portfolio as of April 1, 2005, no investments were considered to have sustained an other-than-temporary decline, and no charge was recorded in

the first quarter of 2005.

### **Critical Accounting Policies**

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our consolidated financial statements:

We review customer contracts to determine if all of the requirements for revenue recognition have been met prior to recording revenues from sales transactions. We generally record sales revenue upon shipment of our products, net of

any discounts, since we generally do not have significant post delivery obligations, the product price is fixed and determinable, collection of the resulting receivable is probable, and product returns are reasonably estimable. We generally ship products upon receipt of a purchase order from a customer. We record revenue in accordance with the applicable terms of each respective customer contract. Accordingly, revenue on products shipped FOB destination is recorded when the customer takes possession of the goods, and revenue on products shipped FOB shipping point is recorded when the goods leave our facilities. Shipping and handling fees are included in net sales, and the related costs are included in cost of sales in the accompanying consolidated statements of operations.

We generally record royalty revenue from OEMs upon shipment of the related products in which our software or firmware is embedded by the OEMs, based upon shipment data provided by the OEMs. We generally record license revenue from sales of our software upon shipment or electronic transfer of the software. We generally defer revenues from the sale of extended warranty agreements and software support and maintenance agreements. The deferred revenue is amortized into income on a pro rata basis over the applicable contract lives.

We accrue for sales returns as a reduction of sales and cost of sales based on our experience from historical customer returns, which we believe provides a reasonable estimate of future returns. Our sales agreements generally include a one-month unconditional return policy. We also allow additional rights of return to certain distributors, which generally extend the return period to 90 days. If actual future customer returns are less favorable than those projected by management, additional sales return costs may be incurred. The reserve is included as a reduction in the carrying value of accounts receivable in the accompanying consolidated balance sheets.

Prior to extending credit to a new customer, we perform a detailed credit review of the customer and establish credit limits based on the results of our credit review. We review collection experience periodically to determine if the customer's payment terms and credit limits need to be revised. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. If circumstances change with regard to individual receivable balances that had previously been determined to be uncollectible (and for which a specific reserve had been established), a reduction in our allowance for doubtful accounts may be required.

We participate in cooperative advertising and market development programs with certain distributors and OEMs. We use these programs to reimburse distributors and OEMs for the actual costs of advertising, and in general, allow distributors and OEMs credits up to a specified percentage of net purchases. Our costs associated with these programs are estimated and accrued at the time of sale, and are included in sales and marketing expenses in the accompanying consolidated statements of operations.

We carry our inventory at the lower of cost or market, with cost being determined using the first-in, first-out method. We use standard costs for material, labor, and manufacturing overhead to value our inventory. We review and revise our standard costs on a quarterly basis. Therefore, our inventory costs approximate actual costs at the end of each reporting period. We write down our inventory for estimated obsolescence or unmarketable inventory to the estimated market value based upon assumptions about future demand and market conditions. If actual future demand or market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

We provide for the estimated cost of product warranties at the time revenue is recognized. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers and contract manufacturers, our warranty obligation is affected by product failure rates, failure rates of purchased components integrated into our products, material usage, and other rework costs incurred in correcting a product failure. Should actual product failure rates, material usage, or other rework costs differ from our estimates, revisions to our estimated warranty liability may be required.

We hold investments in various publicly traded debt securities, including mortgaged-backed and other asset-backed securities. We record an investment impairment charge when we believe an investment has experienced a decline in value that is other than temporary. Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investments that may not be reflected in an investments current carrying value, thereby possibly requiring an impairment charge in the future. There were no other-than-temporary impairment charges recorded against investments in the first quarter of 2005 or 2004.

We also invest in privately held entities and generally record our investments in these entities at cost or we use the equity method if we have the ability to exercise significant influence over the entity. We review our investments in these entities periodically to determine if circumstances (both financial and non-financial) exist that indicate that we will not recover our initial investment. We record impairment charges on investments having a carrying value that is greater than the value that we would reasonably expect to receive in an arm's length sale of the investment.

As required by SFAS No. 142 *Goodwill and Other Intangible Assets*, we test for impairment of goodwill at least annually. Our annual test for goodwill impairment, performed in the fourth quarter of 2004 and 2003, determined that no adjustment for impairment was required. Our testing indicated that the fair value of our goodwill exceeded its carrying value; accordingly, in accordance with SFAS 142, no further impairment analysis was required. If economic conditions deteriorate and indicators of impairment become present, an adjustment to the carrying value of goodwill and other intangible assets may be required.

We review long-lived assets for impairment under the guidance prescribed by SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. We recognize impairment losses on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying values. An impairment loss would be recognized in the amount by which the recorded value of the asset exceeds the fair value of the asset, measured by the quoted market price of an asset or an estimate based on the best information available in the circumstances. There were no such losses recognized during the first quarter of 2005 or 2004.

We account for income taxes using the asset and liability method. We provide for income taxes currently payable and, in addition, provide deferred income taxes for temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements and for known contingencies. Temporary differences relate principally to the allowance for doubtful accounts, allowance for sales returns, liability for warranty claims, unrealized gain (loss) on investments, acquired intangible assets, accumulated depreciation, loss on write-down of investments, and inventory reserves. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

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

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share based Payment*, which replaces SFAS No. 123, *Accounting for Stock Based Compensation* and APB Opinion No 25 *Accounting for Stock Issued to Employees*. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first annual period after June 15, 2005. The pro-forma disclosures previously permitted under SFAS No. 123 no longer will be an alternative to inclusion of the expense in the financial statements. We are required to adopt SFAS 123R beginning January 1, 2006. Under SFAS 123R, we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. We expect to utilize the prospective method which requires that compensation expense begin being recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS 123R. We are evaluating the requirements of SFAS 123R and expect the adoption of SFAS 123R will have a material impact on our consolidated results of operations and earnings per share. We have not determined the effect of adopting SFAS 123R and we have not determined whether the adoption will result in amounts similar to the current pro-forma disclosures under SFAS 123. Under the current approach of SFAS 123 we would have unamortized fair value of unvested stock options of approximately \$15 million for currently outstanding stock options to be recognized as expense in our income statements after 2005, prior to the acceleration of vesting discussed above. Following this acceleration we believe the balance to be expensed in future periods would be reduced to approximately \$2 million for currently outstanding stock options under the SFAS 123 methodology.



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On October 22, 2004, the American Jobs Creation Act of 2004 became law. This legislation repeals export tax benefits, which have historically reduced our effective tax rate. This legislation phases in the repealed export tax benefits by allowing 100 percent of the repealed export benefits in 2004, 80 percent in 2005 and 60 percent in 2006. We do not expect this change to have a material impact on our effective tax rate or provision for taxes.

The legislation also transitions in a new tax deduction for qualifying U.S. manufacturing activities. Under the guidance in FASB Staff Position No. FAS 109-1 which articulates the application of SFAS 109, Accounting for Income Taxes, to the tax deduction on qualified production activities provided by the Act, the deduction will be treated as a special deduction as described in SFAS 109. As such, we expect the new manufacturing activities deduction provision of the new legislation will reduce our effective rate in future periods as the deduction is taken on our tax returns.

The legislation also provides for the optional repatriation of earnings from foreign subsidiaries allowing an 85 percent dividends received deduction. The deduction is subject to a number of limitations. We have not yet initiated an analysis nor determined if we will repatriate any overseas earnings pursuant to this provision. If our intention to permanently reinvest overseas earnings in our overseas operations changes and we decide to repatriate any of the earnings to the U.S., we would incur additional income tax expense equal to the incremental U.S. income tax in excess of the credits available for taxes already paid overseas.

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

Our primary market risk is the potential loss arising from increases in interest rates, which could have an adverse impact on the fair value of our investment securities. Our investment policy is to manage our investment portfolio to preserve principal and liquidity while maximizing the return on our investment portfolio through the investment of available funds. We diversify our investment portfolio by investing in a variety of highly-rated investment-grade securities and through the use of different investment managers. Our investment securities portfolio is primarily invested in securities with maturities (or interest rate resets) of two years or less with at least an investment grade rating to minimize interest rate and credit risk as well as to provide for an immediate source of funds. Market risk, calculated as the potential change in fair value in our investment portfolio resulting from a hypothetical 10% change in interest rates, was not material at April 1, 2005. We generally hold investment securities until maturity.

We also face foreign currency exchange rate risk to the extent that the value of certain foreign currencies relative to the U.S. dollar affects our financial results. Our international operations transact a portion of our business in currencies other than the U.S. dollar, predominantly the euro, and changes in exchange rates may positively or negatively affect our revenues, gross margins, operating expenses, and retained earnings since these transactions are reported by us in U.S. dollars. We occasionally purchase foreign currency forwards aimed at limiting the impact of currency fluctuations. These instruments provide only limited protection against currency exchange risks, and there can be no assurance that such an approach will be successful, especially if a significant and sudden decline occurs in the value of local currencies. As of April 1, 2005, we had one open forward contract with a fair value of zero..

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

(a) *Evaluation of disclosure controls and procedures.* Based on their evaluation as of April 1, 2005, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

(b) *Changes in internal control over financial reporting.* There were no changes in our internal controls over financial reporting during the quarter ended April 1, 2005 that materially affected or is reasonably likely to materially affect, our internal controls over financial reporting. However, we did extend our ERP system to our location in San Jose, California, which has enhanced our internal control over financial reporting through the automation and standardization of certain controls and processes, as all of our financially significant locations are now operating under the same ERP system. We also created a new corporate treasurer position during the first quarter of 2005 to provide enhanced oversight of our investments, tax planning, and risk management activities.



**PART II OTHER INFORMATION****Item 1. Legal Proceedings.**

In May 2001, we filed a complaint for patent infringement in the United States District Court for the Southern District of New York against Raritan Computer Inc. The Raritan complaint sought injunctive relief, damages, attorneys' fees and costs under three patents. After a seven day bench trial in New York in January of 2002, U.S. District Judge Milton Pollack found that there was no infringement of these patents by Raritan and ordered that judgment be entered in favor of Raritan.

In April 2003, the United States Court of Appeals for the Federal Circuit issued its ruling on our appeal in this patent litigation. The Court of Appeals ruled in our favor by vacating the non-infringement decision of the District Court for the Southern District of New York and remanding the case for further proceedings consistent with the Court of Appeals' opinion.

In September 2003, Raritan petitioned the United States Supreme Court for a Writ of Certiorari to review the Court of Appeals decision. The Supreme Court declined to review Raritan's petition in December 2003, and the case was sent back to the United States District Court for the Southern District of New York. A Markman hearing on claims construction was held in February 2005. This case is currently scheduled for trial in May 2005.

In October 2003, we filed a complaint for patent infringement in the United States District Court for the Northern District of Alabama against ClearCube Technology, Inc. The ClearCube complaint seeks injunctive relief, damages, attorneys' fees, and costs under three of our patents. ClearCube has filed counterclaims alleging non-infringement, unenforceability, invalidity, and misuse of the Avocent patents. A Markman hearing on claims construction was originally set for February 2005, but in response to an inquiry from the Court, we agreed that the hearing should be postponed until the United States Court of Appeals for the Federal Circuit issues its ruling on certain similar issues raised in an unrelated patent case.

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

In the fourth quarter of 2004 our Board of Directors approved a stock repurchase program whereby we may, from time to time, to purchase up to two million shares of our common stock in the open market, in privately negotiated transactions or otherwise, at prices that we deem appropriate. The plan has no expiration date. Details of purchases made during the quarter ended April 1, 2005 are as follows:

| Period:                              | Total Number of<br>Shares Purchased<br>During the Period | Average Price Paid<br>Per Share | Total Cumulative<br>Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced Plan | Maximum Number<br>of Shares<br>Remaining to<br>Purchase Under the<br>Plan (1) |
|--------------------------------------|--|---------------------------------|--|---|
| January 1, 2005 - January 31, 2005   | 195,600  | \$ 36.04                        | 295,600  | 1,704,400   |
| February 1, 2005 - February 28, 2005 | 154,400  | \$ 35.41                        | 450,000  | 1,550,000   |
| March 1, 2005 - April 1, 2005        | 350,000  | \$ 26.70                        | 800,000  | 1,200,000   |
| Totals                               | 700,000  | \$ 31.23                        |  |   |

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(1) Does not include the additional two million shares approved by our Board of Directors for our stock repurchase program on April 29, 2005. A total of four million shares is now authorized to be repurchased under the board approved program.

### Item 6. Exhibits.

(a) Exhibits

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

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

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

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

**SIGNATURE**

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

AVOCENT CORPORATION  
(Registrant)

Date: May 9, 2005

/s/ Douglas E. Pritchett  
Douglas E. Pritchett  
Executive Vice President of Finance, Chief Financial  
Officer and Assistant Secretary (Principal Financial Officer)