

DSP GROUP INC /DE/
Form 10-Q
May 09, 2008
[Table of Contents](#)

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

FORM 10-Q

(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended March 31, 2008

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission File Number 0-23006

DSP GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

94-2683643
(I.R.S. employer identification number)

Edgar Filing: DSP GROUP INC /DE/ - Form 10-Q

3120 Scott Boulevard, Santa Clara, California

(Address of Principal Executive Offices)

95054

(Zip Code)

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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). 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 ☐

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

As of May 1, 2008, there were 28,320,290 shares of Common Stock (\$.001 par value per share) outstanding.

Table of Contents

INDEX

DSP GROUP, INC.

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements (Unaudited)</u>	
<u>Condensed consolidated balance sheets March 31, 2008 and December 31, 2007</u>	2
<u>Condensed consolidated statements of income Three months ended March 31, 2008 and 2007</u>	4
<u>Condensed consolidated statements of cash flows Three months ended March 31, 2008 and 2007</u>	5
<u>Condensed consolidated statements of stockholders' equity Three months ended March 31, 2008 and 2007</u>	6
<u>Notes to condensed consolidated financial statements March 31, 2008</u>	7
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	26
Item 4. <u>Controls and Procedures</u>	26
<u>PART II. OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	26
Item 1A. <u>Risk Factors</u>	26
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	41
Item 6. <u>Exhibits</u>	42
<u>SIGNATURES</u>	43

Table of Contents**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)

	March 31, 2008 Unaudited	December 31, 2007 Audited
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 69,554	\$ 69,586
Restricted deposit	3,428	
Marketable securities	30,832	63,682
Trade receivables, net	44,668	51,636
Deferred income taxes	5,529	4,011
Other accounts receivable and prepaid expenses	10,400	7,705
Inventories	17,652	16,361
Related party receivable	468	468
TOTAL CURRENT ASSETS	182,531	213,449
PROPERTY AND EQUIPMENT, NET	18,329	14,270
LONG-TERM ASSETS:		
Long-term marketable securities	35,084	34,469
Long-term prepaid expenses and lease deposits	1,892	694
Deferred income taxes	4,997	5,109
Severance pay fund	7,379	6,883
Intangible assets, net	89,921	95,234
Goodwill	143,312	142,735
	282,585	285,124
TOTAL ASSETS	\$ 483,445	\$ 512,843

Note: The balance sheet at December 31, 2007 has been derived from the audited financial statements at that date.

See notes to condensed consolidated financial statements.

Table of Contents**DSP GROUP, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

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

	March 31, 2008 Unaudited	December 31, 2007 Audited
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 16,910	\$ 18,817
Accrued compensation and benefits	14,803	19,130
Income tax accruals and payables	14,578	14,136
Accrued expenses and other accounts payable	15,492	13,292
Related party payable	11,835	11,814
Total current liabilities	73,618	77,189
LONG-TERM LIABILITIES:		
Accrued severance pay	7,839	7,303
Other long-term liability	1,556	1,364
Accrued pensions	2,003	1,758
Deferred tax liabilities	803	372
Total long-term liabilities	12,201	10,797
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$ 0.001 par value -		
Authorized shares: 5,000,000 at March 31, 2008 and December 31, 2007; Issued and outstanding shares: none at March 31, 2008 and December 31, 2007		
Common stock, \$ 0.001 par value -		
Authorized shares: 50,000,000 at March 31, 2008 and December 31, 2007; Issued and outstanding: 29,146,859 and 31,229,810 shares at March 31, 2008 and December 31, 2007, respectively	29	31
Additional paid-in capital	304,505	300,542
Treasury stock	(88,020)	(63,804)
Accumulated other comprehensive income	2,446	1,025
Retained earnings	178,666	187,063
Total stockholders' equity	397,626	424,857
Total liabilities and stockholders' equity	\$ 483,445	\$ 512,843

Note: The balance sheet at December 31, 2007 has been derived from the audited financial statements at that date.

See notes to condensed consolidated financial statements.

Table of Contents**DSP GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

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

	Three months ended March 31,	
	2008	2007
Revenues	\$ 72,729	\$ 49,288
Costs of revenues (includes \$18,429 and \$0 with related party for the three months ended March 31, 2008 and 2007, respectively) (1)	45,776	30,001
Gross profit	26,953	19,287
Operating expenses:		
Research and development (2)	20,028	12,757
Sales and marketing (3)	6,021	4,197
General and administrative (4)	4,250	3,596
Intangible assets amortization	5,782	
Total operating expenses	36,081	20,550
Operating loss	(9,128)	(1,263)
Interest and other income, net	1,234	3,652
Income (loss) before taxes on income	(7,894)	2,389
Taxes on income (tax benefit) (5)	(286)	1,025
Net income (loss)	\$ (7,608)	\$ 1,364
Net earnings (loss) per share:		
Basic	\$ (0.25)	\$ 0.05
Diluted	\$ (0.25)	\$ 0.05

- (1) Includes equity-based compensation expense in the amount of \$257 and \$166 for the three months ended March 31, 2008 and 2007, respectively.
- (2) Includes equity-based compensation expense in the amount of \$2,091 and \$2,088 for the three months ended March 31, 2008 and 2007, respectively.
- (3) Includes equity-based compensation expense in the amount of \$507 and \$440 for the three months ended March 31, 2008 and 2007, respectively.
- (4) Includes equity-based compensation expense in the amount of \$1,106 and \$1,460 for the three months ended March 31, 2008 and 2007, respectively.

- (5) Includes tax benefit resulting from equity-based compensation expense in the amount of \$131 and \$185 for the three months ended March 31, 2008 and 2007, respectively.

See notes to condensed consolidated financial statements.

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

(U.S. dollars in thousands)

	Three Months Ended March 31,	
	2008	2007
Net cash provided by (used in) operating activities	\$ (151)	\$ 7,122
Investing activities		
Purchase of marketable securities and short-term investments	(10,034)	(49,287)
Proceeds from maturity and sale of marketable securities and short-term investments	41,856	40,300
Investment in a restricted deposit	(3,293)	
Purchases of property and equipment	(4,097)	(1,212)
Payment of transaction costs related to the acquisition of the cordless and VoIP terminals business of NXP B.V. (1)	(589)	
Net cash provided by (used in) investing activities	23,843	(10,199)
Financial activities		
Purchase of Treasury Stock	(23,941)	
Issuance of Common Stock and Treasury Stock for cash upon exercise of options	68	901
Net cash provided by (used in) financing activities	(23,873)	901
Decrease in cash and cash equivalents	\$ (181)	\$ (2,176)
Cash erosion due to exchange rate differences	149	
Cash and cash equivalents at the beginning of the period	\$ 69,586	\$ 37,344
Cash and cash equivalents at the end of the period	\$ 69,554	\$ 35,168

- (1) On September 4, 2007, the Company acquired certain assets and assumed certain liabilities of the cordless and VoIP terminals business of NXP B.V.

Table of Contents**DSP GROUP, INC.****CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY****(UNAUDITED)****(U.S. dollars in thousands)**

Three Months Ended	Number of		Additional			Other		
	Common	Common	Paid-In	Treasury	Retained	Comprehensive	Total	Total
	Stock	Stock	Capital	Stock	Earnings	Income	Comprehensive	Stockholders
						(Loss)	Income	Equity
March 31, 2007								
Balance at December 31, 2006	28,378	\$ 28	\$ 216,041	\$ (44,546)	\$ 195,198	\$ 28		\$ 366,749
Net income					1,364		\$ 1,364	1,364
Unrealized gain from hedging activities, net						(6)	(6)	(6)
Total comprehensive income							\$ 1,358	
Issuance of Treasury Stock upon purchase of Common Stock under employee stock purchase plan	44	(*)		1,029	(214)			815
Issuance of Treasury Stock upon exercise of stock options by employees	49	(*)		1,145	(484)			661
Equity based compensation			4,153					4,153
Cumulative impact of change in accounting for uncertainties in income taxes (FIN 48 See note F)					(1,485)			(1,485)
Balance at March 31, 2007	28,471	\$ 28	\$ 220,194	\$ (42,372)	\$ 194,379	\$ 22		\$ 372,251
Three Months Ended								
March 31, 2008								
Balance at December 31, 2007	31,230	\$ 31	300,542	\$ (63,804)	187,063	\$ 1,025		424,857
Net loss					(7,608)		\$ (7,608)	(7,608)
Unrealized gain from hedging activities, net						89	89	89
Unrealized loss from marketable securities, net						(32)	(32)	(32)
Foreign currency translation adjustments, net						1,364	1,364	1,364
Total comprehensive loss							\$ (6,187)	
Issuance of Treasury Stock upon purchase of Common Stock under employee stock purchase plan	82			1,605	(758)			847
Issuance of Treasury Stock upon exercise of stock options by employees	6			99	(31)			68

Edgar Filing: DSP GROUP INC /DE/ - Form 10-Q

Purchase of treasury stock	(2,171)	(2)	2	(25,921)				(25,921)
Equity based compensation			3,961					3,961
Balance at March 31, 2008	29,147	\$ 29	\$ 304,505	\$ (88,020)	\$ 178,666	\$ 2,446		\$ 397,626

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

See notes to condensed consolidated financial statements.

Table of Contents**DSP GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2008****(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 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 months ended March 31, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. 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, 2007.

Reclassification

Certain prior year amounts have been reclassified to conform to the current year presentation.

NOTE B RESTRUCTURING PLAN

Following the acquisition (the "Acquisition") of the cordless and VoIP terminals business (the "CIPT Business") of NXP B.V. ("NXP"), the Company approved a plan to restructure certain operations of the CIPT Business to eliminate redundant costs resulting from the Acquisition and improve operational efficiencies. The restructuring charges recorded are based on management's current best estimates.

The estimated restructuring costs associated with exiting activities of the CIPT Business totaled \$ 6,000, consisting primarily of employee severance costs. These costs were recognized as a liability assumed in the Acquisition and included in the allocation of the cost to acquire the CIPT Business and, accordingly, have resulted in an increase in goodwill. The restructuring expenses may change as management executes the approved restructuring plan. Assuming the charges will occur within a year from the date of consummation of the Acquisition, the effect of the charges will reduce or increase the cost of the acquired business. The Company estimates that it will finalize the restructuring plan within a year from the date of consummation of the Acquisition.

Summary of the plan:

	Initial costs	Adjustments to cost	Cash payments	Accrued as of March 31, 2008	Accrued as of December 31, 2007
Severance and others	\$ 6,000	\$	\$ (1,426)	\$ 4,574	\$ 6,000
Total restructuring	\$ 6,000	\$	\$ (1,426)	\$ 4,574	\$ 6,000

As part of the agreement with the French employees of the Company, the Company transferred a restricted deposit in the amount of \$3,178 to an escrow account for the benefit of these employees related to termination severance costs. As of March 31, 2008, the full amount held in escrow remains outstanding.

Table of Contents**NOTE C INVENTORIES**

Inventories are stated at the lower of cost or market value. Cost is determined using the average cost method. 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:

	March 31, 2008 (Unaudited)	December 31, 2007 (Audited)
Work-in-process	\$ 5,374	\$ 4,437
Finished goods (*)	12,278	11,924
	\$ 17,652	\$ 16,361

(*) The finished products inventory includes \$667 and \$585 of inventory held in consignment by other parties as of March 31, 2008 and December 31, 2007, respectively. Write off of inventory amounted to \$678 and \$154 for the first three months ended March 31, 2008 and 2007, respectively.

NOTE D NET EARNINGS PER SHARE

Basic net earnings per share are computed based on the weighted average number of shares of Common Stock outstanding during the period. For the same periods, diluted net earnings per share further include the effect of dilutive stock options and stock appreciation rights outstanding during the period, all in accordance with Statement of Financial Accounting Standard (SFAS) No. 128 Earnings per Share. The following table sets forth the computation of basic and diluted net earnings per share:

	Three months ended March 31,	
	2008	2007
Net income (loss)	\$ (7,608)	\$ 1,364
Earnings (loss) per share:		
Basic	\$ (0.25)	\$ 0.05
Diluted	\$ (0.25)	\$ 0.05
Weighted average number of shares of Common Stock outstanding during the period used to compute basic net earnings per share (in thousands)	30,574	28,455
Incremental shares attributable to exercise of outstanding options (assuming proceeds would be used to purchase Treasury Stock) (in thousands)		236
Weighted average number of shares of Common Stock used to compute diluted net earnings per share (in thousands)	30,574	28,691

NOTE E INVESTMENTS IN MARKETABLE SECURITIES

The Company accounts for investments in marketable securities in accordance with SFAS No. 115 Accounting for Certain 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.

Table of Contents

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 and dividends on securities are included in financial income, net. Prior to the second quarter of 2007, marketable securities were classified as held-to-maturity as the Company previously had the intent and ability to hold the securities to maturity and were stated at amortized cost. The following is a summary of available-for-sale securities at March 31, 2008 and December 31, 2007:

	Amortized cost		Unrealized gains (losses), net		Estimated fair value	
	March 31, 2008	December 31, 2007	March 31, 2008	December 31, 2007	March 31, 2008	December 31, 2007
	(Unaudited)	(Audited)	(Unaudited)	(Audited)	(Unaudited)	(Audited)
U.S. government obligations and political subdivisions	\$ 34,300	\$ 58,249	\$ 215	\$ (117)	\$ 34,515	\$ 58,132
Corporate obligations	31,871	40,125	(470)	(106)	31,401	40,019
	\$ 66,171	\$ 98,374	\$ (255)	\$ (223)	\$ 65,916	\$ 98,151

The amortized cost of available-for-sale debt securities at March 31, 2008, by contractual maturities, is shown below:

	Unrealized gains (losses)			
	Amortized cost	Gains	(Losses)	Estimated fair value
Due in one year or less	\$ 30,711	\$ 121	\$	\$ 30,832
Due after one year to five years	35,460	274	(650)	35,084
	\$ 66,171	\$ 395	\$ (650)	\$ 65,916

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

The unrealized losses in the Company's investments in all types of marketable securities were caused mainly by overall market conditions and interest rate changes. Since the Company has the ability and intent to hold these investments until a recovery of fair value, the investments were not considered to be other than temporarily impaired at March 31, 2008.

NOTE F TAXES ON INCOME-NOT UPDATE

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. The difference between the effective tax rate and the statutory rate primarily is due to foreign tax holiday and tax-exempt income in Israel and the anticipated tax ruling in Switzerland as further described below. Tax provision for the three months ended March 31, 2008 and March 31, 2007 included the tax benefit associated with equity-based compensation expenses in the amount of \$131 and \$185, respectively.

In connection with the Acquisition, the Company applied for a tax ruling with the Swiss tax authorities to determine the tax rate applicable to the taxable income generated by the Company's Swiss subsidiary, including the amortization period for tax purposes of goodwill and all other intangible assets acquired in the Acquisition. As of March 31, 2008 and the date of this periodic report, the tax ruling process has not been finalized.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48), which establishes a single model to address accounting for uncertain tax positions. FIN 48 clarified the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Table of Contents

The total amount of net unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$ 13,387 and \$13,244 at March 31, 2008 and December 31, 2007, respectively. The Company accrues interest and penalties, related to unrecognized tax benefits, in its provision for income taxes. At March 31, 2008 and December 31, 2007, the Company had accrued interest and penalties related to unrecognized tax benefits of \$ 2,900 and \$2,700, respectively. A change in the amount of unrecognized tax benefit is reasonably possible in the next 12 months due to the examination by the U.S. Internal Revenue Service of the Company's U.S. federal income tax returns for 2003 and 2004. The Company currently cannot make an estimate of the range of change in the amount of the unrecognized tax benefits due to the ongoing status of the examination.

With respect to DSP Group Ltd., the Company's Israeli subsidiary, the Company is no longer subject to income tax audits for years before 2004.

NOTE G SIGNIFICANT CUSTOMERS

The Company sells its products to customers primarily through a network of distributors and original equipment manufacturer (OEM) representatives. The Company's future performance will depend, in part, on the continued success of its distributors and representatives in marketing and selling its products. The loss of the Company's distributors and representatives 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. A significant amount of its revenues will continue to be derived from a limited number of large customers. 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.

Revenues derived from sales through one distributor, Tomen Electronics Corporation (Tomen Electronics), accounted for 26% and 49% of the Company's total revenues for the three months ended March 31, 2008 and 2007, respectively. The Japanese market and the original equipment manufacturers (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 approximately 16% and 31% of the Company's revenues for the three months ended March 31, 2008 and 2007, respectively. Additionally, sales to Uniden through Tomen Electronics or directly to Uniden represented 11% and 22% of the Company's total revenues for the three months ended March 31, 2008 and 2007, respectively.

Sales to Hong Kong-based VTech represented 18% and 0% of the Company's total revenues for the three months ended March 31, 2008 and 2007, respectively. Sales to Hong Kong-based CCT Telecom represented 10% and 12% of the Company's total revenues for the three months ended March 31, 2008 and 2007, respectively. Sales to Hong Kong-based SunCorp represented 0.5% and 13% of the Company's total revenues for the three months ended March 31, 2008 and 2007, respectively.

NOTE H DERIVATIVE INSTRUMENTS

SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133), requires companies to recognize all of its derivative instruments as either assets or liabilities in the statement of financial position at fair value.

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.

Table of Contents

To protect against the increase in value of forecasted foreign currency cash flow resulting from salary and rent payments in New Israeli Shekels (NIS) during the year, the Company has instituted a foreign currency cash flow hedging program. The Company hedges portions of the anticipated payroll and lease payments of its Israeli facilities denominated in NIS for a period of one to twelve months with put options and forward contracts.

These forward contracts and put options are designated as cash flow hedges, as defined by SFAS No. 133, and are all effective as hedges of these expenses.

As of March 31, 2008 and December 31, 2007, the Company recorded comprehensive income of \$570 and \$481, respectively, from its put options and forward contracts in respect to anticipated payroll and rent payments expected in 2008. Such amounts will be recorded into earnings in the remainder of 2008.

NOTE I 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. For example, in a lawsuit against Microsoft Corporation, AT&T asserted that the Company's TrueSpeech 8.5 algorithm includes certain elements covered by a patent held by AT&T. AT&T sued Microsoft, one of the Company's TrueSpeech 8.5 licensees, for infringement. The Company was not named in AT&T's suit against Microsoft. During 2002, the Company created a provision, which was included in the cost of product revenues, in respect of this legal exposure. 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 Company.

NOTE J ACCOUNTING FOR EQUITY-BASED COMPENSATION

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R Share-Based Payment (SFAS 123(R)). SFAS 123(R) establishes accounting for equity-based awards exchanged for employee services. Accordingly, equity-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period. The Company previously applied APB 25 and related interpretations and provided the required pro forma disclosures required under SFAS 123. The Company elected to adopt the modified prospective application method as provided by SFAS 123(R), and, accordingly, the Company recorded compensation costs as the requisite service was rendered for the unvested portion of previously issued awards that remain outstanding at the initial date of adoption and any awards issued, modified, repurchased or cancelled after the effective date of SFAS 123(R). Upon adoption of SFAS 123(R), the Company also changed its method of valuation for equity-based awards granted beginning in fiscal year 2006 to an exercise multiple-based lattice option-pricing model (EMLM/binomial model) from the Black-Scholes option-pricing model (Black-Scholes model) which was previously used to present the Company's pro forma information required under SFAS 123. For options granted prior to 2006, the Company did not change its valuation method. Binomial models have evolved such that the currently available models are more capable of incorporating the features of the Company's employee stock options than closed-form models such as the Black-Scholes model.

Table of Contents**Grants for Three Months Ended March 31, 2008 and March 31, 2007:**

The weighted average estimated fair value of employee stock options and share appreciation rights (SAR) granted during the three months ended March 31, 2008 and March 31, 2007 was \$3.79 and \$7.67 per share, respectively, using the binomial model, with the following weighted average assumptions (annualized percentages):

	Three months ended March 31, 2008	Three months ended March 31, 2007
Volatility	52.92%	37.70%
Risk-free interest rate	3.34%	4.88%
Dividend yield	0%	0%
Pre-vest cancellation rate	3.68%	2.69%
Post-vest cancellation rate	1.59%	0.46%
Suboptimal exercise factor	1.65	1.69

The expected life of employee stock options is impacted by all of the underlying assumptions used in the Company's model. The binomial model assumes that employees' exercise behavior is a function of the option's remaining contractual life and the extent to which the option is in-the-money (*i.e.*, the average stock price during the period is above the exercise price of the stock option). The binomial model estimates the probability of exercise as a function of these two variables based on the history of exercises and cancellations of past option grants made by the Company. The expected life for options granted during the three months ended March 31, 2008 and 2007 derived from the binomial model was 4.40 and 5.47 years, respectively.

Employee Stock Benefit Plans

As of March 31, 2008, the Company had five stock option plans and one employee stock purchase plan. As of March 31, 2008, approximately 111,000 shares of Common Stock remain available for grant under the Company's employee stock purchase plan and approximately 2,034,000 shares of Common Stock remain available for grant under the Company's stock option plans.

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

	Number of Options/SAR Units	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (*) (in thousands)
Outstanding at Jan 1, 2008	6,506,640	\$ 22.65		
Options granted	416,800	\$ 10.95		
SAR units granted (**)	2,306,790	\$ 10.25		
Options / SAR units cancelled/forfeited/expired	(293,667)	\$ 23.07		
Options exercised	(5,938)	\$ 11.48		
Outstanding at March 31, 2008(***)	8,930,625	\$ 18.90	5.28	\$ 6,658
Exercisable at March 31, 2008(****)	3,740,415	\$ 22.73	3.74	\$ 358

(*) Calculation of aggregate intrinsic value is based on the share price of the Company's Common Stock as of March 31, 2008 (\$12.74 per share).

Table of Contents

(**) Each SAR grant is convertible for a maximum number of shares of the Company's Common Stock equal to 50% of the SAR units subject to the grant.

(***) Due to the ceiling imposed on the SAR grants, the outstanding amount can be exercised for a maximum of 6,549,405 shares of the Company's Common Stock.

(****) Due to the ceiling imposed on the SAR grants, the currently exercisable amount is a maximum of 3,336,167 shares of the Company's Common Stock.

Additional information about stock options outstanding at March 31, 2008 with exercise prices less than or above \$12.74 per share (the closing price of the Company's Common Stock at March 31, 2008) is as follows:

Exercise Prices	Exercisable		Unexercisable		Total	
	Number of Options/SAR Units	Weighted Average Exercise Price	Number of Options/SAR Units	Weighted Average Exercise Price	Number of Options/SAR Units	Weighted Average Exercise Price
Less than \$12.74	231,824	\$ 11.20	2,648,190	\$ 10.36	2,880,014	\$ 10.43
Above \$12.74	3,508,591	\$ 23.49	2,524,020	\$ 22.15	6,050,611	\$ 22.93
Total	3,740,415	\$ 22.73	5,190,210	\$ 16.14	8,930,625	\$ 18.90

The Company's aggregate compensation cost for the three months ended March 31, 2008 and 2007 totaled \$3,961 and \$4,154, respectively. The total income tax benefit recognized in the income statement related to the Company's equity-based compensation cost for the three months ended March 31, 2008 and 2007, was \$131 and \$185, respectively.

As of March 31, 2008, there was \$18,533 of total unrecognized compensation cost related to unvested equity-based compensation awards granted under the Company's stock option plans. This amount is expected to be recognized over the period from 2008 through 2012.

NOTE K PENSION LIABILITY

The Company acquired the CIPT Business on September 4, 2007. This business sponsored various defined benefits schemes for their employees, including pension funds, early retirement benefits, lump sum retirement indemnities and jubilee awards in several countries.

The largest of these plans that the Company assumed in connection with the Acquisition is the Swiss pension fund that insures the retirement, disability and death benefits of the employees who were formerly covered by the NXP Semiconductors Switzerland AG scheme. The Swiss pension plan is currently the only pension plan externally funded through a foundation. The difference between the liability (the Projected Benefit Obligation or PBO as defined in SFAS No. 87 Employers Accounting for Pensions (SFAS No. 87)) and the market value of the plan assets is accounted for on the financial statements of the Company. The other defined benefits plans that the Company assumed in connection with the Acquisition that are accounted for on the Company's financial statements are the pension plans in Germany, Hong Kong and India. Consistent with the requirements of local law, the Company deposits funds for certain plans with insurance companies, third-party trustees, or into government-managed accounts, and/or accrue for the unfunded portion of the obligation.

The liabilities for these plans have been calculated in accordance with SFAS No. 87. The net pension liability as of March 31, 2008 amounted to \$2,003.

Table of Contents

The following table provides the components of net periodic benefits cost for the period ended March 31, 2008:

	March 31, 2008	March 31, 2007
Components of net periodic benefits cost		
Service cost	\$ 34	\$
Interest cost		
Expected return on plan assets		
Amortization of net loss (gain)		
Exchange rate expenses	211	
Net periodic benefit cost	\$ 245	\$

NOTE L FAIR VALUE MEASUREMENTS

As discussed in Note N, the Company adopted SFAS No. 157 Fair Value Measurements (as impacted by FSP Nos. 157-1 and 157-2) (SFAS No. 157) effective January 1, 2008, with respect to fair value measurements of (a) nonfinancial assets and liabilities that are recognized or disclosed at fair value in the Company's financial statements on a recurring basis (at least annually) and (b) all financial assets and liabilities.

SFAS No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS No. 157 establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows:

Level 1- observable inputs such as quoted prices in active markets;

Level 2- inputs, other than the quoted market prices in active markets, which are observable, either directly or indirectly; and

Level 3- unobservable inputs in which there are little or no market data, which requires the reporting entity to develop its own assumptions.

Assets and liabilities are to be measured at fair value using one or more of the three valuations techniques noted in SFAS No. 157. The valuation techniques are as follows:

- (a) Market approach prices and other relevant information generated by market transactions involving identical or comparable assets;
- (b) Cost approach amount that would be required to replace the service capacity of an asset (replacement cost); and
- (c) Income approach techniques to convert future amounts to a single present amount based on expectations (including present value techniques, option pricing and excess earnings models).

The following table provides information by level for assets and liabilities that are measured at fair value, as defined by SFAS No. 157, on a recurring basis.

Description	Fair Value	Fair Value Measurements		
	March 31, 2008	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 69,554	\$ 69,554		
Short-term marketable securities	\$ 30,832	\$ 30,832		

Edgar Filing: DSP GROUP INC /DE/ - Form 10-Q

Long-term marketable securities	\$ 35,084	\$ 35,084
Derivative assets	\$ 570	\$ 570

Table of Contents

NOTE M STOCKHOLDERS' EQUITY

On January 30, 2008, the Company's board of directors approved an increase of additional 2.9 million shares available for repurchase under the Company's share repurchase program. Also on January 30, 2008, the Company's board of directors approved the Company's entry into a share repurchase plan, in accordance with Rule 10b(5)-1 of the Securities Exchange Act of 1934, as amended, for up to 5,000,000 shares of the Company's common stock, which plan became effective on February 7, 2008.

During the first quarter of 2008, the Company repurchased 2,170,584 shares of its common stock at an average purchase price of \$11.91 per share for an aggregate amount of approximately \$25.9 million (approximately \$23.9 million was paid in cash as of March 31, 2008). Pursuant to the share repurchase program, 2,883,128 shares of the Company's common stock remain authorized for repurchase as of March 31, 2008.

NOTE N NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157), which establishes a single definition of fair value and a framework for measuring fair value, sets out a fair value hierarchy to be used to classify the source of information used in fair value measurements, and requires new disclosures of assets and liabilities measured at fair value based on their level in the hierarchy. This statement applies to other accounting pronouncements that require or permit fair value measurements. In February 2008, the FASB issued Staff Positions (FSPs) No. 157-1 and No. 157-2, which, respectively, removed leasing transactions from the scope of SFAS No. 157 and deferred SFAS No. 157's effective date for one year relative to certain nonfinancial assets and liabilities. As a result, the application of the definition of fair value and related disclosures of SFAS No. 157 (as impacted by these two FSPs) was effective for the Company beginning on January 1, 2008 on a prospective basis with respect to fair value measurements of (a) nonfinancial assets and liabilities that are recognized or disclosed at fair value in the Company's financial statements on a recurring basis (at least annually) and (b) all financial assets and liabilities. This adoption did not have a material impact on the Company's consolidated results of operations or financial condition. The remaining aspects of SFAS No. 157 for which the effective date was deferred under FSP No. 157-2 are currently being evaluated by the Company. Areas impacted by the deferral relate to nonfinancial assets and liabilities that are measured at fair value, but are recognized or disclosed at fair value on a nonrecurring basis. This deferral applies to such items as nonfinancial assets and liabilities initially measured at fair value in a business combination (but not measured at fair value in subsequent periods) or nonfinancial long-lived asset groups measured at fair value for an impairment assessment. The effects of these remaining aspects of SFAS No. 157 are to be applied by the Company to fair value measurements prospectively beginning on January 1, 2009. The Company does not expect them to have a material impact on the Company's consolidated results of operations or financial condition. Refer to Note L for disclosures required by SFAS No. 157.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 permits an entity to choose, at specified election dates, to measure eligible financial instruments and certain other items at fair value that are not currently required to be measured at fair value. An entity reports unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Upfront costs and fees related to items for which the fair value option is elected are recognized in earnings as incurred and not deferred. SFAS No. 159 also established presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 was effective for financial statements issued for fiscal years beginning after November 15, 2007 (January 1, 2008 for the Company). On the effective date, an entity could elect the fair value option for eligible items that existed on that date. The entity was required to report the effect of the first remeasurement to fair value as a cumulative-effect adjustment to the opening balance of retained earnings. The Company did not elect the fair value option for eligible items that existed as of January 1, 2008.

Table of Contents

In December 2007, the FASB issued SFAS No. 141 (revised 2007) Business Combinations (SFAS No. 141(R)). Under SFAS No. 141(R), an entity is required to recognize the assets acquired, liabilities assumed, contractual contingencies and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred, restructuring costs generally be expensed in periods subsequent to the acquisition date, and changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period that impact income tax expenses. In addition, acquired in-process research and development (IPR&D) is capitalized as an intangible asset and amortized over its estimated useful life. The adoption of SFAS No. 141(R) will change the Company's accounting treatment for business combinations on a prospective basis beginning in the first quarter of fiscal year 2009.

In March 2008, the FASB issued SFAS No. 161 Disclosures about Derivative Instruments and Hedging Activities (SFAS No. 161), which will require increased disclosures about an entity's strategies and objectives for using derivative instruments; the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under SFAS No. 133, and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. Certain disclosures will also be required with respect to derivative features that are credit risk-related. SFAS No. 161 is effective for the Company beginning on January 1, 2009 on a prospective basis. The Company does not expect this standard to have a material impact on the Company's consolidated results of operations or financial condition.

In December 2007, the U.S. Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin 110 (SAB 110) to amend the SEC's views discussed in Staff Accounting Bulletin 107 (SAB 107) regarding the use of simplified method in developing an estimate of expected life of share options in accordance with SFAS No. 123(R). SAB 110 is effective for the Company beginning in the first quarter of fiscal year 2008. The adoption of SAB 110 did not have an impact on the Company's consolidated financial statements.

Table of Contents

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

The discussions in this Quarterly Report on Form 10-Q should be read in conjunction with our accompanying financial statements and the related notes thereto. This Quarterly Report on Form 10-Q contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act of 1934, as amended. All statements included or incorporated by reference in this Quarterly Report, other than statements that are purely historical, are forward-looking statements. Words such as anticipates, expects, intends, plans, believes, seeks, estimates and similar expressions also identify forward looking statements. The forward looking statements in this Quarterly Report on Form 10-Q are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward looking statements and include, without limitation, statements regarding:

Our expectation that sales from DECT and 2.4GHz products and, to a lesser extent, 5.8GHz products, will continue to represent a significant percentage of our revenue for the remainder of 2008;

Our belief that U.S. sales of our 2.4GHz and 5.8GHz products will continue to decrease during 2008 with a sharper decrease in sales of our 5.8GHz products;

Our expectation that the shift from 2.4GHz and 5.8GHz products to DECT 6.0 products in the U.S. market will continue at a fast pace throughout 2008;

Our belief that our DECT products will continue to increase as a percentage of total revenues in 2008 in comparison to 2007;

Our belief that our future growth will depend on our success in expanding our presence in the European DECT market and other developing markets, maintaining our market share during the shift from the traditional 2.4GHz and 5.8 GHz products to DECT 6.0 products in the U.S. market and the general market deployment and acceptance of our DECT and CoIP products;

Our belief that international sales will continue to account for a significant portion of our net product sales for the foreseeable future and that sales to our Hong Kong-based customers will continue to increase in future periods in absolute dollars and as a percentage of total revenues;

Our belief that the market will be more price sensitive in 2008;

Our belief that our gross margin for the first half of 2008 will be lower than our gross margin for the full year 2008, that our gross margin for the second quarter of 2008 will be lower than the gross margin for the first quarter of 2008, and that our gross margin would improve in the second half of 2008;

Our belief that research and development costs will increase in absolute dollars in 2008;

Our expectation that a tax ruling from the Swiss tax authority will be finalized in 2008; and

Our belief that our available cash and cash equivalents at March 31, 2008 should be sufficient to finance our operations for both the short and long term.

Edgar Filing: DSP GROUP INC /DE/ - Form 10-Q

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.

Table of Contents

Overview

The following discussion and analysis is intended to provide an investor 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 consolidated financial statements and notes thereto.

Acquisition of the Cordless and VoIP Terminals Business of NXP B.V.

On September 4, 2007, we acquired the cordless and VoIP terminals business (the *CIPT Business*) of NXP B.V. (*NXP*) (the *Acquisition*). In connection with the Acquisition, we paid NXP approximately \$200 million in cash and issued 4,186,603 shares of our common stock to NXP. We also agreed to a contingent cash payment of up to \$75 million payable based on future revenue performance of the products of the CIPT Business for the first four financial quarters following the closing of the Acquisition. Revenue milestones for the first two financial quarters following the closing were not achieved and no cash payments to NXP were made.

Information contained in this Quarterly Report, including forward looking information and discussions about our business and market trends, should be read in light of the Acquisition.

Business

DSP Group is a fabless semiconductor company that is a leader in providing chipsets to telephone equipment and design manufacturers (OEMs and ODMs) for incorporation into consumer products for the short-range residential wireless communications market.

In recent years, we have become a worldwide leader in developing and marketing Total Telephony Solutions for the wireless residential market by taking advantage of the market transformation from analog-based technologies to digital-based technologies for telephony products and the shift from 900MHz to 2.4GHz to 5.8GHz technologies. One additional primary factor that contributed to our success in recent years is our penetration of the DECT market.

Our current primary focus is digital cordless telephony with sales of our in-house developed Cordless over Internet Protocol (CoIP), 1.9GHz (Digital Enhanced Cordless Telephony (DECT)), 2.4GHz and 5.8GHz chipsets representing approximately 84% of our total revenues for the first quarter of 2008. Our revenues were \$ 72.7 million for the first quarter of 2008, an increase of 48% in comparison to 2007. This increase was mainly the result of increased sales of our DECT products, mainly due to the Acquisition, which increase was partially offset by decreased sales of our 2.4GHz and 5.8GHz products. We believe that U.S. sales of our 2.4GHz and 5.8GHz products will continue to decrease during 2008 with a sharper decrease in sales of our 5.8GHz products. We anticipate our revenues from DECT products will continue to increase in absolute number and as a percentage of total revenues in 2008 due to the Acquisition. The decrease in sales of 2.4GHz and 5.8GHz products is mainly on account of increased sales of DECT 6.0 products in the U.S. market, our primary market, where the shift to DECT 6.0 products is occurring faster than anticipated. We anticipate this trend to continue throughout 2008.

Notwithstanding our successes to date, our business operates in a highly competitive environment. Competition has historically increased pricing pressures for our products and decreased our average selling prices. Our gross margin decreased to a level of 37% of total revenues for the first quarter of 2008 from 39% for the first quarter of 2007, primarily due to the continued decline in the average selling prices of our products, and the increased sales of DECT products with lower gross margin on account of 5.8GHz products with higher gross margin. The cordless telephony market is additionally undergoing a challenging period of transition characterized by stagnation due to the lack of new model launches and market anticipation of next generation products. As a result, we expect the market to become more price sensitive in 2008. We expect that our gross margin for the first half of 2008 will be lower than our gross margin for the full year 2008, and that our gross margin would improve in the second half of 2008 mainly due to the ramp-up in production of cost-improved integrated circuits and the implementation of cost synergies following the Acquisition. We also expect that our gross margin for the second quarter of 2008 will be lower than the gross margin for the first quarter of 2008. However, if the implementation of cost synergies and ramp-up of cost-improved integrated circuits do not occur or

Table of Contents

occur slower than anticipated, we may not be able to increase our gross margin in the second half of 2008 and our gross margin will decrease year over year at a sharper rate. Moreover, various other factors, including over-capacity problems (shortage of capacity to meet our fabrication, testing and assembly needs), increases in raw materials and silicon wafer costs and increases in production, assembly or testing costs, all may decrease our gross profit in future periods. To address pricing pressures, we may need to offer our products in the future at lower prices which may result in lower profits. Also to partially offset these factors, we are implementing cost improvement plans designed to reduce testing costs and offer our customers more cost effective products.

Operating expenses increased by 76% for the first quarter of 2008 compared to the same period for 2007, reaching a level of \$36.1 million. The increase in operating expenses for the first quarter of 2008 was primarily attributable to (i) the inclusion of the operating expenses of the CIPT Business for the first quarter of 2008 in the amount of \$8.2 million, (ii) the amortization of intangibles and other assets related to the Acquisition in the amount of \$5.8 million for the first quarter of 2008, and (iii) an increase in IP and tapeout expenses related to research and development. Our operating loss was \$9.1 million for the first quarter of 2008, approximately 13% of revenues, compared to \$1.3 million of operating loss for the same period in 2007, representing 2.6% of revenues. The increase in operating loss was mainly due to the same factors as noted above for the increase in operating expenses. An additional factor for the increase in operating loss was the decrease in gross margin for the first quarter of 2008 as compared to the same period in 2007. Notwithstanding the increase in our operating expenses due to the absorption of the operating expenses of the CIPT Business, there are no assurances that the proposed benefits of the Acquisition can be achieved or achieved at the levels currently anticipated, which could materially harm our business.

There are also several emerging market trends that challenge our continued business growth potential. For example, the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, as well as the projected lack of growth in products using fixed-line telephony, may reduce our revenues derived from, and unit sales of, cordless telephony products, which are currently our primary focus. Our business also may be affected by the outcome of the current competition between cellular phone operators and fixed-line operators for the provision of residential communication. Our revenues are currently primarily generated from sales of chipsets used in cordless phones that are based on fixed-line telephony. Another market trend that could affect the results of our operations is the shift in the U.S. digital telephony market towards DECT products. The U.S. market is currently the dominant market for our customers. An increase in demand for DECT 6.0 products in the U.S. in lieu of our 2.4GHz and 5.8GHz products, and our inability to successfully develop and market new DECT 6.0 products to address this market may have a material adverse effect on our profits and results of operations. The shift in sales of our 2.4GHz and 5.8GHz products to DECT 6.0 products in the U.S. market, our primary market, also results in overall decrease in our revenues and gross margin as our DECT 6.0 products are sold at lower average selling prices and gross margin. We also are currently witnessing a move of manufacturing activities from large systems suppliers in the U.S., Japan and Europe to Southeast Asia, a trend that also could adversely affect our business.

We recognize the competitive landscape and are actively engaged in addressing these market challenges and trends. We penetrated and continue to expand our presence in the DECT market to grow our business. Our investment in DECT technologies continued with the Acquisition. Revenues derived from the sale of DECT products represented 63% of our total revenues for the first quarter of 2008. In addition to DECT technologies, we invested in developing CoIP technologies in house. However sales of our CoIP products decreased from 7% of our total revenues for the first quarter of 2007 to 1% of our total revenues for the first quarter of 2008. We believe that our DECT products will increase as a percentage of total revenues in 2008 in comparison to 2007. We also increased our presence in additional markets, including China, Korea, South America and the domestic Japanese market, with our existing products. We believe our future growth will depend on our success in expanding our presence in the European DECT market and other developing markets as described above, maintaining our market share during the shift from the traditional 2.4GHz and 5.8GHz products to DECT 6.0 products in the U.S. market, our primary market, and the general market deployment and acceptance of our DECT and CoIP products. However, our success in introducing new products and penetrating new markets may not occur and may require us to substantially increase our operating expenses. As a result, our past operating results should not be relied upon as an indication of future performance.

Table of Contents

In addition to penetrating new markets and introducing new products to expand our business, our strategic focus is to launch next generation products to capitalize on the transition underway in the residential communications market with the move from wireless voice communication to voice communication over IP networks and ultimately the convergence of voice, video and data communication. As an initial step, we have introduced products to facilitate the deployment of residential broadband services. Our long term goal is to leverage the Wi-Fi technology acquired in 2004 from Bermai Inc. to develop and offer products for home communication that integrate voice, data and video with broadband offerings.

As of March 31, 2008, our principal source of liquidity consisted of cash and cash equivalents of approximately \$69.6 million and marketable securities of approximately \$65.9 million, totaling to \$135.5 million. Our cash, investments and securities were materially decreased in the first quarter of 2008 mainly due to the repurchase of 2,170,584 shares of our common stock for approximately \$25.9 million during the first quarter of 2008 (of which approximately \$23.9 million was paid in cash as of March 31, 2008).

RESULTS OF OPERATIONS

Total Revenues. Our total revenues were \$72.7 million for the first quarter of 2008, as compared to \$49.3 million for the same period in 2007. Our revenues for the first quarter of 2008 included revenues of the CIPT Business acquired on September 4, 2007. This represents an increase in revenues of 48% for the first quarter of 2008 as compared to the same period in 2007. This increase was primarily as a result of the inclusion of the revenues of the CIPT Business, which reflected a strong demand for our DECT products, partially offset by decreased sales of our 2.4GHz and 5.8GHz products. Sales of DECT products were \$45.9 million for the first quarter of 2008, representing 63% of total revenues. Sales of DECT products during the same period of 2007 were \$7.9 million, representing 16% of total revenues. The increase in sales of DECT products for the first quarter of 2008 as compared to the same period in 2007 was mainly attributable to the consolidation of the results of the CIPT Business within our combined results beginning on September 4, 2007. Revenues from CoIP products represented \$1.0 million and \$3.6 million of our total revenues for the first quarters of 2008 and 2007, respectively. This represents approximately 1% and 7% of our total revenues for the first quarters of 2008 and 2007, respectively. Sales of 5.8GHz products were \$5.2 million and \$19.7 million for the first quarter of 2008 and 2007, respectively, representing approximately 7% and 40% of our total revenues for the first quarters of 2008 and 2007, respectively, representing a decrease of 74% in absolute dollars. Sales of 2.4GHz products were \$8.9 million and \$10.1 million for the first quarters of 2008 and 2007, respectively, representing 12% and 21% of our total revenues for the first quarters of 2008 and 2007, respectively, representing a decrease of 12% in absolute dollars. A factor that may decrease our revenues for future periods is the shift from 2.4GHz and 5.8GHz products to DECT 6.0 products in the U.S. market, our primary market, as DECT 6.0 products are being sold at lower average selling prices.

The following table shows the breakdown of revenues for the periods indicated by geographic location (in thousands):

	Period Ended March 31,	
	2008	2007
United States	\$ 6,732	\$ 151
Japan	\$ 26,308	\$ 34,520
Europe	\$ 10,398	\$ 76
Hong Kong	\$ 24,637	\$ 12,761
Other	\$ 4,654	\$ 1,780
Total revenues	\$ 72,729	\$ 49,288

Sales to our customers in Hong Kong increased for the first quarter of 2008 as compared to the same period in 2007, representing a 93% increase in absolute dollars (\$15.4 million of such revenues for the first quarter of 2008 resulted from the inclusion of the CIPT Business in the combined results since September 4, 2007). The decrease in our sales to Japan resulted mainly from the decrease in sales to Panasonic in 2008 as compared to 2007, representing a 24% decrease

Table of Contents

in absolute dollars. In addition there was a decrease in sales to the Japanese domestic market and to Uniden of 21% and 28% in absolute dollars, respectively. The increase in our sales to Europe and United States resulted mainly from the inclusion of the CIPT Business in the combined results since September 4, 2007. We anticipate that sales to our Hong Kong-based customers will continue to increase in future periods in absolute dollars and as a percentage of total revenues as a result of the expansion of our new DECT products, mainly to customers of the CIPT Business, which are sold to original design manufacturers (ODMs) that are mainly located in Hong Kong.

As our products are generally incorporated into consumer products sold by our OEM customers, our revenues are affected by seasonal buying patterns of consumer products sold by our OEM customers that incorporate our products. The fourth quarter in any given year is usually the strongest quarter of sales for our OEM customers and, as a result, the third quarter in any given year is usually the strongest quarter for our revenues as our OEM customers request increased shipments of our products in anticipation of the fourth quarter holiday season. This trend can be generally observed from reviewing our quarterly information and results of operations. However, the magnitude of this trend varies annually.

Significant Customers. The Japanese market and the OEMs that operate in that market are among the largest suppliers of residential wireless products with significant market share in the U.S. market. Revenues derived from sales through our largest distributor, Tomen Electronics Corporation (Tomen Electronics), accounted for 26% of our total revenues for the first quarter of 2008 as compared to 48% for the same period in 2007. The decrease was primarily due to a decrease in sales to Panasonic and the Japanese domestic market. In addition, due to the increase in revenues for the first quarter of 2008 (mainly as a result of the inclusion of the revenues of the CIPT Business), the percentage of revenues attributable to Tomen out of our total revenues decreased.

Tomen Electronics sells our products to a limited number of customers. One customer, Panasonic Communications Co., Ltd., (Panasonic), has continually accounted for a majority of the sales through Tomen Electronics. Sales to Panasonic through Tomen Electronics generated approximately 16% and 31% of our revenues for the three months ended March 31, 2008 and 2007, respectively. Sales through Tomen Electronics or directly to Uniden represented 11% and 22% of our revenues for the three months ended March 31, 2008 and 2007, respectively. The loss of Tomen Electronics as a distributor and our inability to obtain a satisfactory replacement in a timely manner would harm our sales and results of operations. Additionally, the loss of Panasonic and Tomen Electronics' inability to thereafter effectively market our products would also harm our sales and results of operations.

Other significant customers of the company include various Hong Kong-based OEMs. Sales to VTech represented 18% and 0% of total revenues for the three months ended March 31, 2008 and 2007, respectively. Sales to CCT Telecom represented 10% and 12% of total revenues for the three months ended March 31, 2008 and 2007, respectively. Sales to SunCorp represented 0.5% and 13% of total revenues for the three months ended March 31, 2008 and 2007, respectively.

Significant Products. Revenues from our DECT products represented 63% of total revenues for the first quarter of 2008. Revenues from our 5.8GHz and 2.4GHz digital products represented 7% and 12%, respectively, of total revenues for the first quarter of 2008. We believe that sales of DECT and 2.4GHz digital products and, to a lesser extent, 5.8GHz digital products will continue to represent a substantial percentage of our revenues in 2008. However, we believe that U.S. sales of our 2.4GHz and 5.8GHz products will decrease in 2008 with a sharper decrease in sales of our 5.8GHz products. For the long term, we believe that the rapid deployment of new communication access methods, as well as the projected lack of growth in fixed-line telephony, will reduce our total revenues derived from, and unit sales of, cordless telephony products, including future sales of our DECT, 2.4GHz and 5.8GHz products.

Gross Profit. Gross profit as a percentage of revenues was 37% for the first quarter of 2008 and 39% for the first quarter of 2007. The decrease in our gross profit was primarily due to the continuing decline in the average selling prices of our products and the increased sales of DECT products with lower average gross margin on account of 5.8GHz products with higher average gross margin. 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, our failure to achieve the corresponding cost reductions, roll-out of new products in any given period and our failure to introduce new engineering processes, over-capacity problems (shortage of capacity to meet our fabrication, testing and assembly needs), increases in raw materials

Table of Contents

such as gold and oil and silicon wafer costs and increases in production, assembly or testing costs. We cannot guarantee that our ongoing efforts in cost reduction and yield improvements will be successful or that they will keep pace with the anticipated continuing decline in average selling prices of our products. One approach we are using to offset the expected decrease in gross profit is offering our customers bare-die chips that eliminate assembly and testing services in return for lower selling prices to our customers. Other steps we are taking include the implementation of cost improvement plans to reduce testing costs and offer our customers more cost effective products. However, we can provide no assurance that any alternative solutions we provide to our customers will be acceptable to them or that these steps will help us to offset the expected decrease in gross margins of our products. Furthermore, as gross profit reflects the sale of chips and chipsets that have different margins, changes in the mix of products sold have impacted and will continue to impact our gross profit in future periods.

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 relating to manufacturing and testing support and logistics personnel.

Research and Development Expenses. Our research and development expenses increased to \$20.0 million for the first quarter of 2008 from \$12.8 million for the first quarter of 2007. The increase in research and development expenses in 2008 as compared to 2007 was mainly attributed to (i) an increase in research and development expenses in the amount of \$5.4 million as a result of the inclusion of the expenses of the CIPT Business in the combined results and (ii) an increase of \$1.2 million in IP and tapeout expenses for the first quarter of 2008 as compared to the same period in 2007. Equity-based compensation expenses amounted to \$2.1 million for the first quarters of 2008 and 2007.

Our research and development expenses as a percentage of total revenues were 28% for the three months ended March 31, 2008 and 26% for the three months ended March 31, 2007. This increase in research and development expenses as a percentage of total revenues was due to the increase in absolute dollars of the research and development expenses.

As our research and development staff is currently working on various projects simultaneously, we may need to incur additional expenses and hire additional research and development staff and contractors related to the development of new products and to support the development of existing products and technologies. In addition, the research and development expenses for 2008 will include all the research and development expenses attributable to the CIPT Business whereas such expenses were prorated from September 4, 2007, the date of completion of the Acquisition, in our 2007 results. As a result, our research and development expenses in absolute dollars, as compared to 2007, are expected to increase for the remaining quarters of 2008.

Research and development expenses consist mainly of payroll expenses to employees involved in research and development activities, expenses related to tapeout 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 \$6.0 million for the first quarter of 2008 from \$4.2 million for the first quarter of 2007. The increase in sales and marketing expenses was mainly a result of the inclusion of the expenses of the CIPT Business in the amount of \$2.0 million in the combined results. The increase also was a result of expenses related to equity-based compensation resulting from the adoption of SFAS 123(R). Equity-based compensation expenses amounted to \$ 0.5 million for the first quarter of 2008 as compared to \$0.4 million for the first quarter of 2007. The increase in our sales and marketing expenses for the first quarter of 2008 was partially offset by a decrease in commissions paid to our sales representatives due to a lower level of revenues subject to commissions for the first quarter of 2008, as compared to the same period in 2007.

Our sales and marketing expenses as a percentage of total revenues were 8% and 9% for the three months ended March 31, 2008 and 2007, respectively. This decrease in sales and marketing expenses as a percentage of total revenues was due to the increase in revenues.

Table of Contents

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 \$4.3 million for the three months ended March 31, 2008, as compared to \$3.6 million for the three months ended March 31, 2007. The increase in general and administrative expenses for the first quarter of 2008 was mainly a result of the inclusion of the expenses of the CIPT Business in the amount of \$0.8 million in the combined results. The increase in general and administrative expenses for the first quarter of 2008 was partially offset by a decrease related to equity-based compensation expense. Equity-based compensation expense amounted to \$1.1 million for the first quarter of 2008 as compared to \$1.5 million for the first quarter of 2007. General and administrative expenses as a percentage of total revenues were 6% and 7% for the first quarters of 2008 and 2007, respectively. This decrease in general and administrative expenses as a percentage of total revenues was due to the increase in revenues.

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.

Amortization of Intangible Assets. During the first quarter of 2008, we recorded an expense item in the amount of approximately \$5.8 million related to the amortization of intangible assets associated with the Acquisition.

Interest and Other Income, net. Interest and other income, net, for the three months ended March 31, 2008 decreased to \$1.2 million from \$3.7 million for the three months ended March 31, 2007. The decrease in 2008 compared to 2007 was due to the payment of approximately \$200 million in cash in September 4, 2007 as partial consideration for the Acquisition, which resulted in less investment balance held in the first quarter of 2008 and due to lower interest rates. Additional factors for the decreased interest income for the first quarter of 2008 were the repurchase of 2,170,584 shares of our common stock for approximately \$25.9 million, of which approximately \$23.9 million was paid in cash during the first quarter of 2008 and the devaluation of the U.S. dollar against the Israeli currency (NIS), which resulted in expenses associated with the exchange rate differences.

Our total cash, cash equivalents and marketable securities were \$135.5 million as of March 31, 2008, compared to \$355.3 million as of March 31, 2007.

Provision for Income Taxes. Our income tax benefit was \$0.3 million for the first quarter of 2008, as compared to tax expenses of \$1.0 million for the first quarter of 2007. The decrease in provision for income taxes was mainly a result of a decrease in income before taxes.

DSP Group Ltd., our Israeli subsidiary, was granted Approved Enterprise status by the Israeli government with respect to six separate investment plans. Approved Enterprise status allows our Israeli subsidiary to enjoy a tax holiday for a period of two to four years and a reduced corporate tax rate of 10%-25% for an additional six or eight years, on each investment plan's proportionate share of taxable income. The tax benefits under these investment plans are scheduled to gradually expire by 2015.

On April 1, 2005, an amendment to the Israeli Investment Law came into effect. The amendment revised the criteria for investments qualified to receive tax benefits. An eligible investment program under the amendment will qualify for benefits as a Privileged Enterprise (rather than the previous terminology of Approved Enterprise). Among other things, the amendment provides tax benefits to both local and foreign investors and simplified the approval process. The amendment does not apply to investment programs approved prior to December 31, 2004. The new tax regime will apply to new investment programs only. We believe that we are currently in compliance with these requirements. However, if we fail to meet these requirements, we would be subject to corporate tax in Israel at the regular statutory rate (27% for 2008). We also could be required to refund tax benefits, with interest and adjustments for inflation based on the Israeli consumer price index.

Table of Contents

As of December 31, 2007, DSP Group Ltd. has elected the status of a Privileged Enterprise under the amendment to the Israeli Investment Law for its seventh plan. The seventh plan entitles DSP Group Ltd. to a corporate tax exemption for a period of two years and to a reduced corporate tax rate of 10%-25% (based on the percentage of foreign ownership) for an additional period of eight years from the first year it has taxable income. As of March 31, 2008, DSP Group Ltd. did not generate taxable income relating to this plan.

In connection with the Acquisition, we applied for a tax ruling with the Swiss tax authorities to determine the tax rate applicable to the taxable income generated by our Swiss subsidiary, including the amortization period for tax purposes of goodwill and all other intangible assets acquired in the Acquisition). We are currently under discussion with the Swiss authorities and expect a tax ruling to be finalized during 2008.

Currently, our U.S. federal income tax returns for 2003 and 2004 are under examination. A change in the amount of unrecognized tax benefit is reasonably possible in the next 12 months due to the examination by the U.S. Internal Revenue Service of the Company's U.S. federal income tax returns for 2003 and 2004. We currently cannot make an estimate of the range of change in the amount of the unrecognized tax benefits due to the ongoing status of the examination.

LIQUIDITY AND CAPITAL RESOURCES

Operating Activities. Our cash flows used in operating activities were \$0.2 million for the first quarter of 2008. For the first quarter of 2007, we generated \$7.1 million of cash and cash equivalents from our operating activities. The decrease in net cash provided by operating activities for the first quarter of 2008 as compared to the same period in 2007 resulted mainly from the increase in prepaid expenses and other assets by \$3.8 million during the first quarter of 2008 compared with an increase in prepaid expenses of \$0.6 million during the first quarter of 2007. The decrease in cash from operating activities also was a result of the decrease in accrued compensation and benefits by \$3.6 million and \$2.0 million for the first quarters of 2008 and 2007, respectively, due to the payment of annual bonuses to our executive officers and employees. Another factor that contributed to the negative cash flows from operations for the first quarter of 2008 was certain employee severance payments associated with our restructuring plan that was paid in the first quarter of 2008. The decrease in cash from operating activities also was the result of the decrease in net income for the comparable periods.

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 three months of 2008, we purchased \$10.0 million of investments in marketable securities, as compared to \$49.3 million during the first three months of 2007. During the same periods, \$41.9 million and \$40.3 million, respectively, of investments in marketable securities matured, were called by the issuer or were sold.

As of March 31, 2008, the amortized cost of our marketable securities was \$66.2 million and their stated market value was \$65.9 million, representing an unrealized loss of \$0.3 million.

Our capital equipment purchases for the first three months of 2008, consisting primarily of research and development software tools, computers and other peripheral equipment, engineering test and lab equipment, leasehold improvements, furniture and fixtures totaled \$4.1 million, as compared to \$1.2 million for the first three months of 2007. The increase for the first quarter of 2008 compared to the same period for 2007 mainly is due to the purchase of software tools for our development employees.

Financing Activities. During the first quarter of 2008, we paid \$23.9 million for the purchase of treasury stock and \$0 for the same during the first quarter of 2007. We received \$0.1 million and \$0.9 million upon the exercise of employee stock options during the first quarters of 2008 and 2007, respectively. We cannot predict cash flows from option exercises for future periods.

In March 1999, our board of directors authorized the repurchase of up to 4.0 million shares of our common stock. In July 2003, October 2004 and January 2007, our board authorized the repurchase of an additional 2.5 million, 2.5 million and 3.0 million shares of our common stock, respectively, for repurchase. In January 2008, our board

Table of Contents

authorized an additional 2.9 million shares for repurchase. The number of shares authorized for repurchase after giving effect to the January 2008 board approval was 5.1 million. Also in January 2008, our board of directors approved the company's entry into a share repurchase plan for up to 5,000,000 shares of the 5.1 million shares of our common stock authorized for repurchase, which plan became effective on February 7, 2008. The share repurchase plan is in accordance with Rule 10b5-1 of the United States Securities Exchange Act of 1934, as amended, that is designed to facilitate these purchases.

During the first quarter of 2008, we repurchased 2,170,584 shares of our common stock at an average purchase price of \$11.91 per share for an aggregate amount of approximately \$25.9 million (approximately \$23.9 million was paid in cash as of March 31, 2008). Pursuant to our share repurchase program, 2,829,416 shares of our common stock remain authorized for repurchase as of March 31, 2008. As of March 31, 2008, 2,883,128 shares of our common stock in the aggregate remain authorized for repurchase. Additional share repurchases occurred after the first quarter of 2008, and as of the date of this report, 1,973,712 shares of our common stock remain authorized for repurchase.

As of March 31, 2008, we had cash and cash equivalents totaling approximately \$69.5 million and marketable securities of approximately \$65.9 million. The cash component of the consideration for the Acquisition was financed using our existing liquidity resources, and therefore the Acquisition materially decreased our current levels of cash investments and securities, as compared to March 31, 2007.

Our working capital at March 31, 2008 was approximately \$108.9 million, compared to \$167.1 as of March 31, 2007. The decrease in working capital was mainly due to the sale of certain marketable securities to finance the Acquisition in 2007, as well as the share repurchases made during the second quarter of 2007 and the first quarter of 2008. As we generate most of our cash flows from our operating activities, we believe that our current cash, cash equivalents, cash deposits and marketable securities and our forecasted positive cash flows for future periods, 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 "Risks Related to the Proposed Acquisition" and the risk factor 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 exposure since we do not have any financial obligation, and our financial assets are measured on a held-to-maturity basis.

Foreign Currency Exchange Rate Risk. As a significant part of our sales and expenses are denominated in U.S. dollars, we have experienced only insignificant foreign exchange gains and losses to date, and do not expect to incur significant gains and losses in 2008. However, part of our expenses in Israel is paid in New Israeli Shekel (NIS), the Israeli currency, 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

Table of Contents

acquisition of the CIPT Business, a portion of our expenses for our European operations are paid in Euro and Swiss Franc, which subjects us to the risks of foreign currency fluctuations between the U.S. dollar and the Euro and Swiss Franc. Our primary expenses paid in Euro and Swiss Franc 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 2008, we instituted a foreign currency cash flow hedging program. These option and forward contracts are designated as cash flow hedges, as defined by SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities, and are all effective as hedges of these expenses. For more information about our hedging activity, see Note H to the attached Notes to the Condensed Consolidated Financial Statement for the period ended March 31, 2008. An increase in the value of the NIS, Euro and Swiss Franc in comparison to the U.S. dollar, which has been the trend in recent periods due to the devaluation of 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. 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 are effective in timely alerting them to material information required to be included in this report.

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 activities. 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. For example, in a lawsuit against Microsoft Corporation, AT&T asserted that our TrueSpeech 8.5 algorithm includes certain elements covered by a patent held by AT&T. AT&T sued Microsoft, one of our TrueSpeech 8.5 licensees, for infringement. We were not named in AT&T's suit against Microsoft. 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 us.

ITEM 1A. RISK FACTORS.

This Form 10-Q contains forward-looking statements concerning our future products, expenses, revenue, liquidity and cash needs as well as our plans and strategies. These forward-looking statements are based on current expectations and we assume no obligation to update this information. Numerous factors could cause our actual results to differ significantly from the results described in these forward-looking statements, including the following 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, 2007 other than (1) changes to the Risk Factor

Table of Contents

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; (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 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; (4) changes to the Risk Factor below entitled Our 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; (5) changes to the Risk Factor below entitled The planned reduction in workforce associated with the restructuring efforts relating to the CIPT Business acquired from NXP could disrupt the operation of our business; (6) 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; (7) changes to the Risk Factor below entitled Because we depend on NXP to manufacture all of our products for the CIPT Business, we are subject to additional risks that may materially disrupt our business; (8) 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; (9) changes to the Risk Factor below entitled Our failure to compete effectively in the U.S. DECT market could have a material adverse effect on our business; (10) changes to the Risk Factor below entitled We are exposed to fluctuations in currency exchange rates; and (11) changes to the Risk Factor below entitled An unfavorable tax ruling from the Swiss tax authorities relating to the tax rate applicable to the taxable income generated by our Swiss subsidiary could affect our operating results.

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.

We sell our products to customers primarily through a network of distributors and original equipment manufacturer (OEM) representatives. Particularly, revenues derived from sales through our Japanese distributor, Tomen Electronics, accounted for approximately 26% of our total revenues for the three months ended March 31, 2008. 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 Communications Co., Ltd., has continually accounted for a majority of the sales through Tomen Electronics. Sales to Panasonic through Tomen Electronics generated approximately 16% of our revenues for the three months ended March 31, 2008. 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 and results of operations.

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—Panasonic, Uniden, CCT and VTech—accounted for approximately 54% of total revenues for the three months ended March 31, 2008. In addition to Panasonic mentioned above, sales to Uniden, CCT Telecom and VTech represented approximately 11%, 10% and 17%, respectively, of total revenues for the three months ended March 31, 2008. 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 cancel or significantly reduce 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 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. For example, the financial instability of a Canadian customer will result in decreased sales to this customer.

Table of Contents

which in turn decreased our overall projected sales for 2008. 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.

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. 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.

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 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.

Sales of our digital cordless telephony products comprised a majority of our total revenues for the first quarter of 2008. Specifically, sales of our 2.4GHz, 5.8GHz, DECT and CoIP products comprised 84% of our total revenues for the first quarters of 2008 and 2007. Revenues from our 5.8GHz and 2.4GHz digital products represented 7% and 12%, respectively, of total revenue for the first quarter of 2008, and 40% and 21%, respectively, of our total revenues for the first quarter of 2007. We believe U.S. sales of our 2.4GHz and 5.8GHz products will decrease for the remainder of 2008 with a sharper decrease in sales of our 5.8GHz products.

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 intensive pricing pressures, and we expect that competition and pricing pressures will only 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, sale 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, we believe new developments in the home residential market may adversely affect the revenues we derive from our digital cordless telephony products. For example, the rapid deployment of new communication access methods, including mobile, wireless broadband, cable and other connectivity, may reduce the market for products using fixed-line telephony. This decrease in demand would reduce our revenues derived from, and unit sales of, our digital cordless telephony products.

Table of Contents

Our business and results of operations may be affected by the acquisition of the cordless and VoIP terminals business.

On September 4, 2007, we acquired the cordless and VoIP terminals business (the CIPT Business) of NXP B.V. The acquisition could have an adverse effect on our business in the near term if current and prospective customers and strategic partners are reluctant to enter into new agreements with us due to uncertainty about the direction of the company after the acquisition. In addition, the process of integrating the CIPT Business into our company may be prolonged due to unforeseen difficulties and may require a disproportionate amount of our resources and management's attention. The diversion of management's and employees' attention from our day-to-day business, including implementation of strategic initiatives, may cause disruptions among our relationships with customers and strategic partners, all of which could detract from our ability to generate revenue and implement strategic initiatives. Furthermore, we cannot assure you that the proposed benefits of the acquisition can be achieved or achieved at the level currently anticipated. Our results of operations after the acquisition could be below the expectations of market analysts, which could cause a decline in our stock price. Moreover, the acquisition diluted our stockholders' equity as we issued 4,186,603 shares of our common stock to NXP as partial consideration for the acquisition.

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;

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

timing of new product introductions by us, including our DECT and CoIP products, 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;

entry into new markets, including China, Korea, South America and the domestic Japanese market;

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

general economic conditions, including the changing economic conditions in the United States and worldwide.

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. The fourth quarter in any given year is usually the strongest quarter for sales by our OEM customers in the consumer markets, and thus, our third quarter in any given year is usually the strongest quarter for revenues as our OEM customers request increased shipments of our products in anticipation of the increased activity in the fourth quarter. By contrast, the first quarter in any given year is usually the weakest quarter for us.

Table of Contents

Our 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.

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 through 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. As an example, our gross margin for the first quarter of 2008 was 37%, as compared to 39% for the first quarter of 2007. Our forecast is that the gross margin for the second quarter of 2008 will be lower than the first quarter of 2008. 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.

Also, increases in the price of silicon wafers, increases in testing costs and increases in gold, oil and other commodities which may result in increased production costs, mainly assembly and packaging costs may result in a decrease to our gross margins. For example, our gross margin decreased for the first quarter of 2008 due to the increased sales of DECT products with lower average gross margin on account of 5.8GHz products with higher average gross margin. Furthermore, 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.

The planned reduction in workforce associated with the restructuring efforts relating to the CIPT Business acquired from NXP could disrupt the operation of our business.

Pursuant to the acquisition of the CIPT Business from NXP, we increased our headcount and established new foreign subsidiaries in France, Germany, Switzerland, Hong Kong and India. In connection with the establishment of a new organizational structure for the combined company and the implementation of a unified synergy plan, we have implemented a restructuring plan that mainly involves a reduction in workforce in several locations. Workforce reductions in connection with any restructuring activity could result in an erosion of morale, affect the focus and productivity of our remaining employees, including those directly responsible for revenue generation, and result in work stoppages, all of which in turn may adversely affect our future revenues or cause other administrative deficiencies. Additionally, reduction in workforce in EU countries may be protracted, require us to comply with complex foreign labor regulations and may entail substantial severance costs. We also may face actions from employees that may be costly to defend. Furthermore, such matters could divert the attention of our employees, including management, away from our operations, harm productivity, harm our reputation and increase our expenses. We cannot assure you that our restructuring efforts will be successful or implemented in a timely manner. Also, in order to capitalize on the cost savings associated with the Acquisition, we may need to enter into new restructuring plans that could have the same effects as described above.

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 and representatives 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 91% of our total revenues for the first quarter of 2008.

Table of Contents

Furthermore, pursuant to the acquisition of the CIPT Business from NXP, we established new foreign subsidiaries, and have material operations, in France, Germany, Switzerland, 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.

Because we depend on independent foundries to manufacture 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 by independent foundries. While these foundries have been able to adequately meet the demands of our increasing business, we are and will continue to be dependent upon these foundries to achieve acceptable manufacturing yields, quality levels and costs, and to allocate to us a sufficient portion of their foundry 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, we may encounter capacity shortage issues in the future. In the event of a worldwide shortage in foundry capacity, we may not be able to obtain a

Edgar Filing: DSP GROUP INC /DE/ - Form 10-Q

sufficient allocation of foundry 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 we use, or future foundries we may use, to manufacture our integrated circuit products may lead to increased operating costs and lower gross margins. In addition, such a shortage could lengthen our products' manufacturing 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 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.

Table of Contents

In addition, as TSMC produces a significant portion of our integrated circuit products and ASE tests and assembles 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 we depend on NXP to manufacture all of our products for the CIPT Business, 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 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 for up to seven years following the closing of the acquisition at predetermined costs. Products from the CIPT Business (e.g. DECT products) currently generate approximately 50% of our total revenues and are anticipated to continue to generate significant revenues for the company in future periods. While NXP has been able to adequately meet our manufacturing demands to date, our manufacturing arrangement with NXP was established only in September 2007. Our business could be materially harmed if NXP fails to achieve acceptable manufacturing yields, quality levels or allocate to us a sufficient portion of its foundry capacity to meet our needs for the CIPT Business products due to its capacity constraints, including as a result of the provision of manufacturing services to NXP's internal business units. We also may encounter capacity shortage issues in the future if sales for the CIPT Business products continue to increase as we anticipate and NXP cannot sufficiently meet our increasing demands. A capacity shortage could lengthen our CIPT Business products' manufacturing cycle, cause a delay in the shipment of our products to our customers, lead to a loss of sales of our products, harm our reputation and competitive position with customers, some of whom we recently established relationships as a result of the acquisition, and our revenues could be materially reduced. Furthermore, as part of the acquisition, we negotiated a predetermined cost structure for NXP's provision of manufacturing, pre-testing, assembling and final-testing services relating to the CIPT Business products. Our business would be harmed if such cost structure increases, which reduces the anticipated gross margin for our CIPT Business products. Our business also would be materially harmed if NXP terminates its relationship with us and we are unable to obtain satisfactory replacement to fulfill customer orders on a timely basis and in a cost-effective manner.

Moreover, in order to enable NXP to provide the specified manufacturing, pre-testing, assembling and final-testing services relating to the CIPT Business products to us, we provide binding capacity commitments to NXP based on a periodic rolling forecast. The manufacturing agreement with NXP provides that we may be subject to monetary penalties if we fail to meet our capacity commitments to NXP that we previously provided to them. If we fail to meet our capacity commitments due to errors in planning logistics, a decrease in forecast from our customers or other reasons, we may be subject to such monetary penalties.

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.

Table of Contents

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. 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, quality assurance problems, increased manufacturing costs, and/or supply chain disruption.

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.

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. We are exploring opportunities to expand sales of our products to China, Korea, South America and the domestic Japanese market. However, there are no assurances that we will gain significant market share in those competitive markets. In addition, 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. 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 failure to compete effectively in the U.S. DECT market could have a material adverse effect on our business.

The U.S. digital telephony market is currently our dominant market as our OEM customers have significant market share in this market. Although the current telephony technology for the U.S. market is based on 2.4GHz and 5.8GHz products, we are witnessing a shift in the U.S. market towards DECT products at a higher rate than previously anticipated. We can provide no assurance that our current OEM customers, with whom we have strong existing relationships, will gain significant market share in the DECT 6.0 market. Moreover we can provide no assurance that our DECT 6.0 chipsets will be acceptable to our OEM customers or that the OEM customers to whom we sale DECT 6.0 chipsets will gain significant U.S. market share. If we are unable to develop and market DECT products to compete effectively in any emerging DECT 6.0 market against the introduction of new products by our competitors, our profits and results of operation may be materially adversely effected. In addition, if our OEM customers do not succeed in penetrating any emerging DECT 6.0 market or fail to incorporate our chipsets in new DECT products introduced by them for this market, our business also could suffer.

Table of Contents

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 through a network of distributors and OEM representatives. 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 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.

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

We believe new technological developments in the home residential 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 projected 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 that integrate video, voice, data and communication technologies in a wider multimedia market, as well as on our success in developing and selling DECT, CoIP and video products. We cannot assure you that we will succeed in expanding our product lines, or develop and sell in a timely manner a portfolio of system-on-a-chip solutions.

Furthermore, there is a growing threat from alternative technologies accelerating the decline of the fixed-line telephony market. This competition comes mainly from mobile telephony, including emerging dual-mode mobile Wi-Fi phones, but also from other innovative applications, such as Skype. 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.

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.

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 March 31, 2008, 263 of our 511 employees were located in Israel, including 164 out of 313 of our research and development

Table of Contents

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, and as amended. The Investment Law provides that capital investments in a production facility (or other eligible assets) may be designated as an Approved Enterprise. Under that law, we receive certain tax benefits in Israel. 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 Industry and Trade and to 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 (27% for 2008) and could be required to refund tax benefits already received. We cannot assure you that such grants and tax benefits will be continued in the future at their current levels, if at all. The tax benefits under these investment plans are scheduled to gradually expire by 2018. The termination or reduction of certain programs and tax benefits (particularly benefits available to us as a result of the Approved Enterprise status of our facilities and programs) or a requirement to refund tax benefits already received may have a material adverse effect on our business, operating results and financial condition.

On April 1, 2005, an amendment to the Investment Law came into effect. The amendment revised the criteria for investments qualified to receive tax benefits. An eligible investment program under the amendment will qualify for benefits as a Beneficiary Enterprise (rather than the previous terminology of Approved Enterprise). Among other things, the amendment provides tax benefits to both local and foreign investors and simplifies the approval process. The amendment does not apply to investment programs approved prior to December 31, 2004. The new tax regime will apply to new investment programs only. We believe that we are currently in compliance with these requirements and have calculated our current tax provision for the first quarter of 2008 accordingly. However, if we fail to meet these requirements, we would be subject to corporate tax in Israel at the regular statutory rate (27% for 2008). We also could be required to refund tax benefits, with interest and adjustments for inflation based on the Israeli consumer price index.

Table of Contents

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.

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 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. For example, in a lawsuit against Microsoft Corporation, AT&T asserted that our TrueSpeech 8.5 algorithm includes certain elements covered by a patent held by AT&T. AT&T sued Microsoft, one of our TrueSpeech 8.5 licensees, for infringement. We were not named in AT&T's suit against Microsoft. 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 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

Table of Contents

cause us to incur substantial liabilities and to suspend the manufacturing of products utilizing the technology. 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.

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 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 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 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. Furthermore, as part of the acquisition of the CIPT Business, we increased our customer base with new customers in Europe and Asia who are less established and have less financial resources than our

Table of Contents

existing customers. 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.

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 both the United States and various foreign jurisdictions. In addition to our significant operations in Israel, pursuant to the acquisition of the CIPT Business from NXP, we now have operations in France, Germany, Switzerland, 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. 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 91% of our total revenues for the first quarter of 2008. 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, due to the acquisition of the CIPT Business, a portion of our expenses for our European operations are paid in Euro and Swiss Franc, which subjects us to the risks of foreign currency fluctuations between the U.S. dollar and the Euro and Swiss Franc. Our primary expenses paid in Euro and Swiss Franc are employee salaries, lease and operational payments on our European facilities. As a result, an increase in the value of the NIS, Euro and Swiss Franc in comparison to the U.S. dollar, which has been the trend in recent periods due to the devaluation of 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. Our financial results may be harmed if the trend relating to the devaluation of the U.S. dollars continues for an extended period.

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

Table of Contents

competition and new product introductions. Our future growth is dependent not only on the continued success of our existing products but also successful introduction of new products as some of our existing products, such as 900MHz, 2.4GHz and 5.8GHz, experienced decreased sales. 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 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 Infineon and SiTel (formerly the DECT division of National Semiconductor). Our principal competitors in the VoIP market include AudioCodes, Broadcom, Infineon, Texas Instruments and new Taiwanese IC vendors.

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

Table of Contents

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. The outcomes from these examinations may have an adverse effect on our operating results and financial condition. Our U.S. Federal income tax returns for 2003 and 2004 have been selected for audit by the Internal Revenue Service. While we believe that we have made adequate provisions related to the audits of these tax returns, the final determination of our obligations may exceed the amounts provided for by us in the accompanying Consolidated Financial Statements. Specifically, we may receive assessments related to the audits and/or reviews of our U.S. income tax returns that exceed amounts provided for by us. In the event we are unsuccessful in reducing the amount of such assessments, our business, financial condition or results of operations could be adversely affected. Further, if additional taxes and/or penalties are assessed as a result of these audits, there could be a material effect on our income tax provision, operating expenses and net income in the period or periods for which that determination is made.

An unfavorable tax ruling from the Swiss tax authorities relating to the tax rate applicable to the taxable income generated by our Swiss subsidiary could affect our operating results.

In connection with the acquisition of the CIPT Business of NXP, we applied for a tax ruling with the Swiss tax authorities to determine the tax rate applicable to the taxable income generated by our Swiss subsidiary, including the amortization period for tax purposes of goodwill and all other intangible assets acquired in the acquisition. As of March 31, 2008 and the filing date of this periodic report, the tax ruling process has not been completely finalized. Although we believe such ruling will be obtained, in the event we do not receive a favorable tax ruling, the tax rate of our Swiss subsidiary could increase.

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 IDT 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.

Table of Contents

Our certificate of incorporation and bylaws contain anti-takeover provisions that 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. We have a staggered board, which means it will generally take two years to change the composition of our board. 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. It is possible that these provisions may prevent or discourage third parties from acquiring us, even if the acquisition would be beneficial to our 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.

The table below sets forth the information with respect to repurchases of our common stock in open market purchases during the three months ended March 31, 2008, pursuant to a share repurchase plan established in accordance with Rule 10b5-1 of the United States Securities Exchange Act of 1934, as amended.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
Month #1 (January 1, 2008 to January 31, 2008)				5,053,712
Month #2 (February 1, 2008 to February 29, 2008)	1,262,329	11.84	1,262,329	3,791,383
Month #3 (March 1, 2008 to March 31, 2008)	908,255	12.01	908,255	2,883,128
TOTAL	2,170,584	11.91	2,170,584	2,883,128

In March 1999, our board of directors authorized the repurchase of up to 4.0 million shares of our common stock. In July 2003, October 2004 and January 2007, our board authorized the repurchase of an additional 2.5 million shares, 2.5 million shares and 3.0 million shares of our common stock, respectively, for repurchase. In January 2008, our board authorized an additional 2.9 million shares for repurchase. The number of shares authorized for repurchase after giving affect to the January 2008 board approval was 5.1 million shares. Also in January 2008, our board of directors approved the company's entry into a share repurchase plan for up to 5,000,000 shares of the 5.1 million shares of our common stock authorized for repurchase, which plan became effective on February 7, 2008. The share repurchase plan is in accordance with Rule 10b5-1 of the United States Securities Exchange Act of 1934, as amended, that is designed to facilitate these purchases. 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. The repurchase program has no set

Table of Contents

expiration or termination date. Pursuant to our share repurchase program, 2,829,416 shares of our common stock remain authorized for repurchase as of March 31, 2008. As of March 31, 2008, 2,883,128 shares of our common stock in the aggregate remain authorized for repurchase. Additional share repurchases occurred after the first quarter of 2008, and as of the date of this report, 1,973,712 shares of our common stock remain authorized for repurchase.

ITEM 6. EXHIBITS.

Exhibit 31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 31.2	Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 32.1	Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Exhibit 32.2	Certification of the Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

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)

Date: May 9, 2008

By: /s/ Dror Levy
Dror Levy, Chief Financial Officer and Secretary
(Principal Financial Officer and Principal Accounting Officer)