PERFORMANCE TECHNOLOGIES INC \DE\
Form 10-Q
August 09, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarter Ended June 30, 2005

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 0-27460

PERFORMANCE TECHNOLOGIES, INCORPORATED
(Exact name of registrant as specified in its charter)

Delaware	16-1158413
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification No.)
205 Indigo Creek Drive, Rochester, New York	14626
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (585) 256-0200

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 [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [X] No [ ]

The number of shares outstanding of the registrant's common stock was 12,871,297 as of July 27, 2005.

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

ASSETS

	June 30, 2005 (unaudited)	December 31, 2004
Current assets:		
Cash and cash equivalents	$10,829,000	$10,361,000
Investments	18,600,000	15,250,000
Accounts receivable, net	8,505,000	10,185,000
Inventories, net	6,336,000	6,573,000
Prepaid income taxes	640,000	771,000

Prepaid expenses and other assets	416,000	801,000
Deferred taxes	3,092,000	3,088,000
Total current assets	48,418,000	47,029,000
Property, equipment and improvements, net	1,940,000	2,186,000
Software development costs, net	4,057,000	3,653,000
Goodwill	4,143,000	4,143,000
Total assets	$58,558,000	$57,011,000

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	$ 1,219,000	$ 1,476,000
Accrued expenses	3,746,000	3,916,000
Total current liabilities	4,965,000	5,392,000
Deferred taxes	1,412,000	1,198,000
Total liabilities	6,377,000	6,590,000
Stockholders' equity:		
Preferred stock - $.01 par value; 1,000,000 shares authorized; none issued		
Common stock - $.01 par value; 50,000,000 shares authorized; 13,260,038 shares issued	133,000	133,000
Additional paid-in capital	13,631,000	13,476,000
Retained earnings	42,328,000	41,978,000
Treasury stock - at cost; 390,775 and 482,681 shares held at June 30, 2005 and December 31, 2004, respectively	(3,911,000)	(5,188,000)
Accumulated other comprehensive income		22,000
Total stockholders' equity	52,181,000	50,421,000
Total liabilities and stockholders' equity	$58,558,000	$57,011,000

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

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004

Sales	$10,802,000	$13,273,000	$23,959,000	$28,839,000
Cost of goods sold	5,916,000	6,653,000	12,378,000	14,241,000
Gross profit	4,886,000	6,620,000	11,581,000	14,598,000
Operating expenses:				
Selling and marketing	1,369,000	1,572,000	2,846,000	3,200,000
Research and development	2,327,000	2,621,000	4,872,000	5,212,000
General and administrative	1,094,000	1,199,000	2,527,000	2,542,000
Restructuring charges	139,000		196,000	
In-process research and development				218,000
Total operating expenses	4,929,000	5,392,000	10,441,000	11,172,000
Income(loss)from operations	(43,000)	1,228,000	1,140,000	3,426,000
Other income, net	330,000	151,000	625,000	289,000
Income before income taxes and equity in income of unconsolidated company	287,000	1,379,000	1,765,000	3,715,000
Income tax provision	83,000	428,000	512,000	1,219,000
Income before equity in income of unconsolidated company	204,000	951,000	1,253,000	2,496,000
Equity in income of unconsolidated company		80,000		92,000
Net income	$ 204,000	$ 1,031,000	$ 1,253,000	$ 2,588,000
Basic earnings per share	$ .02	$ .08	$ .10	$ .20
Diluted earnings per share	$ .02	$ .08	$ .10	$ .19
Weighted average number of common shares used in basic earnings per share	12,863,345	12,741,867	12,836,333	12,673,917
Potential common shares	180,747	680,294	293,643	855,534
Weighted average number of common shares used in diluted earnings per share	13,044,092	13,422,161	13,129,976	13,529,451

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

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Cash flows from operating activities:		
Net income	$ 1,253,000	$ 2,588,000
Non-cash adjustments:		
Depreciation and amortization	1,325,000	1,352,000
Reserve for inventory obsolescence	656,000	383,000
Tax benefit from stock option exercises	143,000	
Deferred taxes	210,000	115,000
In-process research and development		218,000
Equity in income of unconsolidated company		(92,000)
Other	41,000	43,000
Changes in operating assets and liabilities, net of effects of acquisition:		
Accounts receivable	1,653,000	(2,562,000)
Inventories	(419,000)	(1,663,000)
Prepaid expenses and other assets	385,000	252,000
Accounts payable and accrued expenses	(427,000)	(483,000)
Income taxes payable and prepaid income taxes	131,000	(1,353,000)
Net cash provided (used) by operating activities	4,951,000	(1,202,000)
Cash flows from investing activities:		
Purchases of property, equipment and improvements	(198,000)	(248,000)
Capitalized software development costs	(1,308,000)	(1,124,000)
Purchases of investments	(32,900,000)	(29,050,000)
Proceeds from sales of investments	29,550,000	30,900,000
Loan to unconsolidated company		(1,300,000)
Business acquisition		(7,044,000)
Net cash used by investing activities	(4,856,000)	(7,866,000)
Cash flows from financing activities:		
Proceeds from exercise of stock options	373,000	2,911,000
Net cash provided by financing activities	373,000	2,911,000
Net increase (decrease) in cash and cash equivalents	468,000	(6,157,000)
Cash and cash equivalents at beginning of period	10,361,000	12,639,000
Cash and cash equivalents at end of period	$ 10,829,000	$ 6,482,000

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

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note A - Basis of Presentation

The unaudited Consolidated Financial Statements of Performance Technologies, Incorporated and Subsidiaries (the "Company") have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, the Consolidated Financial Statements 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 considered necessary for a fair presentation have been included. The results for the interim periods are not necessarily indicative of the results to be expected for the year. The accompanying Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements of the Company as of December 31, 2004, as reported in its Annual Report on Form 10-K filed with the Securities and Exchange Commission.

Note B - Stock-Based Compensation and Earnings Per Share

At June 30, 2005, the Company had stock options outstanding under three stock option plans. The Company accounts for the stock option plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no stock-based compensation cost has been recognized in net income for the stock option plans. On March 25, 2005, the Company accelerated the vesting of 408,285 stock options whose exercise prices were greater than $15.11 to be fully vested on that date. As a result of the acceleration, the Company expects to reduce its exposure to the effects of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised), "Share-Based Payment." Had compensation cost for the stock option awards under the plans been determined based on the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income (loss) and earnings (loss) per share would have been as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Net income, as reported	$ 204,000	$ 1,031,000	$ 1,253,000	$ 2,588,000
Add: Restricted stock compensation expense, net of tax	4,000	6,000	7,000	21,000
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(154,000)	(764,000)	(2,290,000)	(1,223,000)
Pro forma net income (loss)	$ 54,000	$ 273,000	$(1,030,000)	$ 1,386,000

Earnings (loss) per share:				
Basic - as reported	$ .02	$ .08	$ .10	$ .20
Basic - pro forma	$ .00	$ .02	$ (.08)	$ .11
Diluted - as reported	$ .02	$ .08	$ .10	$ .19
Diluted - pro forma	$ .00	$ .02	$ (.08)	$ .10

During the six months ended June 30, 2005, the Company granted 204,000 stock options. The assumption for vesting of stock options granted in 2005 and 2004 was generally 33% per year. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2005 and 2004: Dividend yields of 0% for both years; expected volatility ranges of 65% to 70% in 2005 and 68% to 69% in 2004, risk-free interest rate ranges of 3.3% to 3.7% in 2005 and 2.1% to 3.5% in 2004, and expected life ranges of one to three years for both years.

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per share calculations reflect the assumed exercise of dilutive stock options and unvested restricted stock, applying the treasury stock method. Diluted earnings per share calculations exclude the effect of approximately 1,330,000 and 1,075,000 options for the three months ended June 30, 2005 and 2004, respectively, and 1,144,000 and 621,000, for the six months ended June 30, 2005 and 2004, respectively, since such options have an exercise price in excess of the average market price of the Company's common stock for the respective periods.

During the six months ended June 30, 2005, 91,906 common shares were issued upon exercise of stock options.

Note C - Acquisition

On January 23, 2004, the Company acquired substantially all of the assets and assumed certain liabilities of Mapletree Networks, Inc., a company that provided voice, data and fax processing technology to original equipment manufacturers. The products acquired in this acquisition broaden the Company's product offering to its customers. In accordance with the purchase agreement, the Company paid $6,625,000 at closing and incurred $418,000 of other acquisition related costs. The Company accounted for the acquisition under the provisions of SFAS No. 141, "Business Combinations." Acquired in-process research and development (IPR&D), which was related to certain voice processing products, amounted to $218,000 and was charged to operations during the first quarter 2004. As a component of the acquisition, the Company acquired certain software development costs which amounted to $577,000 at the date of acquisition. The Company also acquired certain net assets which amounted to $574,000 and were comprised principally of accounts receivable, inventory, accounts payable and accrued expenses. During the fourth quarter 2004, the Company resolved certain matters related to the acquisition resulting in a payment to the Company of $1,749,000, which represented a partial return of purchase price and was recorded as a reduction of goodwill. The excess of purchase price over the fair value of the net assets acquired totaled $4,143,000 and is included in goodwill on the accompanying Consolidated Balance Sheets. Operating results of the acquired group have been included in the Consolidated Statements of Income from the date of acquisition.

Note D - Inventories, net

Inventories consisted of the following:

	June 30, 2005	December 31, 2004
Purchased parts and components	$ 3,700,000	$ 3,638,000
Work in process	3,909,000	3,947,000
Finished goods	2,134,000	2,487,000
	9,743,000	10,072,000
Less: reserve for inventory obsolescence	(3,407,000)	(3,499,000)
Net	$ 6,336,000	$ 6,573,000

Note E - Investments

In connection with the preparation of the Company's Annual Report on Form 10-K for 2004, the Company concluded that it was appropriate to classify auction rate municipal securities as investments. Previously, such investments were classified as cash equivalents. Accordingly, the Company revised the classification to report these securities as investments on the Consolidated Balance Sheets as of December 31, 2004. The Company recorded corresponding reclassifications in the accompanying Consolidated Statement of Cash Flows for the six months ended June 30, 2004, to reflect the gross purchases and sales of these securities as investing activities. This change in classification did not affect previously reported cash flows from operations or from financing activities or previously reported net income for any period.

For the six months ended June 30, 2004, net cash provided by investing activities related to these investments totaled $1,850,000, which was previously included in cash and cash equivalents in the Company's Consolidated Statements of Cash Flows.

At June 30, 2005, investments consisted of high grade, auction rate municipal securities which the Company has classified as available-for-sale. The contractual maturities of the available-for-sale securities at June 30, 2005 all exceeded five years.

These investments are recorded at cost, which approximates fair market value due to their variable interest rates. These investments typically reset on approximately a monthly basis, and, despite the long-term nature of their stated contractual maturities, the Company has historically had the ability to quickly liquidate these securities. All income generated from these investments was recorded as interest income.

Note F - Warranty Obligations

The Company has warranty obligations in connection with the sale of certain of its products. The warranty period for its products is generally one year. The costs incurred to provide for these warranty obligations are estimated and recorded as an accrued liability at the time of sale. The Company estimates its future warranty costs based on product-based historical performance rates and related costs to repair. The changes in the Company's accrued warranty

obligations for the six months ended June 30, 2005 and 2004 were as follows:

	2005	2004
Accrued warranty obligations, January 1,	$288,000	$233,000
Actual warranty experience	(57,000)	(274,000)
Warranty provisions	69,000	285,000
Accrued warranty obligations, June 30,	$300,000	$244,000

Note G - Investment in Unconsolidated Company

On February 18, 2004, the Company entered into an agreement to invest up to $3,000,000 in InSciTek Microsystems, Inc. (InSciTek), an unrelated company, in the form of an interest bearing convertible note. During 2004, the Company invested $3,000,000 in conjunction with this agreement. As of December 31, 2004, InSciTek had not raised sufficient outside capital to assure its future as a going concern. Therefore, during the fourth quarter 2004, the Company recorded a valuation charge related to this note receivable in the amount of $3,000,000 as collection of this note was doubtful. The Company has the option to acquire ownership of InSciTek during a future specified period. The note bears interest at 10% annually and is convertible into shares of common stock of InSciTek. All unpaid accrued interest and all outstanding principal on the note is payable in full to the Company on December 31, 2008. InSciTek is currently negotiating with an outside party to raise additional funds. Under the terms currently being negotiated, the Company would forfeit its option to acquire ownership of InSciTek during a future specified period.

Note H - Subsequent Event

On July 11, 2005, the Company announced that its Board of Directors authorized the Company to repurchase shares of its common stock for an aggregate amount not to exceed $10,000,000. Under this program, shares of the Company's common stock may be repurchased through open market or private transactions, including block purchases, over the next twelve months. Repurchased shares will be used for the Company's stock option plan, potential acquisition initiatives and general corporate purposes. To date, there have been no repurchases of shares under this program.

Note I - Recently Issued Accounting Pronouncements

In December 2004, SFAS No. 123 "Accounting for Stock-Based Compensation (Revised 2004)" was issued. This statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This statement requires an entity to measure the cost of employee services received in exchange for an award of equity instruments, based on the fair value of the award at the grant date. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. The effective date of this statement was extended by the Securities and Exchange Commission and will be effective for the Company beginning January 1, 2006. As of the required effective date, all entities that used the fair-value-based method for either recognition or disclosure under SFAS No. 123 may apply this statement using a modified version of prospective application. An alternative method of application is available under SFAS No. 123R. Under the modified version of prospective application, compensation cost is recognized for the portion of outstanding stock-based awards for which the requisite service has not yet been rendered. The Company is currently assessing the impact this statement will have on its financial statements.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs - An Amendment of ARB No. 43, Chapter 4." SFAS No. 151 states that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges. Additionally, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company is required to adopt SFAS No. 151 effective January 1, 2006. The Company does not expect the adoption of SFAS No. 151 will have a material impact on its consolidated results of operations and financial condition.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions." SFAS No. 153 is based on the principle that nonmonetary asset exchanges should be recorded and measured at the fair value of the assets exchanged, with certain exceptions. This standard requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless (1) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits or (2) the transactions lack commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The Company is required to adopt SFAS No. 153 effective for its fiscal quarter beginning after June 15, 2005, and does not expect the adoption of SFAS No. 153 will have a material impact on its consolidated results of operations and financial condition.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections", which replaces APB Opinion No. 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Upon the adoption of SFAS No. 154 beginning January 1, 2006, the Company will apply the standard's guidance to changes in accounting methods as required. At this time, the Company does not expect the adoption of SFAS No. 154 will have a material impact on its consolidated results of operations and financial condition.

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

Matters discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-Q include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The Company's actual results could differ materially from those discussed in the forward-looking statements.

Critical Accounting Estimates and Assumptions

In preparing the financial statements in accordance with GAAP, management is required to make estimates and assumptions that have an impact on the assets, liabilities, revenue and expense amounts reported. These estimates can also affect supplemental information disclosures by the Company, including information about contingencies, risk and financial condition. The Company generally cannot make estimates until preliminary results for a financial quarter are known and analyzed. The Company believes, given current facts and circumstances, its estimates and assumptions are reasonable, adhere to GAAP, and are consistently applied. Inherent in the nature of an estimate or assumption is the fact that actual results may differ from estimates and estimates may vary as new facts and circumstances arise. The critical accounting policies, judgments and estimates that management believes have the most significant effect on the financial statements are set forth below:

- Revenue Recognition
- Software Development Costs
- Valuation of Inventories
- Income Taxes
- Product Warranty
- Carrying Value of Goodwill

Revenue Recognition: The Company recognizes revenue from product sales in accordance with the SEC Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition." Product sales represent the majority of the Company's revenue and include hardware products and hardware products with embedded software. The Company recognizes revenue from these product sales when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sale price is fixed or determinable, and collectability is reasonably assured. Additionally, the Company sells its products on terms which transfer title and risk of loss at a specified location, typically shipping point. Accordingly, revenue recognition from product sales occurs when all factors are met, including transfer of title and risk of loss, which typically occurs upon shipment by the Company. If these conditions are not met, the Company will defer revenue recognition until such time these conditions have been satisfied.

Revenue earned from arrangements for software is accounted for under the provisions of Statement of Position 97-2, "Software Revenue Recognition" and EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables". Revenue from software requiring significant production, modification, or customization is recognized using the percentage of completion method of accounting. Any anticipated losses on contracts are charged to operations as soon as such losses are determined. If all conditions of revenue recognition are not met, the Company defers revenue recognition and will recognize revenue when the Company has fulfilled its obligations under the arrangement. Revenue from software maintenance contracts is recognized ratably over the contractual period.

Revenue from consulting and other services is recognized at the time the services are rendered. The Company also sells certain products through distributors who are granted limited rights of return. Potential returns are accounted for at the time of sale.

The Company believes that the accounting estimate related to revenue recognition is a "critical accounting estimate" because the Company's terms of sale can vary, and management exercises judgment in determining whether to defer revenue recognition. Such judgments may materially affect net sales for any period. Management exercises judgment within the parameters of GAAP in determining when contractual obligations are met, title and risk of loss are transferred, sales price is fixed or determinable and collectability is reasonably assured.

Software Development Costs: All software development costs incurred in establishing the technological feasibility of computer software products to be sold are research and development costs. Software development costs incurred subsequent to the establishment of technological feasibility of a computer software product to be sold and prior to general release of that product are capitalized. Amounts capitalized are amortized commencing after general release of that product over the estimated remaining economic life of that product, generally three years, or using the ratio of current revenues to current and anticipated revenues from such product, whichever provides greater amortization. If in the judgment of management, technological feasibility for a particular project has not been met or recoverability of amounts capitalized is in doubt, project costs are expensed as research and development or charged to costs of goods sold, as applicable. The Company believes that the accounting estimate related to software development costs is a "critical accounting estimate" because the Company's management exercises judgment in determining whether project costs are expensed as research and development or capitalized as an

asset. Such judgments may materially affect expense amounts for any period. Management exercises judgment within the parameters of GAAP in determining when technological feasibility has been met and recoverability of software development costs is reasonably assured.

Valuation of Inventories: Inventories are stated at the lower of cost or market, using the first-in, first-out method. The Company's inventory includes purchased parts and components, work in process and finished goods. The Company provides inventory reserves for excess, obsolete or slow moving inventory after periodic evaluation of historical sales, current economic trends, forecasted sales, estimated product lifecycles and estimated inventory levels. The factors that contribute to inventory valuation risks are the Company's purchasing practices, electronic component obsolescence, accuracy of sales and production forecasts, introduction of new products, product lifecycles, product support and foreign regulations governing hazardous materials (see LIQUIDITY AND CAPITAL RESOURCES for futher information on foreign regulations). The Company manages its exposure to inventory valuation risks by maintaining safety stocks, minimum purchase lots, managing product end-of-life issues brought on by aging components or new product introductions, and by utilizing certain inventory minimization strategies such as vendor-managed inventories. The Company believes that the accounting estimate related to valuation of inventories is a "critical accounting estimate" because it is susceptible to changes from period-to-period due to the requirement for management to make estimates relative to each of the underlying factors ranging from purchasing, to sales, to production, to after-sale support. If actual demand, market conditions or product lifecycles are adversely different from those estimated by management, inventory adjustments to lower market values would result in a reduction to the carrying value of inventory, an increase in inventory write-offs and a decrease to gross margins.

Income Taxes: The Company accounts for income taxes using the asset and liability approach which requires recognition of deferred tax liabilities and assets for the expected future tax consequences of the temporary differences between the carrying amounts and the tax basis of such assets and liabilities. The Company would record a valuation allowance to reduce deferred tax assets to the amount that is more likely than not to be realized. The Company believes that the accounting estimate related to income taxes is a "critical accounting estimate" because the Company exercises judgment in estimating future taxable income, including prudent and feasible tax planning strategies, in assessing the need for any valuation allowance. If the Company should determine that it would not be able to realize all or part of its net deferred tax assets in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made. Likewise, in the event that the Company were to determine that it would be able to realize its deferred tax assets in the future in excess of the net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made.

Product Warranty: The Company has warranty obligations in connection with the sale of certain of its products. The warranty period for these products is generally one year. The costs incurred to provide for these warranty obligations are estimated and recorded as an accrued liability at the time of sale. The Company estimates its future warranty costs based on historical performance rates and related costs to repair given products. The Company believes that the accounting estimate related to product warranty is a "critical accounting estimate" because the Company exercises judgment in determining future estimated warranty costs. Should actual performance rates or repair costs differ from estimates, revisions to the estimated warranty liability would be required.

Carrying Value of Goodwill: The Company conducts tests for impairments of goodwill annually or more frequently if circumstances indicate that the asset might be impaired. The Company believes that the accounting estimate related to goodwill is a "critical accounting estimate" because these impairment tests

include management estimates of future cash flows that are dependent upon subjective assumptions regarding future operating results including growth rates, discount rates, capital requirements and other factors that impact the estimated fair value. An impairment loss is recognized to the extent that an asset's carrying amount exceeds its fair value.

Overview

The following contains forward-looking statements within the meaning of the Securities Act of 1933 and Securities Exchange Act of 1934 and is subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

The Company is a leading developer of platforms, components, software and services for the embedded systems market. This marketplace is comprised of several sectors, with telecommunications being the largest. The Company markets its products through its direct worldwide sales force under a variety of brand names including IPnexus(TM), SEGway(TM), NexusWare(TM) and Advanced Managed Platforms. These products are sold individually or can be mixed and matched to construct highly integrated, packet-based platforms for the embedded systems marketplace. When sold as integrated platforms (Advanced Managed Platforms) these products offer customers distinct cost advantages, increase overall system reliability and performance, and improve time-to-market for their products. Advanced Managed Platforms, based on the PICMG 2.16 standard, are applicable to the broader embedded systems market, not just telecommunications. Since its introduction in 2003, this product line has realized more than 30 new design wins of varying sizes. Only a small number of these design wins have reached production levels.

Over the past two quarters, the Company has announced and released several new products. Those products include: the new AdvancedTCA (ATCA) Advanced Managed Platform offering, a variety of media and packet-processing slot components including a quad-processor and media gateway blade, and new additions to the Signaling product family, including several Signaling Gateway and IP-STP advancements. Management believes that these new products build upon the Company's platform and software strategy, and provide high growth prospects for future revenue.

The telecommunications market is dependent upon carrier spending to upgrade network infrastructure to next-generation equipment. As the Company entered 2005, there were announcements by major domestic wireless carriers for new spending programs directed at upgrading networks to the third generation (3G) of mobile network capabilities. During the second quarter 2005, actual shipments by the Company to the telecommunications equipment providers for this equipment were less than forecasted volumes. Three customers accounted for the greater part of the revenue shortfall. Despite weakness in a number of end markets, shipments of Advanced Managed Platforms accelerated during the second quarter. Management expects that ongoing competitive pressures on the North American wireless carriers will result in deployment of the previously announced network and data services upgrades during the later part of 2005 and into 2006. Unfortunately, forward-looking visibility of customers' orders continues to be very limited.

Operating expenses for the second quarter 2005 were lower than the first quarter 2005 and reflect continuing progress of the Company's centralization and streamlining plan announced in October 2004. At that time, management began formulating a plan to reduce annualized expenses by approximately $2.0 million with a primary focus on centralizing its multi-location operations and streamlining the organization. During the fourth quarter 2004, the Company completed integration of the Voice Technology Group (VTG) sales, marketing and administrative functions into its corporate operations. During the first quarter 2005, the Company completed integration of the accounting functions for VTG and the Computing Products Group into corporate accounting in Rochester, New York.

During the second quarter 2005, transition of manufacturing operations for VTG products was completed and substantial progress was realized in transitioning the manufacturing of the Computing Products to Rochester. This centralization plan is expected to be completed in September 2005. While the Company continues to pursue its centralization plan, some part of these savings will be reinvested to stimulate future growth.

During the first quarter 2005, the Company announced that its current president and chief executive officer, Donald Turrell, will leave the Company's executive management at the end of the year. The Succession Committee of the Board of Directors has retained an executive search firm to assist in the process of identifying qualified individuals for this position and candidates are being interviewed. Mr. Turrell will maintain active involvement throughout the transition of the Company's change in leadership and expects to remain as a board member thereafter.

On July 11, 2005, the Company announced that its Board of Directors authorized the Company to repurchase shares of its common stock for an aggregate amount not to exceed $10.0 million. Under this program, shares of the Company's common stock may be repurchased through open market or private transactions, including block purchases, over the next twelve months. Repurchased shares will be used for the Company's stock option plan, potential acquisition initiatives and general corporate purposes. To date, there have been no repurchases of shares under this program.

Strategy: The Company has a history of successfully adapting its products and services to a constantly changing technology-driven marketplace. This adaptation has been demonstrated through the course of several business cycles that have occurred since its founding in 1981. During the most recent economic downturn, the Company maintained its commitment to aggressively fund new product development, as well as to use its strong balance sheet to acquire additional products and technologies to strengthen its market position.

The Company's IPnexus product line, based on open system architectures, consists of a wide range of embedded building blocks, which can be mixed and matched to construct highly integrated, packet-based platforms. In September 2003, the Company introduced a new line of application ready platforms marketed under the trade name Advanced Managed Platform (AMP). Initially, this platform line was based on an architecture referred to as PICMG 2.16, which is an embedded technology developed by the Company and adopted as an industry standard. In June 2005, the Company introduced its new AdvancedTCA (ATCA) Advanced Managed Platform offering which incorporates a new architecture specifically targeted at telecommunications applications. Today, the Advanced Managed Platform product line contains the Company's latest generation of configurable, fully-managed and redundant packet-based platforms targeted at communications applications, which leverage all of the Company's IPnexus component-based products. Advanced Managed Platforms offer customers distinct cost advantages, increase overall system reliability and performance, and improve time-to-market for their products. From a market perspective, the Advanced Managed Platform line continues to prove itself as a viable alternative to proprietary platforms and directly addresses equipment manufacturers' requirements for using a flexible and scalable architecture.

In the next phase of its product strategy, the Company is developing and introducing a number of products for selected high growth IP-based applications including media gateway, media server, wireless, voice-over-cable and satellite communications. The thrust of this effort is to combine certain hardware and software elements from the Company's product portfolio to form intelligent embedded solutions which add value for application providers in these target markets.

Historically, the Company's growth has been generated through a combination of

internal growth and acquisition of new products or complementary technologies. In October 2002, the Company acquired a portion of Intel Corporation's Communications Platform Group for its chassis and computing products. In January 2004, the Company completed the acquisition of the assets of Mapletree Networks to acquire its voice processing technology. The products from both acquisitions have enhanced the Company's product offerings to its customers.

There are identifiable risks associated with carrying out the Company's expansive product strategies in the current uncertain economic climate. Many of the Company's end markets are forecasted to show only modest growth in 2005. In order to realize growth in this environment, the Company will have to gain market share from competitors, many of whom are larger, more established companies with greater resources than the Company. However, management believes that based on its analysis of the marketplace and the Company's strengthened and innovative product portfolio, the identified risks are manageable.

If successful, management believes these initiatives will continue to strengthen the organization as an important strategic partner with its customers, thereby increasing their utilization of the Company's broadened product capabilities.

Financial Information

Beginning on January 23, 2004, the Company's revenue and expenses reflect the operations of the Voice Technology Group (acquired from Mapletree Networks).

Revenue:

Revenue in the second quarter 2005 amounted to $10.8 million, compared to $13.3 million in the corresponding quarter a year earlier. Revenue for the six months ended June 30, 2005 amounted to $24.0 million, compared to $28.8 million for the first six months of 2004.

Earnings:

GAAP Information:

On a GAAP earnings basis, net income for the second quarter 2005 amounted to $.2 million, or $.02 per diluted share including restructuring charges related to cost improvement efforts amounting to $.1 million, or $.00 per diluted share, based on 13.0 million shares outstanding. Net income for the second quarter 2004 amounted to $1.0 million, or $.08 per diluted share based on 13.4 million shares outstanding.

GAAP net income for the six months ended June 30, 2005 amounted to $1.3 million, or $.10 per diluted share including restructuring charges related to cost improvement efforts amounting to $.2 million, or $.01 per diluted share, based on 13.1 million shares outstanding. Net income for the first six months of 2004 amounted to $2.6 million, or $.19 per diluted share based upon 13.5 million shares outstanding.

Non-GAAP Information:

Upon the occurrence of certain non-recurring items, the Company will also calculate and report its results excluding these items from its GAAP net income to arrive at a non-GAAP measure of net income. Management believes that the presentation and disclosure of this non-GAAP net income measure provides another view of the operations and financial condition of the Company on the basis in which management operates the Company and the Board of Directors reviews its results. This non-GAAP net income measure is calculated by adjusting net income reported on a GAAP basis for items that the Company deems to be non-recurring

and unusual or infrequent in their nature. The Company adjusts for these non-recurring items as these items are excluded from the Company's operational analysis, budgeting and forecasting functions. The use of this non-GAAP measure by the Company could result in potential limitations related to possible bank lending covenant violations, where certain covenants may be measured on GAAP results. The Company compensates for this potential limitation by attempting to enter into lending agreements under which covenants are calculated utilizing the Company's non-GAAP net income measure. At June 30, 2005, the Company was not a party to any lending arrangements. There can be no assurance that the Company will be successful in its efforts to obtain lending arrangements under which certain covenants are calculated utilizing the non-GAAP net income measure described above.

There was no difference between GAAP net income and non-GAAP net income in the second quarter 2005, the second quarter 2004 or in the first six months of 2005. During the first quarter 2004, the Company recorded in-process research and development costs associated with the acquisition of Mapletree Networks in the amount of $.2 million, or $.02 per diluted share. On a non-GAAP basis, excluding the $.2 million of in-process research and development costs, net income for the first six months of 2004 amounted to $2.8 million, or $.21 per diluted share based on 13.5 million shares outstanding. A reconciliation of GAAP net income to non-GAAP net income for the first six months of 2004 is as follows:

	2004
Net income, GAAP basis	$2,588
Add: Non-recurring item - In-process research and development costs	218
Net income, non-GAAP basis	$2,806

Liquidity:

Cash, cash equivalents and investments amounted to $29.4 million and $25.6 million at June 30, 2005 and December 31, 2004, respectively, and the Company had no long-term debt at either date.

Centralization of Functions:

In October 2004, management began formulating a plan to reduce annualized expenses by approximately $2.0 million with a primary focus on centralizing its multi-location operations and streamlining the organization. When this centralization plan is completed in September 2005, operating expenses (selling, general and administrative) are expected to be reduced by $1.3 million annually and manufacturing overhead (cost of goods sold) is expected to be reduced by $.7 million. During the fourth quarter 2004, the Company completed integration of the Voice Technology Group (VTG) sales, marketing and administrative functions into its corporate operations. During the first quarter 2005, the Company completed integration of the accounting functions for VTG and the Computing Products Group into corporate accounting in Rochester, New York. During the second quarter 2005, transition of manufacturing operations for VTG products was completed and substantial progress was realized in transitioning the manufacturing of the Computing Products to Rochester. Most of the expected operating (selling, general and administrative) expense reductions associated with this program were realized by the end of the second quarter. During the second quarter 2005, the Company incurred charges of $.1 million related to these restructuring efforts and for the first six months of 2005, the Company incurred charges totaling $.2 million related to this plan. Additional charges related to restructuring actions are expected in the range of $.05 million to

$.15 million during the remainder of 2005. While the Company continues to pursue its centralization plan, some part of these savings will be reinvested to stimulate future growth.

Forward Looking Guidance for the Third Quarter 2005 (published July 28, 2005):

The following contains forward-looking statements within the meaning of the Securities Act of 1933 and Securities Exchange Act of 1934 and is subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

The Company provides guidance related to earnings per share expected in future quarters. Any additional information provided, such as revenue forecasts, is provided as supplementary information to the earnings per share guidance.

During weak or uncertain economic periods, the visibility for customers' orders is limited which frequently causes delays in the placement of orders. These factors often result in a substantial portion of the Company's revenue being derived from orders placed within a quarter and shipped in the final month of the same quarter. Unfortunately, forward-looking visibility on customer orders continues to be very limited.

Management expects diluted earnings per share in the third quarter 2005 to be in the range of $.04 to $.07, before any restructuring charges. Based upon the current business mix, the current backlog and review of sales forecasts, revenue is forecasted to be in the range of $11.5 million to $12.5 million in the third quarter 2005. Gross margin is expected to be approximately 45.5% to 47.5% and the effective income tax rate for the third quarter 2005 is expected to be 29%.

Key Performance Indicators:

The Company's platforms, components, software and service solutions are incorporated into current and next-generation embedded systems infrastructure. Traditionally, design wins have been an important metric for management to judge the Company's product acceptance in its marketplace. Design wins, if implemented, reach production volumes at varying rates, generally beginning twelve to eighteen months after the design win occurs. A variety of risks such as schedule delays, cancellations, changes in customer markets and economic conditions can adversely affect a design win before production is reached, or during deployment.

The Company modified its criteria for the measurement of "design wins" in the third quarter 2004 to provide greater accuracy in predicting forward looking potential for the Company and to assist in measuring day-to-day execution of product, sales and marketing programs. Prior the third quarter 2004, the Company reported design wins that were expected to generate greater than $1.0 million of annualized revenue. Upon the change in the measurement criteria, the Company began reporting design wins that were expected to generate greater than $.5 million of annualized revenue. During the second quarter 2005, the Company was notified of six design wins for its integrated platform solutions (with multiple products) (3), individual component design wins for IPnexus network access (2) and for a product that combines the technologies of network access and voice processing (1). During the second quarter 2004, the Company was notified of four new design wins, each for an integrated platform solution incorporating multiple products. Regardless of the change in the measurement metric, management believes that the growth in the number of design wins for integrated platform solutions in 2005 reflects increasing customer demand for more complete platform solutions from a single vendor, such as the Company.

Management believes another key indicator for the Company's business is the volume of orders received from its customers. During weak economic periods, customers' visibility deteriorates causing delays in the placement of orders. While forward-looking visibility on customer orders continues to be very

limited, shipments to customers in the second quarter 2005 amounted to $10.8 million, compared to $13.3 million in second quarter 2004. The shortfall in revenue in the second quarter 2005 was primarily the result of less than expected shipments to three customers.

More in-depth discussions of the Company's strategy and financial performance can be found in the Company's Annual Report on Form 10-K and other filings with the Securities and Exchange Commission.

Three and Six Months Ended June 30, 2005, Compared with
Three and Six Months Ended June 30, 2004

The following table presents the percentage of sales represented by each item in the Company's consolidated statements of income for the periods indicated. The table includes the results of operations of the Voice Technology Group, acquired by the Company in January 2004.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	54.8	50.1	51.7	49.4
Gross profit	45.2	49.9	48.3	50.6
Operating expenses:				
Selling and marketing	12.7	11.8	11.9	11.1
Research and development	21.5	19.7	20.3	18.1
General and administrative	10.1	9.1	10.5	8.8
Restructuring charges	1.3		0.8	
In-process research and development				0.7
Total operating expense	45.6	40.6	43.5	38.7
Income (loss) from operations	(0.4)	9.3	4.8	11.9
Other income, net	3.1	1.1	2.6	1.0
Income before income taxes and equity in income of unconsolidated company	2.7	10.4	7.4	12.9
Income tax provision	0.8	3.2	2.2	4.2
Income before equity in income of unconsolidated company	1.9	7.2	5.2	8.7
Equity in income of unconsolidated company		0.6		0.3
Net income	1.9%	7.8%	5.2%	9.0%

Sales. Total revenue for the second quarter 2005 amounted to $10.8 million, compared to $13.3 million for the same quarter in 2004. Revenue for the six months ended June 30, 2005 totaled $24.0 million, compared to $28.8 million in the same period of 2004. In both the second quarter 2005 and 2004, the Voice Technology Group contributed $.4 million to revenue. For the six months ended

June 30, 2005, the Voice Technology Group contributed $.7 million, or 3% of revenue, compared to a contribution of $1.6 million, or 6%, of revenue in the first six months of 2004.

In the second quarter 2005, the Company had two customers that each represented greater than 10% of sales, and the Company's four largest customers represented 42% of sales. During the second quarter 2004, the Company had two customers that each comprised greater than 10% of revenue and the Company's four largest customers represented 43% of sales.

For the six months ended June 30, 2005, the Company had two customers who each represented greater than 10% of revenue and the Company's four largest customers contributed 45% to revenue. For the six months ended June 30, 2004, three customers each represented greater than 10% of revenue and the Company's four largest customers contributed 43% to revenue.

Shipments to customers outside of the United States represented 49% and 32% of sales during the second quarter 2005 and 2004, respectively and 40% and 30% of revenue for the six months ended June 30, 2005 and 2004, respectively. In the second quarter 2005 and for the six months ended June 30, 2005, shipments to the United Kingdom represented 18% and 12% of revenue, respectively. Total shipments to a single foreign country did not exceed 10% of revenue during the second quarter 2004 or for the six months ended June 30, 2004.

For the periods indicated, the Company's products are grouped into four distinct categories in one market segment: Communications (network access, signaling and voice) products, Computing products, IPnexus switching products and Other products. Revenue from each product category is expressed as a percentage of sales for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Communications products	49%	41%	49%	50%
Computing products	32%	40%	26%	34%
IPnexus switching products	18%	18%	24%	14%
Other products	1%	1%	1%	2%
Total	100%	100%	100%	100%

Communications products:

Communications products are comprised of network access, SEGway signaling and Voice Technology products. Network access products provide a connection between embedded systems platforms and a variety of networks and are used to control the network and/or process information being transported over networks. Many of the Company's signaling products enable the transport of signaling messages over packet-switched (IP) networks. Voice Technology products enable voice, data and fax processing for communications applications.

Revenue from Communications products amounted to $5.3 million and $5.5 million in the second quarter of 2005 and 2004, respectively. The decline in revenue during the second quarter 2005, compared to a year earlier, was attributable to a general decrease in customer purchases due to a weaker market which was partially offset by increased shipments to one customer and a variety of early stage customers contributing smaller seed shipments.

Communications product revenue decreased from $14.5 million in the six months ended June 30, 2004 to $11.7 million in the respective period in 2005. This decrease of $2.8 million, or 19%, was primarily due to a decrease related to one

major customer that, due to market conditions, unexpectedly decreased product requirements, as well as an overall decrease due to a weaker market. These decreases were partially offset by increased sales to one customer in the first six months of 2005.

Computing products:

Computing products includes integrated platform solutions, a range of single board computers, a variety of embedded system chassis and associated chassis management products.

Computing products revenue amounted to $3.5 million in the second quarter 2005, compared to $5.3 million in the second quarter 2004. The significant decrease in revenue of $1.8 million was primarily attributable to two major customers whose product requirements, due to market conditions, began declining during the second half of 2004 and had ceased altogether by the end of 2004. This decrease was partially offset by increased shipments to a major customer in 2005.

Revenue for Computing products in the first six months of 2005 totaled $6.2 million, compared to $9.9 million for the first six months of 2004. This decrease of $3.7 million is primarily attributable to two major customers who, due to market conditions, ceased purchasing product by the end of 2004, offset by increased shipments to a major customer in 2005.

IPnexus switching products:

The Company's IPnexus switching product family has been designed for the rigorous requirements of the embedded systems that use the industry standard PICMG 2.16 architecture.

Revenue from switching products amounted to $1.9 million in the second quarter 2005 compared to $2.4 million the second quarter 2004. This decrease of $.5 million was a result of reduced orders from a major customer during the second quarter 2005.

For the six months ended June 30, 2005, revenue from switching products amounted to $5.8 million compared to $4.0 million for the same period in 2004. This increase in revenue of $1.8 million was primarily attributable to increased sales to one major customer and a variety of early stage customers in this product category.

Other products:

This revenue is primarily related to legacy products. Many of these products are project oriented and shipments can fluctuate on a quarterly and annual basis.

Gross profit. Gross profit consists of sales, less cost of goods sold including material costs, manufacturing expenses, depreciation, amortization of software development costs, and expenses associated with engineering contracts and the technical support function. Gross margin was 45.2% and 49.9% of sales for the second quarter 2005 and 2004, respectively. Gross margin was 48.3% and 50.6% for the six months ended June 30, 2005 and 2004, respectively. For both the second quarter and the six months ended June 30, 2005 compared to the same periods of 2004, the change in the product mix from the 2004 periods to the 2005 periods resulted in a modest improvement in gross margin, but was more than offset by a decline in the volume of shipments, which caused the fixed manufacturing overhead to be spread over fewer units, thereby reducing the overall gross margin.

Total Operating Expenses. Total operating expenses in the second quarter 2005 amounted to $4.9 million, compared to $5.4 million in the second quarter 2004. For the six months ended June 30, 2005 and 2004, total operating expenses

amounted to $10.4 million and $11.2 million, respectively. For 2004, the operating expenses of the Voice Technology Group (VTG) are included from the date of acquisition of January 23, 2004. During the third quarter 2004, management began formulating plans to reduce annualized expenses by approximately $2.0 million with a primary focus on centralizing its multi-location operations and streamlining the organization. When this centralization plan is completed in September 2005, operating expenses are expected to be reduced by $1.3 million annually. Most of the expected operating expense reductions associated with this program were realized by the end of the second quarter. While the Company continues to pursue its centralization plan, some part of these savings will be reinvested to stimulate future growth.

Selling and marketing expenses were $1.4 million and $1.6 million for the second quarter 2005 and 2004, respectively, and $2.8 million and $3.2 million for the six months ended June 30, 2005, and 2004, respectively. The overall decreases in selling and marketing expense for both comparative periods are a result of staff reductions in the Company's effort to centralize its sales organization.

Research and development expenses were $2.3 million and $2.6 million in the second quarter 2005 and 2004, respectively. The decrease in expense primarily reflects increased capitalized software development costs and reductions related to the Company's effort to centralize operations. The Company capitalizes certain software development costs, which reduces the amount of software development charged to operating expenses. Amounts capitalized were $.7 million and $.6 million during the second quarter 2005 and 2004, respectively. Research and development expenses amounted to $4.9 million and $5.2 million, for the six months ended June 30, 2005 and 2004, respectively. The decrease in research and development expenses for this period was primarily a result of increased capitalized software development costs and reductions related to the Company's centralization plan, partially offset by the inclusion of VTG expenses for the full period in 2005. Amounts capitalized related to software development were $1.3 million and $1.1 million during the six months ended June 30, 2005 and 2004, respectively.

General and administrative expenses were $1.1 million in the second quarter 2005, compared to $1.2 million in the second quarter 2004. This decrease was a result of reduced costs related to the Company's efforts to centralize operations, partially offset by increases in corporate governance costs. For each of the six months ended June 30, 2005 and 2004, general and administrative expenses totaled $2.5 million.

Restructuring charges amounted to $.1 million in the second quarter 2005 and $.2 million in the six months ended June 30, 2005, compared to no restructuring charges incurred during 2004. Restructuring charges in 2005 relate primarily to severance payments associated with the Company's efforts to centralize its operations.

In the first quarter 2004, the Company recorded in-process research and development expense of $.2 million. This amount represented a charge for in-process research and development costs associated with the Mapletree Networks acquisition that were expensed in accordance with Financial Accounting Standards Board Interpretation No. 4 "Applicability of SFAS No. 2 to Business Combinations Accounted for by the Purchase Method." This charge relates to research and development projects that had not reached technological feasibility at the time of the acquisition.

Other Income, net. Other income consists primarily of interest income. The Company's funds are primarily invested in high quality auction rate municipal securities. An increase in the funds available for investment as well as higher interest rates in 2005, resulted in increased interest income for both the second quarter 2005 and for the six months ended June 30, 2005, compared to the corresponding periods of 2004. Also contributing to higher interest income was

an increase in interest from a note receivable from an unconsolidated company based upon an increase in the principal amount.

Income taxes. The Company's effective income tax rate is a combination of federal, state and foreign tax rates and is generally lower than statutory rates because it includes benefits derived from the Company's international operations, research activities, tax exempt interest and foreign sales. For the second quarter 2005 and 2004, the Company's effective tax rate was 29% and 31%, respectively. For the six months ended June 30, 2005 and 2004, the Company's effective tax rate was 29% and 33%, respectively. Decreases in the effective tax rate for the comparative periods were the result of changes in certain permanent items. On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (H.R. 4520). The Act contains numerous corporate tax provisions which could affect the Company's current and future tax provisions. The Company is currently assessing any potential impact of these provisions.

Equity in Income of Unconsolidated Company. In the third quarter 2004, the Company sold its ownership interest in Momentum Computer, Inc., a developer of specialized single board computer products. During both the second quarter 2004 and for the six months ended June 30, 2004, the Company's allocation of Momentum's income amounted to $.1 million.

LIQUIDITY AND CAPITAL RESOURCES

The Company's primary source of liquidity is its cash, cash equivalents and investments which totaled $29.4 million at June 30, 2005. The Company had working capital of $43.5 million and $41.6 million at June 30, 2005 and December 31, 2004, respectively.

Cash provided by operating activities amounted to $5.0 million for the first six months of 2005. This amount included net income of $1.3 million, non-cash charges related to depreciation and amortization of $1.3 million, and the reserve for inventory obsolescence of $.7 million. Cash provided by operations due to changes in operating assets and liabilities included a decrease in accounts receivable of $1.7 million resulting from decreased sales and improved collections during the six months ended June 30, 2005. A decrease in prepaid expenses related to the timing of income tax and other certain payments also resulted in an increase in operating cash of $.5 million.

On July 1, 2006, the Restriction of Certain Hazardous Substances Directive ("RoHS") issued by the European Union will become effective. This directive restricts the distribution of products within the EU containing certain substances, including lead. While the enabling legislation of a number of EU member countries has not yet been adopted, it is expected that the Company will not be able to sell non-RoHS compliant product to certain customers who intend to sell their finished goods in the EU after the effective date. At the present time, the majority of the Company's inventory contains substances prohibited by the RoHS directive. Upon effectiveness of the RoHS legislation, a portion of the Company's inventory may become obsolete and unsaleable and, as a result, may have to be written off. In addition, prior to the effectiveness, the Company expects that its overall inventory balances will increase as it builds RoHS compliant product prior to the effective date. The Company is working closely with its customers and suppliers to minimize this impact. At this time, the Company is unable to quantify the potential financial impact, if any, of such obsolete inventory or increases in inventory levels.

Cash used by investing activities during the first six months of 2005 totaled $4.9 million. This utilization was primarily the result of net purchases of auction rate municipal securities of $3.4 million and the capitalization of software development costs amounting to $1.3 million.

Cash provided by financing activities amounted to $.4 million in the first six

months of 2005 resulting from the exercise of stock options. On July 11, 2005, the Company announced that its Board of Directors authorized the Company to repurchase shares of its common stock for an aggregate amount not to exceed $10.0 million. Under this program, shares of the Company's common stock may be repurchased through open market or private transactions, including block purchases, over the next twelve months. Repurchased shares will be used for the Company's stock option plan, potential acquisition initiatives and general corporate purposes. To date, there have been no repurchases of shares under this program.

Off-Balance Sheet Arrangements:

The Company did not enter into any off-balance sheet arrangements during the first six months of 2005.

Contractual Obligations:

The Company did not enter into any other significant contractual obligations during the first six months of 2005.

Current Position:

Assuming there is no significant change in the Company's business, management believes that its current cash, cash equivalents and investments together with cash generated from operations should be sufficient to meet the Company's anticipated operating needs, including working capital and capital expenditure requirements, for at least the next twelve months. However, management is continuing its strategic acquisition program to further accelerate its growth and market penetration efforts. A future acqusition could have an impact on the Company's working capital, liquidity or capital resources, and the Company may need to raise additional capital to facilitate these efforts.

Recently Issued Accounting Pronouncements

In December 2004, SFAS No. 123 "Accounting for Stock-Based Compensation (Revised 2004)" was issued. This statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This statement requires an entity to measure the cost of employee services received in exchange for an award of equity instruments, based on the fair value of the award at the grant date. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. The effective date of this statement was extended by the Securities and Exchange Commission and will be effective for the Company beginning January 1, 2006. As of the required effective date, all entities that used the fair-value-based method for either recognition or disclosure under SFAS No. 123 may apply this statement using a modified version of prospective application. An alternative method of application is available under SFAS No. 123R. Under the modified version of prospective application, compensation cost is recognized for the portion of outstanding stock-based awards for which the requisite service has not yet been rendered. The Company is currently assessing the impact this statement will have on its financial statements.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs - An Amendment of ARB No. 43, Chapter 4." SFAS No. 151 states that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges. Additionally, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company is required to adopt SFAS No. 151 effective January 1, 2006. The Company does not expect the adoption of SFAS No. 151 will have a material impact on its consolidated results of operations and financial condition.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions." SFAS No. 153 is based on the principle that nonmonetary asset exchanges should be recorded and measured at the fair value of the assets exchanged, with certain exceptions. This standard requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless (1) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits or (2) the transactions lack commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The Company is required to adopt SFAS No. 153 effective for its fiscal quarter beginning after June 15, 2005, and does not expect the adoption of SFAS No. 153 will have a material impact on its consolidated results of operations and financial condition.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections", which replaces APB Opinion No. 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Upon the adoption of SFAS No. 154 beginning January 1, 2006, the Company will apply the standard's guidance to changes in accounting methods as required. At this time, the Company does not expect the adoption of SFAS No. 154 will have a material impact on its consolidated results of operations and financial condition.

FORWARD-LOOKING STATEMENTS AND RISK FACTORS

This Quarterly Report on Form 10-Q contains forward-looking statements, which reflect the Company's current views with respect to future events and financial performance, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and is subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are subject to certain risks and uncertainties, including those identified below, which could cause actual results to differ materially from historical results or those anticipated. The words "believes," "anticipates," "plans," "may," "intend," "estimate," "will," "should," "could," "feels," "is optimistic," "expects," and other expressions which indicate future events and trends also identify forward-looking statements. However, the absence of such words does not mean that a statement is not forward-looking.

The Company's future operating results are subject to various risks and uncertainties and could differ materially from those discussed in the forward-looking statements and may be affected by various trends and factors which are beyond the Company's control. These risks and uncertainties include, among other factors, general business and economic conditions, rapid technological changes accompanied by frequent new product introductions, competitive pressures, dependence on key customers, the attainment of design wins, fluctuations in quarterly and annual results, the reliance on a limited number of third party suppliers, limitations of the Company's manufacturing arrangements, the protection of the Company's proprietary technology, the dependence on key personnel, changes in critical accounting estimates, potential delays associated with the purchase and implementation of an advanced planning and scheduling system, potential impairments of investments, and foreign regulations. These statements should be read in conjunction with the audited Consolidated Financial Statements, the Notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company as of December 31, 2004, as reported in its Annual Report on Form 10-K, and other documents as filed with the Securities and Exchange Commission.

Stockholders are cautioned not to place undue reliance on the forward-looking statements which speak as of the date of this Quarterly Report or the date of the documents incorporated by reference in this Quarterly Report.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to various market risks in the normal course of business, primarily interest rate risk and changes in the market value of its investments and believes its exposure to such risk is minimal. The Company's investments are made in accordance with the Company's investment policy and primarily consist of auction rate municipal securities. The Company is also subject to foreign exchange risk related to its operations in Ottawa, Canada. The Company believes that its exposure to foreign currency risk is minimal. The Company does not participate in the investment of derivative financial instruments.

ITEM 4. CONTROLS AND PROCEDURES

A. Evaluation of Disclosure Controls and Procedures

The Company's Chief Executive Officer and its Chief Financial Officer have evaluated the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of such date.

B. Changes in Internal Controls Over Financial Reporting

During the first quarter 2005, the Company completed the integration of the ERP systems and accounting functions of the Company's Voice Technology Group and Computing Products Group into the corporate ERP system and accounting function in Rochester, New York. During the second quarter 2005, transition of manufacturing operations for VTG products was completed and substantial progress was realized in transitioning the manufacturing of the Computing Products to Rochester. The Company's Chief Executive Officer and Chief Financial Officer evaluated these changes and concluded that the changes have not materially affected, or are not reasonably likely to materially affect, the Company's internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The 2005 Annual Meeting of Stockholders was held June 2, 2005. The Directors elected at the meeting were as follows:

	Votes Cast	
Nominees	For	Withheld
Bernard Kozel	11,453,292	335,649
Charles E. Maginness	9,964,871	1,824,070
E. Mark Rajkowski	11,599,053	189,888

John M. Slusser, Stuart B. Meisenzahl, Robert L. Tillman and Donald L. Turrell continue as Directors until the next Annual Meeting, or such times as their respective terms expire.

The stockholders also voted to ratify the appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm for 2005. 11,772,788 shares of common stock were voted in favor of this proposal, 10,903 shares of common stock were voted against this proposal, and 5,250 shares of common stock abstained.

ITEM 6. EXHIBITS

A. Exhibits

10.1	Named Executive Officer Compensation Summary Sheet
31.1	Certification of Chief Executive Officer
31.2	Certification of Chief Financial Officer
32.1	Section 1350 Certification

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.

PERFORMANCE TECHNOLOGIES, INCORPORATED

August 9, 2005 By: /s/ Donald L. Turrell

Donald L. Turrell
President and
Chief Executive Officer

August 9, 2005 By: /s/ Dorrance W. Lamb

Dorrance W. Lamb
Chief Financial Officer and
Vice President of Finance

Exhibit 10.1

Named Executive Officer
Compensation
Summary Sheet

The named executive officers of the Company serve at the discretion of the Board of Directors. From time to time, the Compensation Committee of the Board of Directors reviews and determines the salaries that are paid to the Company's named executive officers. The following table sets forth the annual salary rates for the Company's current named executive officers as of the date of this report on Form 10-Q (1)(2):

Donald L. Turrell President and Chief Executive Officer	$237,000

Dorrance W. Lamb Chief Financial Officer and Vice President of Finance	$197,600
John J. Grana Vice President of Engineering	$163,000
John J. Peters Vice President of Engineering	$163,000
William E. Mahuson Vice President	$141,250

(1) The named executive officers were determined by reference to the Company's Proxy Statement dated May 2, 2005.

(2) For information regarding stock options and bonuses, see the Company's report on Form 8-K filed on May 24, 2005.

Exhibit 31.1

Certification of Chief Executive Officer

I, Donald L. Turrell certify that:

1. I have reviewed this quarterly report on Form 10-Q of Performance Technologies, Incorporated;

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

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

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

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

   b. Designed such internal control over financial reporting, or caused such internal control over

financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

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

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

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

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

Date: August 9, 2005

By:/s/ Donald L. Turrell

Donald L. Turrell
Chief Executive Officer

Exhibit 31.2

Certification of Chief Financial Officer

I, Dorrance W. Lamb certify that:

1. I have reviewed this quarterly report on Form 10-Q of Performance Technologies, Incorporated;

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

were made, not misleading with respect to the period covered by this report;

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

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

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

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

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

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

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

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

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

Date: August 9, 2005

By:/s/ Dorrance W. Lamb

Dorrance W. Lamb
Chief Financial Officer

Exhibit 32.1

Section 1350 Certification

Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 ("Section 906"), Donald L. Turrell and Dorrance W. Lamb, the Chief Executive Officer and Chief Financial Officer, respectively, of Performance Technologies, Incorporated, certify that (i) the quarterly report on Form 10-Q for the quarter ended June 30, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of Performance Technologies, Incorporated.

A signed original of this written statement required by Section 906 has been provided to Performance Technologies, Incorporated and will be retained by Performance Technologies, Incorporated and furnished to the Securities and Exchange Commission or its staff upon request.

Date: August 9, 2005

By:/s/ Donald L. Turrell

Donald L. Turrell
President and Chief
Executive Officer

Date: August 9, 2005

By:/s/ Dorrance W. Lamb

Dorrance W. Lamb
Chief Financial Officer and
Vice President of Finance