PERFORMANCE TECHNOLOGIES INC \DE\
Form 10-K
March 16, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (No Fee Required)
For the Fiscal Year Ended December 31, 2004

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (No Fee Required)
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

Securities registered pursuant to section 12(b) of the Act:
NONE

Securities registered pursuant to section 12(g) of the Act:
COMMON STOCK, par value $.01 per share
(Title of Class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of the close of business on June 30, 2004 was approximately $106,889,000.

The number of shares outstanding of the registrant's Common Stock, $.01 par value, was approximately 12,851,777 as of March 2, 2005.

Documents Incorporated by Reference

The information called for by Items 10-14 of Part III is incorporated by

reference to the definitive Proxy Statement for the Annual Meeting of Stockholders of the Company to be held June 2, 2005, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2004.

Performance Technologies, Incorporated
Index to Annual Report on Form 10-K

ITEM 1 - Business

Overview

Performance Technologies, Incorporated (the "Company") is a supplier of platforms, components, software, and service solutions for the embedded systems marketplace that can be used in a broad range of applications and end markets.

Since its founding in 1981 as a Delaware corporation, the Company has consistently designed innovative embedded products and component solutions that focus on attributes such as reduced time-to-market, enhanced performance, high availability and cost advantages for a user base that includes communications, military and commercial applications. The Company has a history of successfully adapting its products and services to a constantly changing, technology-driven marketplace through the course of several business cycles that have occurred since its founding.

The Company's annual operating performance is subject to various risks and uncertainties. The following discussion should be read in conjunction with the Consolidated Financial Statements and related notes, included elsewhere herein, as well as the section appearing in ITEM 1 of this Form 10-K under the heading "Risk Factors." The Company's future operating results may be affected by various trends and factors which are beyond the Company's control. These 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 and potential impairments related to investments. In addition, during weak economic periods, customers' visibility deteriorates causing delays in the placement of their 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.

The Company's Web site address is www.pt.com. The Company makes available free of charge via a hypertext link on its Web site, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission ("SEC"). The Company will provide this information upon written request to the attention of the Chief Financial Officer, Performance Technologies, Incorporated, 205 Indigo Creek Drive, Rochester, New York 14626. Information is also available through the SEC Web site at www.sec.gov or at the SEC Public Reference Room at 450 Fifth Street, N.W. Washington, D.C. 20549 or by calling 1-800-SEC-0330.

Important Year 2004 Milestones

2004 was a year of contrasting results for the Company. Our Advanced Managed Platform strategy showed promise with significant design wins at key customers and with the addition of a new value-added support and services, the Company continued to strengthen its position as a broad based, integrated platform supplier. However, consolidation amongst companies in the telecommunications space left several existing customer programs in an uncertain state.

The telecommunications segment of the market, which the Company serves, is dependent on carriers spending to upgrade network infrastructure to next-generation equipment. In the first quarter 2004, the carriers increased spending on infrastructure upgrade, but for the remainder of 2004, carrier

spending was limited, and only directed toward niche applications such as media gateways, rather than on general infrastructure upgrading.

During most of 2004, the uncertainty in the telecommunications sector placed pressure on the Company's revenue and operating earnings. However, after several quarters of uncertain conditions in our target markets, the fourth quarter exhibited positive signs of increased customer demand for the Company's products.

To best focus its resources in 2004, management targeted a number of programs to strengthen and promote our platform products and business.

These initiatives included:

1) Further expansion of our Advanced Managed Platform Product line: Critical to our growth is the ongoing development of our fully managed, packet-based platforms and spreading our message to those customers looking to take greater advantage of outsourcing options. The Advanced Managed Platform architecture offers distinct cost advantages which allow developers of next-generation systems to reduce design complexity while increasing overall system reliability and performance. From a market perspective, the Advanced Managed Platform line is a viable alternative to proprietary platforms and directly addresses equipment manufacturers' requirements for designing high availability into their applications using a flexible and scalable architecture. Since the introduction of the Advanced Managed Platform, the Company has realized more than 25 new design wins of varying sizes for its integrated platform products.

2) Further Development of Innovative, Packet-Based IP Products: The Company developed and introduced an impressive portfolio of new products in 2004 directed at IP/packet-based communication applications including:

   Gigabit Embedded Ethernet Switches: The Company's focus in 2004 was the enhancement of its Ethernet switch software with carrier-grade network routing and security capabilities. Since the introduction of our Gigabit class products, the Company's family of embedded Ethernet switching products has grown by more than 100% each year since 2002.

   Intelligent Shelf Manager: In the spring 2003, the Company introduced the Intelligent Shelf Manager (ISM). This product is a key differentiating factor of the Company's Advanced Managed Platforms and is an important requirement for customers because it enables the overall management of individual components in an embedded platform, including third-party supplied embedded products. During 2004, NexusWare(TM) ISM was introduced adding the power of an open source Linux application to support operation of the ISM function.

   Network Access Products: During 2004, the Company launched the first in a series of new products based on unique, intelligent, single or multi-processor hardware architecture. This new product family is intended to offer powerful packet processing solutions for emerging "user based" services that will become an important economic element in contemporary IP-based networks.

   Network Processing, Voice Processing and Compute Products: The Company expanded its line of network processing engines, voice processing products and Intel-based single board computers for embedded applications during 2004. These new products are designed to utilize the advancing capability of microprocessor and memory technologies.

SEGway(TM) Signaling Products: During 2004, the Company introduced five new industry-leading products which enable the migration of signaling traffic from traditional networks to IP-based networks.

3) Extension of the Company's Significant Suite of Software: The Company's software products and expertise continue to be a key differentiating factor for Performance Technologies' products. Many of these products are sold under the trade name NexusWare, which is based on the popular and rapidly growing Linux operating system. Performance Technologies announced major enhancements to its NexusWare software during 2004. This product has evolved to become the overarching software environment for all components in our Advanced Managed Platforms. Management believes that the NexusWare software provides distinct user advantages unmatched by competitive offerings and is an important enabler for our customers.

4) Expansion of the Signaling Products Sales Efforts: Our concerted efforts in 2004 to focus on Carriers, Service Providers and Telecom Equipment Manufacturers (TEMS) with our SEGway Signaling products proved successful. During 2004, the Company realized several significant design wins with Tier 1 and Tier 2 carriers, service providers and TEMs that are expected to result in meaningful revenue in 2005 and beyond.

5) Expanded Presence in the Asia Pacific Region: The Company believes a direct presence is critical to be a successful supplier in the Asia Pacific region. During 2004, additional people and resources were committed to increase our exposure in the region and several new design wins were realized for our Advanced Managed Platform products.

6) Continued Acquisition Activities: Management continued to use acquisitions as a part of the Company's growth strategy in 2004:

Mapletree Networks, Inc.(R): In January 2004, the Company completed the acquisition of Mapletree Networks, a company that provides voice, data and fax processing products using Digital Signal Processing (DSP) technology to original equipment manufacturers. These new products have been integrated with the Company's network access products and integrated platforms to enable the Company to compete more effectively in the re-emerging voice over IP (VoIP) and wireless communications markets.

Industry Overview

The Company is a supplier of embedded systems platforms, components and software products that are based on open standards. These platform solutions can be specifically configured using various components, often from multiple suppliers, to meet a variety of end applications found in market segments such as telecommunications infrastructure, data communications infrastructure, military communications infrastructure and industrial systems.

As 2004 began, the Company's customers, who are primarily equipment manufacturers in the telecom and data communications market segments, continued to maintain tight cost controls, limit engineering resources and proceed with realigning their business models. These fiscal controls created a more concentrated supplier landscape for 2004 that is trimmer, but more highly focused on market opportunities. It was not just these equipment manufacturers who made such adjustments. Across the technology sector, many organizations downsized staffs and tightened cost controls, including many of our customers and suppliers.

Industry market research organizations, such as Dataquest and Venture Development Corporation, are estimating the worldwide, embedded systems market

to be over $100 billion in size by 2008. Traditionally, the largest segment of this market uses "proprietary," purpose-built embedded systems and products. Embedded systems built on open standards comprise a smaller segment of this market, which is estimated to grow to over $10 billion by 2008. While proprietary systems are expected to continue to dominate this market in the future, a growing share of embedded systems being implemented, especially in the more limited market segments served by the Company, is expected to use open standards-based products. The driving factors behind this changing paradigm remain twofold. First, systems are becoming increasingly integrated, more complex, requiring larger investments and longer lead times to design. Second, as organizations have downsized over the past several years, they have not replaced the necessary staff to carry out extensive new product development while successfully meeting the competitive pressures of "time-to-market" found in most technology businesses. Due to these changes, telecom and data communications equipment manufacturers are increasing their reliance on companies such as Performance Technologies to deliver major building blocks or complete platforms. This allows these suppliers to concentrate their efforts and expertise on their "value add" which has typically become software and/or additional hardware elements directed at specific applications.
Many equipment manufacturers entered 2004 with new business models not only in the research and development areas, but also in purchasing, logistics and supply groups. Due to these circumstances, many customers welcome the opportunity to limit their number of suppliers and form strategic relationships with organizations that have broader capabilities.

Management believes that the products and capabilities acquired from the Intel Communications Platform Group in 2002 and from Mapletree Networks in 2004 have substantially expanded the markets served by the Company and have enabled the Company to become a more strategic partner to our customers.

Over the past several years, the Company has refined its ability to supply embedded platforms based on the contemporary use of Ethernet technology as an integral element of the system design. This forward-looking approach to building embedded systems was created by Performance Technologies' engineers and has earned the Company a leading position in the industry as this innovative concept reached standardization and became widely adopted in the embedded marketplace. During 2004, all Advanced Managed Platform design wins for the Company were based on this standard, showing widespread acceptance by equipment manufacturers who incorporated this standard into their next-generation products. Central to this new system architecture is the use of an embedded Ethernet switch and Ethernet technology for communication between the blades in a system, and System Management blades to provide much greater levels of control and reliability for carrier-grade communications systems. Our engineering expertise continues to place the Company in a favorable position to participate and win new design opportunities with customers.

To further bolster its Advanced Managed Platform products, the Company continued aggressive development of its comprehensive line of embedded Ethernet switches. Despite a modest economy, the Company's Ethernet switches have had noteworthy adoption among major customers and again showed 100% revenue growth in 2004, as they did in 2003. It is management's belief that the Company is the leading supplier of carrier grade capability with its embedded switching technology and that this product line will continue to be a key element of the Company's Advanced Managed Platform product family. These switch products are also expected to provide noteworthy growth as a stand-alone component sold for third party integration into customer's embedded platforms.

On a broader but related market observation, management expects its business to show overall improvement in 2005 based on the ongoing number of public announcements from carriers concerning capital spending for next-generation network infrastructure. The telecommunications segment of the market is dependent on the carriers capital spending directed at upgrading their network

infrastructure to next-generation equipment. In the first quarter 2004, carriers increased spending on infrastructure upgrade, but for the remainder of 2004, carrier spending was limited to narrow applications, rather than broader infrastructure upgrade investment. After several quarters of uncertain conditions in our target markets through 2004, the fourth quarter showed positive signs of increased customer demand for our products.

Also, telecommunications as a whole is continuing to demonstrate noteworthy growth in the European and Asia-Pacific regions. Our presence in the European region continues to expand with significant customers in the UK, France and Israel. Asian operators and equipment manufacturers, such as NTT, Huawei, Samsung and LG have demonstrated growth and strength. Mobile phone growth in the Asia-Pacific region is also continuing to grow and future networks in this region will no doubt be IP based because of its low price point and ease of implementation. Based on the Company's IP network focus, these geographic areas are expected to show important market acceptance of the Company's products.

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.

Beginning in 2003, a new product strategy was adopted. This strategy repositioned the Company to deliver fully managed, system-level platform solutions to the embedded systems marketplace. An important milestone in this strategy was achieved in September 2003 with the introduction of the Advanced Managed Platform product line. Throughout 2004, the Company focused its operating efforts on this strategy. This new line of platform solutions specifically addresses equipment manufacturers' requirements for an increased level of system integration and services from suppliers. The Company's new platform products enable "downsized" or limited engineering staffs of equipment manufacturers' to improve time-to-market for their new products. The Company's strategy addresses this trend by enabling customers to replace proprietary or legacy platforms with the latest generation of fully managed system functionality.

In early 2004, the Company completed the Mapletree Networks acquisition, adding important voice processing technology to its product offerings for its communications customers.

With these acquisitions and investments, management believes the Company has moved from a position of addressing approximately 20% of the available market served in 2002, to a position of addressing over 60% of the available market served by the end of 2004.

The Company's initiatives identified for 2005 are as follows:

Emphasis on Product Innovation: The Company currently funds its engineering organization with nearly 20% of every revenue dollar. During 2005, management expects to continue to drive the development of new products in an effort to offer our customers critical advances in technology and to outpace our competition.

Leveraging Product Capabilities: Management expects to develop a number of products for selected high growth IP-based applications including media gateway, media server, wireless, voice-over-cable and satellite communications. Key for 2005 will be to successfully develop and

combine certain hardware and software elements from our product portfolio to form intelligent embedded solutions which add value for application providers in these target markets.

Expansion of the Company's Customer Base Outside of North America: In 2004, the EMEA and APAC regions showed noteworthy growth for the Company. Management plans to continue to aggressively market to potential customers in these regions throughout 2005.

Continue Acquisition Activities: During 2005, the Company will continue to seek additional opportunities to accelerate growth through external initiatives. These efforts are targeted at adding products to the Advanced Managed Platform product line as well as application areas which can add value in addressing customer requirements.

Greater Operational Efficiency: Multiple efforts are underway during 2005 to improve the Company's cost structure and operational efficiency. These initiatives include centralizing accounting and manufacturing operations into corporate operations in Rochester, New York. In addition to lowering operating costs, management believes consolidated operations will also enable the Company to offer a higher service level to our customers.

Certainly, there are identifiable risks associated with carrying out the Company's expansive corporate and 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. 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 reposition the organization as an important strategic partner with many of its customers, thereby increasing their utilization of the Company's broadened product capabilities. As the business cycle starts to show improvement, it is further expected that these ongoing 2005 initiatives can yield significant rewards through accelerated revenue and profitability growth.

Management expects to continue to leverage top-line growth and decrease operating expense levels during the year. With an improving business environment and revenue expansion, the Company should move toward higher levels of profitability.

Products

Performance Technologies is a supplier of platforms, components, software solutions and service offerings for the embedded systems marketplace that can be used in a broad range of applications including telecommunications, data communications, industrial, military and commercial.

The Company markets its products under a variety of brand names including IPnexusTM, SEGway, NexusWare and Advanced Managed Platforms.

The overall embedded systems product line offered by the Company is based on open standards architectures and consists of a wide range of building blocks, which can be mixed and matched to construct packet-based integrated platforms.

Over the course of 2004, the Company continued to commercialize various platform configurations allowing customers to select the appropriate platform, components and software to fit system and application requirements with full confidence that all elements have been designed to work together.

Advanced Managed Platforms: In September 2003, the Company introduced a new line

of application ready platforms marketed under the trade name Advanced Managed Platform (AMP). Today, this 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 our IPnexus component-based products. This new platform line is 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. The Company's Advanced Managed Platforms offer distinct cost advantages while allowing developers of next-generation systems to reduce design complexity with increased overall system reliability and performance. 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 designing high availability into their applications using a flexible and scalable architecture. Since the introduction of the Advanced Managed Platform, the Company has realized more than 25 design wins of varying sizes for its integrated platform products. As of December 2004, a small number of these design wins had reached production levels. Based on discussions with customers, management expects an additional number of these design wins to reach production during 2005.

Key elements of the Company's Advanced Managed Platform products include:

Intelligent Shelf Management: This offers the ability to effectively manage the operation of all the Company's IPnexus products, as well as third-party components when they are integrated into a platform.

Ethernet Switching: The Company's Ethernet switching products operate as the "nexus" of the packet-based platform. As part of the Company's initiative in creating the PICMG 2.16 standard, the Company undertook an aggressive development program aimed at becoming the leading supplier of embedded Ethernet switches. During 2004, the Company focused on developing advanced carrier grade features and reliability. Today, the Company has the broadest carrier grade switch product line for 2.16 embedded platforms.

Platform Components: While chassis, cooling elements (fans) and interconnection details are considered "low level technology," the Company has designed and maintains a line of these products that have advanced features targeted at high availability and rugged, demanding operating environments. Platform components are an important element of the Company's fully integrated Advanced Management Platform offering.

IPnexus Compute Products: Traditional single board computers continue to play a significant role in embedded platforms. The Company introduced a variety of new compute products in 2004 and will continue product introductions in 2005 based on higher-performance processors and higher capacity memory products. These new products will be especially applicable to packet-based systems.

IPnexus Network Access and Communications Products: The Company's IPnexus network access and communications products continue to operate in a broad range of data communications and telecommunications applications. Performance Technologies' access products provide a connection between a variety of voice, data and signaling networks and embedded systems platforms that are used to control the network and/or process information being transported over networks. This family has significant synergies with our NexusWare software and the newly acquired Voice Technology Group products from Mapletree Networks. Several new IPnexus and communications products were announced in 2004 and new products are on the product road map for 2005. The access product family includes stand-alone communication servers and embedded access products that operate as part of systems based on a variety of open standards.

IPnexus Software and Middleware: NexusWare, the core element of our entire

software offering, is a key differentiating factor in the embedded platform marketplace. NexusWare includes a comprehensive Linux-based development environment that can be supplied either as part of the Advanced Managed Platform, or with the Company's individual IPnexus component products, or provided to third parties for inclusion in their embedded platform environments. NexusWare is specifically tailored to assist system engineers in rapidly integrating and developing packet-based embedded systems, while leveraging a robust and standardized software foundation that uses the Linux operating system.

The Company introduced its NexusWare software suite in 2001 and it currently generates additional software license revenue for the Company. Management believes the NexusWare software differentiates the Company's product offering and gives it an important competitive advantage in the market.

Another important aspect of the Company's software offering is the extensive communications software protocols that can be licensed to customers for a variety of applications. Protocol functions include standard communication packages such as X.25, Frame Relay, and SS7 and SS7/IP signaling software, and specialized packages such as radar protocols used in weather tracking and air traffic control, and military communications protocols.

IPnexus Customers. Announced customers for IPnexus products include: ADLINK Technology, Inc., Agilent Technologies, Alcatel SA, APW/Electronic Solutions, Andrew Corporation, AudioCodes, Data Connections, General Dynamics, Hewlett Packard Corporation, Lucent Technologies, Motorola Corporation, Nortel Networks, Northrup Grumman Information Technology, Polycom, Raytheon, Siemens AG, Siemens Carrier Networks LLC, Stratus Technologies, Sun Microsystems, UT Starcom and Walkersun.

AdvancedTCA (ATCA): A new open standard is emerging known as AdvancedTCA, or aTCA. This large, telecommunications-centric architecture is gaining industry following and is expected to be a complementary alternative to the CompactPCI 2.16 standard the Company has embraced for its current products. Product development began in 2004 on a new managed platform, which will be released in mid 2005 that utilizes this young, but maturing, standard.

Voice Technology Products: The 2004 acquisition of Mapletree Networks brought the Company a wide range of products for the processing of voice and fax information. The voice aspect of this product line is an integral part of all VoIP media gateway systems. As the Company proceeds through 2005, the voice products will act as the foundation for a highly integrated media gateway solution, which leverages other Company products, including network access, NexusWare and signaling gateway elements.

Announced customers for the Voice Technology products include: Selta Telematica SpA, Teles Communications and Vertical Networks.

SEGway Signaling Products. The Company's SEGway Signaling products provide a signaling bridge between traditional telephone networks and the growing IP packet-switched network architectures of today. When used in conjunction with softswitches, media gateways and application servers, SEGway signaling products can provide the call control functionality or service processing capabilities of traditional PSTN switches.

Performance Technologies offers a unique suite of signaling solutions in stand-alone or embedded platform models suitable for new or existing telephony service providers, carriers or telephony equipment manufacturers. Powered by carrier-grade SS7 and SS7/IP signaling software, SEGway products are designed for easy installation and network management and are priced to ensure carriers save money in meeting the demands of high growth SS7 networks. The Company's Signaling Blade product provides OEMs with all the functional capabilities

needed to front-end applications requiring access to the SS7 network. This product incorporates a robust SS7 stack on top of the Company's NexusWare software to provide customers with a complete SS7 platform. Based on a target OEM market for this product, 2004 efforts to achieve "design wins" have been an important metric with which to measure future revenue potential. As a result of various 2004 design wins, management expects to see revenue growth in 2005 from this leveraged use of the Company's SS7 Intellectual Property in the embedded OEM market space.

Announced customers for the SEGway Signaling products include: Alcatel SA, Comfone AG, Ericsson Telecommunications, GeoLink, Huawei Technologies, Lucent Technologies, Nortel Networks, Rural Cellular, Siemens, Swisscom AG, TelAlaska, Telecom Italia Sparkle, Telefonica Moviles Espana, Teleglobe and TSI Telecommunications Services.

Sales, Marketing and Distribution

The Company markets its products worldwide to a variety of customers through its direct sales force and various channels including OEMs, Value Added Resellers (VARs), distributors and systems integrators. Almost all of the Company's North American business is sold through the Company's direct sales force.

Due to the highly technical nature of the Company's products, it is essential that the Company's salespeople are technically oriented and are knowledgeable in the embedded systems, networking and communications fields. To supplement its sales force, the Company has field application engineers who assist prospective customers in determining if the Company's products will meet their requirements.

Currently, 38 sales, marketing and sales support personnel are located in the Company's Rochester, New York; San Diego and San Luis Obispo, California; Old Saybrook, Connecticut; Ottawa, Canada; Shanghai, China and Henley-on-Thames, United Kingdom offices. In addition, independent sales representatives and agents cover selected geographic areas nationally and internationally; and distributors or integrators, handling selected products, supplement the Company's direct sales team on a worldwide basis.

The Company executes various ongoing marketing strategies designed to attract new OEM and end-user customers and to stimulate additional orders from existing customers. These strategies include an active and ongoing campaign to direct potential customers to the Company's Web site, hosting technology seminars, direct mail, email campaigns, direct telemarketing, active participation in technical standards groups, participation in regional, national and international trade shows, selected trade press advertisements and technical articles.

Sales to customers outside of North America represented 31%, 21% and 25% of the Company's revenue in 2004, 2003 and 2002, respectively. International sales are subject to import and export controls, transportation delays and interruptions, foreign currency exchange rates, and foreign governmental regulations. Payments for shipments from the United States to outside the United States are generally made in U.S. dollars and payments for shipments from Canada to Canada are generally made in Canadian dollars.

Customers

The Company has more than 50 active customers worldwide, primarily in the server, telecommunications and embedded systems markets. Many of the Company's major customers are Fortune 1000 companies in the United States or companies of similar stature in Europe and Asia. In 2004, the Company's two largest

customers, Lucent Technologies and UT Starcom, represented 13% and 11% of revenue, respectively. The Company's four largest customers (Lucent Technologies, UT Starcom, Andrew Corporation, and MetaSwitch) represented 38% of the Company's revenue.

At December 31, 2004, approximately 75% of the Company's customers are in the telecommunications industry and the Company's products are generally integrated into products for wireless and next-generation IP network infrastructure. These products are targeted at customers in the following sectors: telecommunication equipment manufacturers, server manufacturers, telecommunications service providers and operators, wireless carriers and platform manufacturers. The Company's other customers represent a range of industries utilizing open-architecture embedded systems.

Backlog

The scheduled backlog of orders amounted to $10.0 million and $11.3 million at January 30, 2005 and January 31, 2004, respectively. Orders are subject to postponement of delivery or cancellation in the normal course of business. A substantial portion of the Company's revenue in each quarter results from orders placed within the quarter and shipped in the final month of the same quarter. Unfortunately, forward-looking visibility on customer orders continues to be very limited with almost no visibility beyond ninety days. (See Management's Discussion & Analysis included elsewhere in this report).

Seasonality

The Company's business is not generally subject to large seasonal swings but is frequently softer during the summer months due to the European and United States vacation seasons. Much of the Company's business is project-related, driven by customer demand, which can cause quarterly fluctuations in revenue.

Environmental Matters

The Company does not believe that compliance with federal, state or local laws or regulations relating to the protection of the environment has any material effect on its capital expenditures, earnings or competitive position.

Competition

Embedded systems are either based on proprietary technology or are based on open standards. The Company's products are primarily based on open standards, which is the smaller, but faster growing portion of this market. Frequently, the Company's stiffest competition is the in-house engineering staff of its customers.

The embedded systems market continues to be characterized by rapid technological innovations resulting in new product introductions and frequent advances in price/performance ratios. Competitive factors in this market include product performance, functionality, product quality and reliability, customer service and support, marketing capability, corporate reputation and brand recognition, and changes in relative price/performance ratios.

Competitors are generally split into two categories, the full systems suppliers and technology component suppliers.

For its Advanced Managed Platforms, the Company faces a group of competitors including Kontron AG, Motorola Computer Group, Radisys Corporation and SBS Technologies. Management believes that its continuing emphasis on fully integrated and managed system level platform solutions, with a high level of the Company's component and software content, are a key differentiating factor for winning new business.

The Company's Switching products operate in the CompactPCI systems architecture referred to as the PICMG 2.16 standard. This architecture was developed by the Company and adopted by the industry in the fall of 2001. Today, there are several competitors offering products or technology in this marketplace. Current competitors include Continuous Computing, DSS Networks, Motorola Computer Group, Radisys Corporation, Ramix (owned by GE Fanuc Embedded Systems), SBS Technologies and Zynx Networks. The size of the Ethernet switching market is small compared to the enterprise switch market, and larger companies in that market are not expected to enter this segment due to the customization requirements and relatively low volumes, as compared to the enterprise market.

For its Network Access and Communications products, the Company believes its key differentiators are its depth of market experience, suite of communications software, and NexusWare. The Company's products compete with products from companies including Adax Incorporated, Audiocodes, Artesyn Technologies, Interphase Corporation and NMS Communications.

For its Voice Processing products, the Company is focusing its development efforts on combining this technology with its other technologies to form intelligent solutions offering additional value and capabilities. Targeted application markets include media gateway, media server, wireless, voice-over-cable and satellite communications. The Company's products currently compete with products from companies including Audiocodes, Brooktrout, Motorola Computer Group, TI/Telogy and Voiceboard.

For its SEGway Signaling products, the Company generally focuses its engineering on products that use Internet Protocol (IP) to carry signaling traffic. Since this is a newer area in the signaling market, the Company believes it has an advantage over competitors' products. The Company's products currently compete with products from Adax Incorporated and Ulticom, and several larger companies that have proprietary SS7 technology or products.

Research and Development

The Company's research and development expenses were approximately $10.2 million, $9.5 million and $6.9 million for 2004, 2003 and 2002, respectively. These expenses consist primarily of employee costs, material consumed in developing and designing new products, and amounts expended for software license/tools. The Company expects to continue to invest heavily in research and development in order to create innovative new products for the embedded systems market.

The Company has significant core competencies applicable to computing platforms, single board computers, voice and data communications, voice processing, carrier grade Ethernet networking, high availability, hot swap, redundant technologies and signaling communications. The Company also has significant software expertise that it applies to embedded systems and platforms.

Proprietary Technology

The Company's success depends upon retaining and maximizing the Company's proprietary technologies. To date, the Company has relied principally upon trademark, copyright and trade secret laws to protect its proprietary technology. The Company generally enters into confidentiality or license agreements with its customers, distributors and potential customers that contain confidentiality provisions, and limits access to, and distribution of, the source code to its software and other proprietary information. All of the Company's employees are subject to the Company's employment policy regarding confidentiality. The Company's software products are provided to customers under license, generally in the form of object code, which to date has provided a high degree of confidentiality with respect to the underlying intellectual property.

Suppliers

In the fast paced technology environment, manufacturers are "obsoleting" electronic components more rapidly than ever before. In addition, industry consolidation is resulting in fewer manufacturers offering electronic components. In many situations, the Company is utilizing sole or limited source components on its products. The Company is finding it more challenging to obtain adequate supplies of components than even a couple of years ago. Lack of availability of components can cause delays in shipments. In addition, the costs and time delays caused by redesigning specific products when adequate components are not available are becoming prohibitive. The Company obtains components on a purchase order basis and does not generally have long-term contracts with any of its suppliers.

Manufacturing

The Company maintains a state-of-the-art PCB manufacturing facility in Rochester, New York where it manufactures its network access, switching, signaling and single board computing products. The Computing Products Group manufactures its chassis products under contract, and performs system level manufacturing and integration in-house. In a plan announced in February 2005, management intends to transition system level manufacturing and integration of its chassis products to its Rochester manufacturing operation during 2005.

Rochester manufacturing operates under an integrated MRP system. Many of the Company's products have high software content and are generally produced in low volumes. By utilizing an in-house manufacturing capability, management believes that the Company has achieved some safety from the risks inherent in utilizing PCB contract manufacturing. These risks typically include a contract manufacturer's inability to meet flexible manufacturing requirements, inventory control and cost containment. In addition, use of in-house manufacturing enables the Company to maintain a high quality level for its products and greater responsiveness to customer's delivery requirements. The Company has limited alternative capabilities through third parties to perform such manufacturing activities. In the event of an interruption of production at its Rochester manufacturing facility, the Company's ability to deliver products in a timely fashion would be compromised, which would have a material adverse effect on the Company's results of operations.

The Company intends to purchase and implement a new advanced planning and scheduling system during 2005, which will enhance its current MRP manufacturing system in Rochester. Delays in the implementation of this system, interruption in business activities while implementing this system, or actual costs higher than estimated, could adversely impact the Company's results of operations.

Employees

In October 2004, management began formulating plans and taking steps to centralize its multi-location operations and to streamline the organization. During the fourth quarter, the Company completed integration of the Voice Technology Group's (VTG) sales, marketing and administrative functions into its corporate operations. In a plan announced in February 2005, management expects to integrate accounting and manufacturing operations for VTG by the end of the first quarter of 2005 and for the Computing Products Group in San Luis Obispo, CA, to its Rochester headquarters by the end of the third quarter 2005.

As of December 31, 2004, the Company had 242 full-time employees, four part-time and contract employees, and two engineering cooperative student employees. Management believes its relations with its employees are generally good. The Company's employees are not subject to collective bargaining agreements.

The Company's full-time employees work in the following areas:

Research and Development	107
Marketing and Sales	38
Manufacturing	71
General and Administrative	26

Management believes that the Company's future success will depend on its ability to continue to attract and retain qualified personnel.

Risk Factors

If we do not respond adequately to technological change, our competitive position will decline.

The market for our products is characterized by rapid technological change and frequent introduction of products based on new technologies. As new products are introduced, the industry standards change. Additionally, the overall embedded systems market, particularly the telecommunications industry, is volatile as the effects of new technologies, new standards, new products and short life cycles contribute to changes in the market and the performance of industry participants. Our future revenue will depend upon our ability to anticipate technological changes and to develop and introduce enhanced products on a timely basis that comply with new industry standards. New product introductions, or the delays thereof, could contribute to quarterly fluctuations in operating results as orders for new products commence and orders for existing products decline. Moreover, significant delays can occur between a product introduction and commencement of volume production. The inability to develop and manufacture new products in a timely manner, the existence of reliability, quality or availability problems in our products or their component parts, or the failure to achieve market acceptance for our products would have a material adverse effect on our revenue and operating results. Further, in sluggish economies such as today, current technologies may become obsolete before being replaced by new technologies.

We operate in an extremely competitive industry and our revenues and operating results will suffer if we do not compete effectively.

The embedded systems market, particularly the telecommunications industry, is extremely competitive. We face a number of large and small competitors. Many of our principal competitors have established brand name recognition and market positions and have substantially greater experience and financial resources than us to deploy on promotion, advertising, research and product development. In addition, as we broaden our product offerings, we expect to face competition from new competitors. Companies in related markets could offer products with functionality similar or superior to that offered by our products. Increased competition could result in price reductions, reduced margins and loss of market share, all of which would materially and adversely affect our revenue and operating results. Large companies have recently acquired several of our competitors. These acquisitions are likely to permit our competition to devote significantly greater resources to the development and marketing of new competitive products and the marketing of existing competitive products to their larger installed bases. We expect that competition will increase substantially as a result of these and other industry consolidations and alliances, as well as the emergence of new competitors. We cannot guarantee that we will be able to compete successfully with our existing or new competitors or that competitive pressures faced by us will not have a material adverse effect on our revenue and operating results.

We are dependent on a number of key customers, the loss of any of which would harm our revenues and operating results.

We cannot assure that our principal customers will continue to purchase products from us at current levels. Customers typically do not enter into long-term volume purchase contracts with us and customers have certain rights to extend or delay the shipment of their orders. Even when our contracts have penalties for cancellation we may, as a practical matter, waive such penalties to preserve our business relationship. The loss of one or more of our major customers, the reduction, delay or cancellation of orders, or a delay in shipment of our products to such customers, would have a material adverse effect on our revenue and operating results.

Carriers and system operators in our target markets are experiencing consolidation which could delay or cancel ongoing network infrastructure expansion and upgrade programs.

The telecommunications industry in many of the industrialized areas of the world is experiencing an aggressive phase of consolidation. While these activities may strengthen the industry in the long term, they are often disruptive to ongoing capital programs and projects in the short term. These disruptions and delays can have a material adverse effect on our revenue and operating results.

Achieving "design wins" is an important indicator of success in our industry, however, many factors beyond our control influence whether we achieve design wins.

A design win occurs when a customer or prospective customer notifies us that our product has been selected to be integrated with their product. Ordinarily, there are several steps between the time of the design win and when customers initiate production shipments. Typically, design wins reach production volumes at varying rates if they reach production at all. Historically, this gestation period prior to volume orders has been twelve to eighteen months or more after the design win occurs. A variety of risks such as schedule delays, cancellations, and changes in customer markets and economic conditions can adversely affect a design win before production is reached or during deployment. Traditionally, design wins have been an important metric for management and industry analysts to judge our product acceptance in its marketplace. Unfortunately, during weak economic periods, fewer customers do new design activity and a smaller number of these design wins move into production.

Our annual and quarterly results can fluctuate greatly, which can have a disproportionate effect on net income and the price of our common stock.

Our future annual and quarterly operating results can fluctuate significantly depending on factors such as the timing and shipment of significant orders, new product introductions by us and our competitors, market acceptance of new and enhanced versions of our products, changes in pricing policies by us and our competitors, the mix of distribution channels through which our products are sold, inability to obtain sufficient supplies of sole or limited source components for our products, and seasonal and general economic conditions. Our expense levels are based, in part, on our expectations as to future revenue. Since a substantial portion of our revenue in each quarter results from orders placed within the quarter and often shipped in the final weeks of that quarter, revenue levels are difficult to predict. If revenue levels are below expectations, operating results will be adversely affected. Net income would be disproportionately affected by a reduction in revenue because only a small portion of our net expenses varies with our revenue. In addition, the common stock of the Company is thinly traded and fluctuations in operating results can cause significant fluctuations in the price of our common stock.

We depend on a limited number of third-party suppliers to provide us with important components for our products. If we were unable to obtain components from these suppliers, our revenue and operating results would suffer.

Certain components used in our products are currently available to us from only one or a limited number of sources. There can be no assurance that future supplies will be adequate for our needs or will be available on prices and terms acceptable to us. Our inability in the future to obtain sufficient limited-source components, or to develop alternative sources, could result in delays in product introduction or shipments, and increased component prices could negatively affect our gross margins, either of which would have a material adverse effect on our revenue and operating results.

Potential limitations in our manufacturing arrangements could impair our ability to meet our customers' expectations.

In order to avoid relying on outside contract manufacturers, we manufacture our network access, switch, signaling and single board computer products at our Rochester, New York facility. The Company's platform products have been manufactured at contract manufacturers. We do not have significant alternative manufacturing capabilities, either internally or through third parties, to perform manufacturing of our products. Even if we were able to identify alternative third-party contract manufacturers, we cannot assume that we would be able to retain their services on terms and conditions acceptable to us. In the event of an interruption in production, we would not be able to deliver products on a timely basis, which would have a material adverse effect on our revenue and operating results. Although we currently have business interruption insurance, we cannot assure that such insurance would adequately cover our lost business as a result of such an interruption.

If we do not adequately protect our proprietary technology, or if we infringe on the intellectual property rights of others, our revenues and operating results would suffer.

Our success depends upon our proprietary technologies. To date, we have relied principally upon trademark, copyright and trade secret laws to protect our proprietary technologies. We generally enter into confidentiality or license agreements with our customers, distributors and potential customers and limit access to, and distribution of, the source code to our software and other proprietary information. Our employees are subject to our employment policy regarding confidentiality. We cannot assure that the steps taken by us in this regard will be adequate to prevent misappropriation of our technologies or to provide an effective remedy in the event of a misappropriation by others.

Although we believe that our products do not infringe on the proprietary rights of third parties, we cannot assure that infringement claims will not be asserted, resulting in costly litigation in which we may not ultimately prevail. Adverse determinations in such litigation could result in the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from third parties or prevent us from manufacturing or selling our products, any of which would have a material adverse effect on our revenue and operating results.

Because of the existence of a large number of patents in the computer networking industry and the rapid rate of new patents granted or new standards or new technology developed, we may have to enter into technology licenses from others. We do not know whether these third party technology licenses will be available to us on commercially reasonable terms. The loss of, or inability to obtain, any of these technology licenses could result in delays or reductions in our product shipments. Any such delays or reductions in product shipments would have a material adverse effect on our revenue and operating results.

We are dependent upon a number of key personnel, the loss of these people or delays in replacing them would harm our operating results.

Our success depends on the continued contributions of our personnel, many of

whom would be difficult to replace. Although our employees are subject to our employment policy regarding confidentiality and ownership of inventions, employees are generally not subject to employment agreements or non-competition covenants. Changes in personnel could adversely affect our operating results.

Delays in purchasing and implementing an advanced planning and scheduling system could harm our operating results.

As a continuing effort to improve the flow of management information and control of our operations, we intend to purchase, install, and implement an advanced planning and scheduling (APS) system during 2005. We are currently in the process of evaluating our requirements and available APS systems. We are examining the hardware, software, consulting, and implementation costs of available systems as well as the internal time and resources required for implementation. Our current estimates of the time and costs necessary to implement a system are based upon the facts and information available today. New developments may occur that could affect our estimates of the amount of time and the costs necessary to implement such a system. Significant delays in the implementation of a system, interruption in business activities while implementing a system, or actual costs higher than estimated, could adversely impact our operating results.

We may hold investments in companies from time to time. These investments or other future investments are subject to potential impairment.

We hold investments in privately held companies from time to time. We may make additional investments in the future in these or other companies. During 2003 we recorded an impairment of one of our investments and during 2004, established a reserve against another investment. Depending upon the future success of these companies in meeting their operating goals, an impairment charge or additional reserve could be recorded in the future. The occurrence of a future impairment or additional reserve could adversely affect our results.

ITEM 2 - Properties

The Company's corporate headquarters are located in 57,000 square feet of office and manufacturing space in Rochester, New York. The Company moved to this leased facility in April 2002. This lease expires in 2012. Corporate headquarters include the executive offices, along with sales, marketing, engineering and manufacturing operations. There is sufficient room for growth in this facility in the intermediate term including the transfer of manufacturing operations from the VTG and Computing Products Groups and it is capable of accommodating a variety of expansion options. In 2001, the Company purchased land adjacent to this facility to accommodate future expansion.

The Company's Computing Products Group is located in 61,000 square feet of office and manufacturing space leased in San Luis Obispo, California. This lease expires in 2008. This facility currently includes sales, marketing and engineering personnel, as well as manufacturing. Approximately 14,000 square feet of this facility is currently sublet to a tenant and the Company is actively seeking other tenants to sublet additional space in the building.

The Company's Voice Technology Group is located in 9,000 square feet of office space leased in Norwood, Massachusetts. This lease expires in 2007 and the Company has the right to terminate this lease upon twelve months notice. There is sufficient room for growth in this facility during the lease term.

The Company's Signaling Group has sales, marketing, and engineering staff located in 13,000 square feet of office space leased in a building located in downtown Ottawa, Canada. The office lease agreements in this building expire in May 2006.

The Company also leases sales and engineering offices in San Diego, California and sales offices in Connecticut and the United Kingdom.

ITEM 3 - Legal Proceedings

From time to time, the Company is involved in litigation relating to claims arising out of its operations in the normal course of business. The Company is not presently a party to any legal proceedings, the adverse outcome of which, individually or in the aggregate, would have a material adverse effect on the Company's results of operations, financial condition or cash flows. During 2003, the settlement agreement for the class action suit brought against the Company in May 2000 was accepted by the Court and was paid by the Company.

ITEM 4 - Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter 2004.

PART II

ITEM 5 - Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company's common stock is traded on the Nasdaq National Market System under the trading symbol "PTIX." The following table sets forth the high and the low quarterly closing prices of the common stock during the two most recent years, as reported on the Nasdaq National Market System. These prices represent quotations among securities dealers without adjustments for retail markups, markdowns or commissions and may not represent actual transactions.

2004	High	Low
First Quarter	$ 21.11	$ 13.48
Second Quarter	19.17	8.47
Third Quarter	9.76	5.30
Fourth Quarter	$ 9.30	$ 5.39

2003	High	Low
First Quarter	$ 4.62	$ 3.25
Second Quarter	7.69	3.44
Third Quarter	12.79	7.22
Fourth Quarter	$ 14.86	$ 10.07

As of March 9, 2005, there were 174 stockholders of record of the Company's common stock.

To date, the Company has not paid cash dividends on its common stock and has no intention to do so for the foreseeable future.

ITEM 6 - Selected Financial Data

(in thousands, except per share amounts)

For the Years Ended December 31:	2004	2003	2002	2001	2000
Sales	$53,489	$49,992	$27,014	$36,517	$38,963
Net income	2,780	3,050	326	5,186	7,050
Basic earnings per share:					

Net income	$ .22	$ .25	$ .03	$ .42	$ .54
Weighted average common shares	12,720	12,259	12,263	12,282	13,106
Diluted earnings per share:					
Net income	$ .21	$ .24	$ .03	$ .41	$ .51
Weight average common and common equivalent shares	13,219	12,692	12,373	12,708	13,769

Excluding non-recurring items (4)	2004 (1)	2003 (2)	2002 (3)	2001	2000
Net income	$ 3,801	$ 3,529	$ 1,186	$ 5,186	$ 7,050
Basic earnings per share	$ .30	$ .29	$ .10	$ .42	$ .54
Diluted earnings per share	$ .29	$ .28	$ .10	$ .41	$ .51

At December 31:	2004	2003	2002	2001	2000
Working capital	$41,637	$38,219	$32,130	$34,728	$36,975
Total assets	$57,011	$51,660	$45,204	$42,954	$44,758
Total stockholders' equity	$50,421	$43,952	$38,809	$38,342	$39,468

All per share amounts described below are presented on a diluted basis. Management believes that the Company's results excluding non-recurring items provide better comparability of its operations as non-recurring items result from facts and circumstances that vary in frequency, amounts and cause.

(1) In 2004, using applicable tax rates, amounts exclude non-recurring items amounting to $1.0 million, or $.08 per share. These non-recurring items in 2004 include a gain on sale of an investment in an unaffiliated company amounting to $1.2 million, $.09 per share, in-process research and development expense of $.2 million, or $.01 per share, a valuation charge on a note receivable in an unaffiliated company amounting to $3.0 million, or $.15 per share, and a restructuring charge amounting to $.2 million, or $.01 per share.

(2) In 2003, using an effective tax rate of 26%, amounts exclude non-recurring expenses amounting to $.5 million, or $.04 per share. These non-recurring expenses in 2003 include an incremental restructuring charge of $.1 million, or $.01 per share, and a minority investment impairment charge of $.4 million, or $.03 per share.

(3) In 2002, using an effective tax rate of 31%, amounts exclude non-recurring expenses amounting to $.9 million, or $.07 per share. These non-recurring charges in 2002 include restructuring charges of $.6 million, or $.03 per share, in-process research and development expense of $.4 million, or $.03 per share, and class action settlement costs of $.1 million, or $.01 per share.

(4) This data is a non-GAAP measure that should be read in conjunction with the GAAP disclosures above, as well as footnotes (1), (2) and (3) above.

ITEM 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations

The Company's annual operating performance is subject to various risks and uncertainties. The following discussion should be read in conjunction with the Consolidated Financial Statements and related notes, included elsewhere herein, as well as the section appearing in ITEM 1 of this Form 10-K under the caption "Business," for further information regarding "Risk Factors." The Company's future operating results may be affected by various trends and factors, which are beyond the Company's control. These 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 and potential impairments related to investments. In addition, during weak economic periods, customers' visibility deteriorates causing 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.

Matters discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-K 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.

Overview

Performance Technologies, Incorporated is a supplier of platforms, components, software, and service solutions for the embedded systems marketplace that can be used in a broad range of applications and end markets.

Since its founding in 1981 as a Delaware corporation, the Company has consistently designed innovative embedded products and component solutions that focus on attributes such as reduced time-to-market, enhanced performance, high availability and cost advantages for a user base that includes communications, military and commercial applications. The Company has a history of successfully adapting its products and services to a constantly changing, technology-driven marketplace through the course of several business cycles that have occurred since its founding.

The Company markets its products through its direct worldwide sales force under a variety of brand names including IPnexus, SEGway, NexusWare and Advanced Managed Platforms.

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. Beginning in 2003, management adopted a new product strategy to reposition the Company to deliver fully managed, system-level platform solutions to the marketplace. The launch of the Advanced Managed Platform product line in September 2003 marked the introduction of an extensive family of platform solutions that enable equipment manufacturers to improve time-to-market for their products. Customers can select Advanced Managed Platforms with the Intelligent Shelf Manager, NexusWare, various components and software to fit system and application requirements with full confidence that all elements have been designed and engineered to function together.

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 compute 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. The Company continues to focus on acquisitions as an important part of its growth strategy.

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 can not 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 Inventory
- Income Taxes
- Product Warranty
- Impairment of Investments
- Carrying Value of Goodwill

Revenue Recognition: The Company recognizes revenue in accordance with the SEC Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition." The Company recognizes revenue 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, which represents the majority of the Company's revenue, occurs when all factors are met, including transfer of title and risk of loss, which occurs upon shipment by the Company. Revenue earned from arrangements for software systems requiring significant production, modification, or customization of software is recognized over the contract period as performance milestones are fulfilled. If all conditions of revenue recognition are not met, the Company defers revenue recognition. Revenue from consulting and other services is recognized at the time the services are rendered. Any anticipated losses on contracts are charged to operations as soon as such losses are determined. Revenue from software maintenance contracts is recognized ratably over the contractual period. 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 and the associated product support. 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.

Impairment of Investments: During 2003, the Company held convertible debt and equity investments in one company and in 2004, made a debt investment in another company. On a periodic basis, the Company reviews and evaluates its investments for potential impairment. In determining whether impairment has occurred, the

Company considers such factors as the original expectations of the investment, performance of the investee company since the date of the investment, and current and future prospects for the investee company. If events or changes in circumstances occur in which an other than temporary loss has occurred, the Company will record an impairment of the investment by writing down the investment to the Company's estimate of fair value at the time of the impairment. The Company believes that the accounting estimate related to Impairment of Investments is a "critical accounting estimate" because the Company exercises judgment in determining whether an other than temporary loss has occurred and the Company also estimates the fair value of the investment at the time of the impairment.

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.

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 use its strong balance sheet to acquire additional products and technologies to strengthen its market position.

Beginning in 2003, a new product strategy was adopted. This strategy repositioned the Company to deliver fully managed, system-level platform solutions to the embedded systems marketplace. An important milestone in this strategy was achieved in September 2003 with the introduction of the Advanced Managed Platform product line. Throughout 2004, the Company focused its operating efforts on this strategy. This new line of platform solutions specifically addresses equipment manufacturers' requirements for an increased level of system integration and services from suppliers. The Company's new platform products enable equipment manufacturers' downsized or limited engineering staffs to improve time-to-market for their new products and to replace proprietary or legacy platforms with the latest generation of fully managed system functionality.

Please refer to PART 1, ITEM 1, under the caption "Business," for further information regarding the Company's "Strategy."

Key Performance Indicators

The Company's integrated platforms, components and software 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 2004 to provide greater granularity in predicting forward looking potential for the

Company and to assist in measuring day-to-day execution of product, sales and marketing programs. During 2004, the Company was notified of 22 design wins for its products with each expected to generate greater than $.5 million of annualized revenue when reaching production volumes. These new design wins were for its integrated platform solutions (with multiple products) (13), and individual component design wins for IPnexus access (2), IP Switching (2), SEGway (4), and Voice Processing (1) products. During 2003, the Company's metric for design wins only included customers that were expected to generate greater than $1.0 million of annualized revenue when reaching production volumes. Based on this measurement criterion, the Company was notified of 16 design wins for its products. These 2003 design wins were for its integrated platform solutions (with multiple products) (8), individual component design wins for IP Switching (2), IPnexus access (2), Computing products (1) and SEGway products (3). Not all design wins are expected to result in production orders. Regardless of the change in the measurement metric, the Company believes that the growth in the number of design wins for integrated platform solutions from 2003 to 2004 reflects increasing customer demand for more complete platform solutions from a single vendor.

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 2004 amounted to $53.5 million (including the VTG products) and $51.0 million (excluding the VTG products), compared to $50.0 million in 2003. Revenue in 2004 was impacted by a decline in business from the Company's two largest customers in 2003, Andrew Corporation and UT Starcom, Inc. Shipments to these two customers declined by $6.6 million, to $10.3 million in 2004 due to changes in their businesses.

Industry Overview

As 2004 began, the Company's customers, who are primarily equipment manufacturers in the telecom and data communications market segments, continued to maintain tight cost controls, limit engineering resources and proceed with realigned business models. These fiscal controls created a more concentrated supplier landscape for 2004 that is trimmer, but more highly focused on market opportunities. It was not just these equipment manufacturers who made such adjustments. Across the technology sector, many organizations downsized staffs and tightened cost controls, including many of our customers and suppliers.

Industry marketing research organizations, such as Dataquest and Venture Development Corporation, are estimating the worldwide, embedded systems market to be over $100 billion in size by 2008. Traditionally, the largest segment of this market uses "proprietary," purpose-built embedded systems and products. Embedded systems built on open standards comprise a smaller segment of this market, which is estimated to grow to over $10 billion by 2008. While proprietary systems are expected to continue to dominate this market in the future, a growing share of embedded systems being implemented, especially in the more limited market segments served by the Company, is expected to use open standards-based products. The driving factors behind this changing paradigm remain twofold. First, systems are becoming increasingly integrated, more complex, requiring larger investments and longer lead times to design. Second, as organizations have downsized over the past several years, they have not replaced the necessary staff to carry out extensive new product development while successfully meeting the competitive pressures of "time-to-market" found in most technology businesses. Due to these changes, telecom and data communications equipment manufacturers are increasing their reliance on companies such as Performance Technologies to deliver major building blocks or complete platforms, allowing the supplier to "layer on" their "value add" which has become software and/or additional hardware elements directed at specific applications. Please refer to PART 1, ITEM 1, under the caption "Business", for

further discussion of the Industry, economic environment and the Company's initiatives for 2005.

Financial

Revenue:

Revenue for 2004 amounted to $53.5 million, compared to $50.0 million in 2003. The increase in revenue of $3.5 million includes $2.5 million of revenue from the newly acquired Voice Technology Group. Revenue in 2004 was impacted by a decline in business from the Company's two largest customers in 2003, Andrew Corporation and UT Starcom, Inc. Shipments to these two customers declined by $6.6 million, to $10.3 million in 2004 due to changes in their businesses.

Sales outside of North America amounted to $16.4 million and $10.4 million in 2004 and 2003, respectively. The increase in 2004 is attributable to the Company's continuing efforts to extend its presence in Europe and emerging markets.

Earnings:

GAAP information

Net income in 2004 amounted to $2.8 million, or $.21 per diluted share based on 13.2 million shares outstanding. Net income in 2003 amounted to $3.0 million, or $.24 per diluted share based on 12.7 million shares outstanding.

Non-GAAP information

Management believes that the Company's results excluding non-recurring items provide better comparability of its operations as non-recurring items result from facts and circumstances that vary in frequency, amounts and cause.

Net income for 2004 amounted to $3.8 million, or $.29 per diluted share excluding non-recurring items based on 13.2 million shares outstanding. For 2004, the following non-recurring items affected the comparability of net income between years:

- In-process research and development costs related to the Mapletree acquisition($.2 million, or $.01 per diluted share);
- Gain from the sale of an investment in Momentum Computer ($1.2 million, or $.09 per diluted share);
- Valuation charge related to a note receivable from InSciTek ($3.0 million, or $.15 per diluted share);
- Restructuring charges related to cost structure improvement efforts ($.2 million, or $.01 per diluted share).

Net income for 2003 amounted to $3.5 million, or $.28 per diluted share excluding non-recurring expenses based on 12.7 million shares outstanding. For 2003, the following non-recurring expenses affected the comparability of net income between years:

- An incremental restructuring charge ($.1 million, or $.01 per diluted share);
- Minority investment impairment charge ($.4 million, or $.03 per diluted share).

Cash, cash equivalents and investments amounted to $25.6 million and $29.6 million at December 31, 2004 and 2003, respectively, and no long-term debt existed at either date.

Cash generated from operating activities amounted to $.6 million in 2004 and $5.6 million in 2003. The overpayments of income taxes ($2.5 million) plus increases in accounts receivable ($1.9 million) and inventories ($1.4 million) contributed to the decline in cash generated from operating activities in 2004, compared to 2003.

Acquisitions, Equity Investments and Notes Receivable:

Mapletree Networks, Inc. (subsequently, the Voice Technology Group, or VTG) - On January 23, 2004, the Company acquired substantially all of the assets of Mapletree Networks, Inc., a company that provided voice, data and fax processing technology to original equipment manufacturers. The initial investment consisted of cash and the assumption of certain debt at closing of $6.6 million and other acquisition costs of $.4 million. The Company agreed to pay an additional $1.6 million of purchase price if the operations of the acquired group (operated by the Company on a stand-alone basis) achieved certain milestones ("earn-out"). Based upon the operating results of the acquired group in the second quarter 2004, the earn-out was terminated. During the fourth quarter 2004, the Company resolved certain matters related to the acquisition resulting in a payment to the Company of approximately $1.7 million, which represented a partial return of purchase price. Beginning at the time of acquisition, the Company's revenue and expenses reflect the operations of VTG.

Momentum Computer, Inc. (Momentum) - Momentum is a developer of specialized single board computer products. At the time of the Company's initial investment in September 2002, the Company acquired a 47% ownership interest in Momentum. During 2003, the Company reduced its ownership in Momentum to 30% when the Company sold a portion of its investment back to the majority stockholder of Momentum. Based upon the Company's expectations of Momentum's performance at the time of the investment and its business prospects in late 2003, the Company concluded that an other than temporary impairment of this investment occurred and the Company recorded an impairment charge of $.4 million for this investment during the fourth quarter 2003. During the third quarter 2004, the Company completed the sale of its investment in Momentum for $2.1 million and realized a gain of $1.2 million. Cash received in the fourth quarter 2004 from the sale amounted to $3.1 million, including the collection of a $1.0 million note receivable.

InSciTek Microsystems, Inc. (InSciTek) - On February 18, 2004, the Company entered into an agreement to invest up to $3.0 million in InSciTek in the form of an interest bearing convertible note. During 2004, the Company invested $3.0 million in conjunction with this agreement (including committed funding of $.4 million in January 2005). 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 $3.0 million as collection of this note is 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 is payable in full on December 31, 2008.

Centralization of Functions:

During most of 2004, uncertainty in the telecommunications sector using the Company's products and services placed pressure on revenue and operating earnings. Despite this weakness, management continues to believe the Company is strategically positioned to improve its financial performance when target markets become more positive. Nonetheless, management began formulating plans and taking steps in September 2004 to reduce annualized expenses by

approximately $2.0 million with a primary focus on centralizing its multi-location operations and streamlining the organization. During 2004, the Company completed integration of the VTG sales, marketing and administrative functions into its corporate operations and during the first quarter 2005, management expects to complete the integration of the VTG accounting and manufacturing operations into the existing Rochester, NY, headquarters. Also during the first quarter 2005, the Company began transitioning the accounting and manufacturing operations of the Computing Products Group in San Luis Obispo, CA, to its Rochester headquarters. This transition is expected to be completed by the end of the third quarter 2005. During 2004, the Company incurred a charge of $.2 million related to these restructuring efforts. Additional charges related to restructuring actions are expected during 2005.

When this centralization plan is completed, operating expenses are expected to be reduced by $1.3 million annually and manufacturing overhead (cost of goods) is expected to be reduced by $.7 million annually. However, the Company expects to increase expenditures in certain areas during 2005 to stimulate growth.

Results of Operations

The following table sets forth, for the years indicated, certain consolidated financial data expressed as a percentage of sales, included as an aid to understanding the Company's results and should be read in conjunction with the selected financial data and Consolidated Financial Statements (including the notes thereto) appearing elsewhere in this report. The table includes the results of operations of the Voice Technology Group from its date of acquisition on January 23, 2004 and the results of operations of the Computing Products Group since it was acquired on October 2, 2002.

	Year Ended December 31,		
	2004	2003	2002
Sales	100.0%	100.0%	100.0%
Cost of goods sold	52.4	50.6	47.6
Gross profit	47.6	49.4	52.4
Operating expenses:			
Selling and marketing	12.0	11.8	16.2
Research and development	19.2	19.0	25.6
General and administrative	8.9	9.3	10.1
Restructuring charges	.4	.2	2.1
In-process research and development	.4		1.4
Class action legal settlement			.5
Total operating expenses	40.9	40.3	55.9
Income (loss) from operations	6.7	9.1	(3.5)
Note receivable valuation charge	(5.6)		
Other income, net	1.4	1.0	2.0
Income (loss) before income taxes, equity in income (loss) of unconsolidated company, gain on sale of investment and impairment of minority interest investment	2.5	10.1	(1.5)
Income tax (benefit) provision	(.2)	2.6	(3.0)
Income before equity in income (loss) of unconsolidated company, gain on			

sale of investment and impairment of minority interest investment	2.7	7.5	1.5
Equity in income (loss) of unconsolidated company	.3	(.6)	(.3)
Gain on sale of investment in unconsolidated company, net of tax	2.2		
Impairment of minority interest investment		(.8)	
Net income	5.2%	6.1%	1.2%

Excluding non-recurring items (4)	2004(1)	2003(2)	2002(3)
Income (loss) before income taxes, equity in income (loss) of unconsolidated company, gain on sale of investment and impairment of minority interest investment	8.9%	10.4%	2.5%
Income tax provision (benefit)	2.1	2.7	(2.2)
Income before equity in income (loss) of unconsolidated company, gain on sale of investment and impairment of minority interest investment	6.8	7.7	4.7
Equity in income (loss) of unconsolidated company	.3	(.6)	(.3)
Net income, excluding non-recurring items	7.1%	7.1%	4.4%

All per share amounts described below are presented on a diluted basis. Management believes that the Company's results excluding non-recurring items provide better comparability of its operations as non-recurring items result from facts and circumstances that vary in frequency, amounts and cause.

(1) In 2004, using applicable tax rates, amounts exclude non-recurring items amounting to $1.0 million, or $.08 per share. The non-recurring items in 2004 include a gain on sale of an investment in an unaffiliated company amounting to $1.2 million, $.09 per share, in-process research and development expense of $.2 million, or $.01 per share, a valuation charge on a note receivable from an unaffiliated company amounting to $3.0 million, or $.15 per share, and a restructuring charge amounting to $.2 million, or $.01 per share.

(2) In 2003, using an effective tax rate of 26%, amounts exclude non-recurring expenses amounting to $.5 million, or $.04 per share. The non-recurring expenses in 2003 include an incremental restructuring charge of $.1 million, or $.01 per share, and a minority investment impairment charge of $.4 million, or $.03 per share.

(3) In 2002, using an effective tax rate of 31%, amounts exclude non-recurring

expenses amounting to $.9 million, or $.07 per share. The non-recurring charges in 2002 include restructuring charges of $.6 million, or $.03 per share, in-process research and development expense of $.4 million, or $.03 per share, and class action settlement costs of $.1 million, or $.01 per share.

(4) This data is a non-GAAP measure and should be read in conjunction with the GAAP disclosures above as well as footnote (1), (2) and (3) above.

Year Ended December 31, 2004 compared with the Year Ended December 31, 2003

Sales. Total revenue for 2004 was $53.5 million, compared to $50.0 million for 2003. For the years indicated, the Company's products are grouped into four distinct categories in one market segment: Communications (network access, signaling and voice (acquired in January 2004)) products, Computing products (acquired in October 2002), IPnexus switching products and Other products. Revenue from each product category is expressed as a percentage of sales for 2004 and 2003 as follows:

	2004	2003
Communications products	46%	52%
Computing products	34%	37%
IPnexus switching products	19%	10%
Other products	1%	1%
Total	100%	100%

Communications 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 the Communications products amounted to $24.5 million and $26.1 million in 2004 and 2003, respectively. This decrease of $1.6 million, or 6%, was primarily the result of a significant decline in revenue from a major customer in 2003 whose product requirements unexpectedly decreased in the second quarter of 2004. This decrease was partially offset by the addition of Voice Technology products in 2004, totaling $2.5 million.

Computing products:

Computing products include a range of single board computers, a variety of embedded system chassis and associated chassis management products. These products enable the Company to provide integrated platform solutions incorporating multiple components from the Company's portfolio. This category includes revenue generated by the Computing Products group acquired in October 2002.

In 2004, Computing products revenue amounted to $18.1 million, compared to $18.3 million in 2003. This decrease amounted to $.2 million, or 1% of sales. This product category experienced a significant decline in revenue in 2004 due to a major customer's significant decrease ($2.4 million) in product requirements. This decrease was partially offset in 2004 by new customers ordering integrated platforms.

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 increased by $5.3 million, or 106%, from $5.0 million in 2003 to $10.3 million in 2004. One customer accounted for $3.5 million of this growth. The remainder of the switching revenue growth was generated by an expanding customer base.

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. Revenue from these products amounted to $.7 million and $.6 million in 2004 and 2003, respectively.

Gross profit. Gross profit consists of sales, less cost of goods sold including material costs, manufacturing expenses, depreciation, amortization of software development costs, expenses associated with engineering contracts and technical support function expenses. During the first half of 2004, the Company began manufacturing a greater number of its single board computer products at its Rochester manufacturing facility, rather than outsourcing the production to contract manufacturing.

Gross margin was 47.6% and 49.4% in 2004 and 2003, respectively. The decline in gross margin was partially attributable to Voice Technology products which negatively impacted gross margin due to low sales volumes and the acquisition accounting for inventory related to the Mapletree purchase. Increased amortization of software development costs also had a negative impact on gross margins. Included in cost of goods sold, is the amortization of software development costs which totaled $1.7 million and $1.0 million, for 2004 and 2003, respectively. Partially offsetting this decline in gross margin was the savings generated by manufacturing single board computers at the Rochester facility.

Total Operating Expenses. Total operating expenses in 2004 amounted to $21.9 million in 2004, compared to $20.1 million in 2003. For 2004, the operating expenses of the Voice Technology Group are included from the date of acquisition on January 23, 2004. During the third quarter 2004, management began formulating plans and taking steps 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, operating expenses are expected to be reduced by $1.3 million annually and manufacturing overhead (cost of goods) is expected to be reduced by $.7 million.

Selling and marketing expenses totaled $6.4 million in 2004, compared to $5.9 million in 2003. This increase of $.5 million is primarily attributable to the inclusion of the Voice Technology Group expenses.

Research and development expenses totaled $10.2 million and $9.5 million in 2004 and 2003, respectively. This increase of $.7 million is related to the inclusion of the Voice Technology Group expenses, offset by no corporate bonus and an increase in capitalized software development costs in 2004. The Company capitalizes certain software development costs, which reduces the amount of software development charged to operating expense. Amounts capitalized were $2.2 million and $1.5 million for 2004 and 2003, respectively. Gross expenditures for engineering and software development amounted to $12.4 million in 2004 and $11.0 million in 2003. The increased spending for engineering, research and software development is principally the result of the VTG organization acquired in January 2004.

General and administrative expenses amounted to $4.8 million and $4.6 million in 2004 and 2003, respectively. This increase of $.2 million in 2004 is primarily related to Voice Technology Group expenses and external costs associated with Sarbanes-Oxley compliance, offset by no corporate bonus in 2004.

Restructuring charges amounted to $.2 million and $.1 million in 2004 and 2003, respectively. In 2003, the Company incurred an incremental restructuring charge related to the lease of its Raleigh, North Carolina facility. This incremental charge was the result of a revised management estimate regarding future expected sublease receipts for this facility. During 2004, the Company completed integration of the VTG sales, marketing and administrative functions into its corporate operations. The Company incurred $.2 million of expense related to these restructuring efforts in 2004.

In-process research and development expense amounted to $.2 million in 2004. This was a charge for in-process research and development costs associated with the Voice Technology Group acquisition 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."

Note Receivable Valuation Charge. At December 31, 2004, the Company held a note receivable from InSciTek. 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 $3.0 million as collection of this note is doubtful.

Other Income, net. Other income consists primarily of interest income. The Company's funds are primarily invested in high quality auction rate municipal securities. Interest rates increased in 2004, compared to 2003, resulting in increased interest income. Also contributing to this increase was an increase in interest income from notes receivable from unconsolidated companies.

Income Taxes. The Company's income tax benefit in 2004 totaled $.1 million, compared to an income tax provision of $1.3 million in 2003. 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 its international operations, research activities, tax-exempt interest and foreign sales. For 2004, the Company's effective tax rate was (6.5%). This income tax benefit was primarily the result of the benefits derived from tax credits and international operations which exceeded the statutory tax amounts. For 2003, the Company's effective tax rate was 26.3% and also included the favorable resolution of prior year tax uncertainties. 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 (Loss) 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 2004, the Company's allocation of Momentum's income totaled $.2 million. During 2003, the Company recorded losses of $.3 million related to its allocation of Momentum's net loss. During the fourth quarter 2003, the Company recorded an impairment of its investment due to Momentum's weaker than expected financial results. The Company wrote this investment down by $.4 million, to $.4 million at December 31, 2003, the Company's estimate of the investment's fair value at that date.

Gain on Sale of Investment in Unconsolidated Company, net of tax. In the third quarter 2004, the Company sold its ownership interest in Momentum Computer, Inc. and realized a gain of $1.2 million, after tax of $.3 million.

Year Ended December 31, 2003 compared with the Year Ended December 31, 2002

Sales. Total revenue for 2003 was $50.0 million, compared to $27.0 million for 2002. For the years indicated in the following table, the Company's products are grouped into four distinct categories in one market segment: Communications (network access and signaling), Computing products (acquired in October 2002), IPnexus switching products, and Other products. Revenue from each product category, expressed as a percentage of sales for 2003 and 2002, is as follows:

	2003	2002
Communications products	52%	70%
Computing products	37%	18%
IPnexus switching products	10%	9%
Other products	1%	3%
Total	100%	100%

Communications products:

Revenue from these products amounted to $26.1 million and $18.8 million in 2003 and 2002, respectively. This 39% increase in revenue in 2003 was the result of the economic stabilization within the Company's target markets and increased shipments related to existing design wins and new customers for these products in 2003.

Computing products:

This category represents revenue generated by the Computing Products Group acquired in October 2002. For the last three months of 2002, revenue from these products amounted to $5.0 million. For 2003, revenue amounted to $18.3 million reflecting a full year of sales. On an annualized basis, revenue from the Computing Products Group was lower in 2003 compared to 2002, due to a decrease in revenue from a single large customer in late 2003.

IPnexus switching products:

Revenue from switching products grew by 108% to $5.0 million in 2003, from $2.4 million in 2002. This growth reflects the rising adaptation of the new embedded systems architecture, which requires use of Ethernet switches and the Company's focus of providing a broad family of products to meet this need.

Other Products:

Revenue from other products amounted to $.6 million and $.8 million in 2003 and 2002, respectively. This revenue is related to legacy products.

Gross Profit. Gross profit consists of sales, less cost of goods sold including material costs, manufacturing expenses, depreciation, amortization of software development costs, expenses associated with engineering contracts and technical support function expenses. Gross margin was 49.4% and 52.4% of sales in 2003 and 2002, respectively. Gross margin as a percentage of sales decreased in 2003 primarily because of the increase in shipments of lower margin Computing products. Gross margins for Computing products are generally lower than the gross margins realized by the Company's other product categories because the Computing products are more hardware centric products and include less proprietary technology as compared to the Company's other products. Since the Computing Products Group's operations were included for the full year in 2003, compared with only three months in 2002, revenue from Computing products constituted a greater percentage of total revenue causing a decrease in overall

gross margins. The decrease in gross margins attributable to the Computing products was partially offset by increases in gross margin for the other product categories as the Company's fixed manufacturing overhead was spread over a larger volume of shipments in 2003, compared to 2002.

Total Operating Expenses. Total operating expenses amounted to $20.1 million in 2003, compared to $15.1 million in 2002. For 2003, the operating expenses include a full year of operations of the Computing Products Group, compared to only three months in 2002. During 2002, the Company took actions to improve its cost structure by more appropriately aligning expenses with current revenue levels. These expense reductions amounted to $2.6 million annually and were attained by reducing staffing levels by approximately 20% and by consolidating one remote office location to more efficiently provide engineering and product support.

Selling and marketing expenses totaled $5.9 million in 2003, compared to $4.4 million in 2002. This increase of $1.5 million in 2003 is primarily attributable to the inclusion of the Computing Products Group for a full year of operations amounting to $1.0 million and an increase of $.5 million related to additional sales people and related expenses.

Research and development expenses totaled $9.5 million and $6.9 million in 2003 and 2002, respectively. This increase of $2.6 million in 2003 is primarily attributable to the inclusion of the Computing Products Group for a full year increasing expense by $2.3 million. The Company capitalizes certain software development costs, which reduces the amount of software development charged to operating expense. Amounts capitalized were $1.5 million and $1.2 million for 2003 and 2002, respectively. Gross expenditures for engineering and software development were $11.0 million and $8.1 million for 2003 and 2002, respectively.

General and administrative expenses amounted to $4.6 million and $2.7 million in 2003 and 2002, respectively. This increase of $1.9 million in 2003 is primarily related to the inclusion of the Computing Products Group for the entire year increasing expenses by $1.0 million, plus increases in personnel related and other administrative costs of $.9 million associated with the Company's growth in 2003, compared to 2002.

Restructuring charges amounted to $.1 million and $.6 million in 2003 and 2002, respectively. In 2002, these non-recurring expenses were associated with actions the Company took to improve its cost structure and included severance related to staffing reductions and expenses associated with closing the Raleigh, North Carolina engineering facility. In 2003, the Company incurred an incremental restructuring charge related to the lease of its Raleigh, North Carolina facility. This incremental charge was the result of a revised management estimate regarding future expected sublease receipts for this facility.

In-process research and development expenses were $.4 million in 2002. This was a charge for in-process research and development costs associated with the Computing Products Group acquisition 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."

Class action legal settlement charges were $.1 million in 2002. In September 2002, the Company signed a Memorandum of Understanding for settlement of the class action litigation outstanding since May 2000. During 2003, the settlement agreement was accepted and approved by the Court and the settlement was paid by the Company.

Other Income, net. Other income consists primarily of interest income. The Company's funds are primarily invested in high quality auction rate municipal securities. Interest rates declined in 2003, compared to 2002, resulting in reduced interest income. Offsetting this reduction was an increase in interest

income from the note receivable issued to an unconsolidated company in September 2002.

Income Taxes. The Company's income tax provision for 2003 totaled $1.3 million, compared to an income tax benefit of $.8 million in 2002. 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 its international operations, research activities, tax-exempt interest and foreign sales. For 2003, the Company's effective tax rate was 26.3% and also included the favorable resolution of prior year tax uncertainties. For 2002, the Company's income tax was a tax benefit due the Company and included the effect of in-process research and development expenses as well as the favorable resolution of prior year tax uncertainties.

Equity in Income (Loss) of Unconsolidated Company. In September 2002, the Company completed a minority interest investment in Momentum Computer, Inc., a developer of specialized single board computer products located in Carlsbad, California. During 2003, the Company recorded losses of $.3 million related to its allocation of Momentum's net loss. During the fourth quarter 2003, the Company reduced its investment in Momentum to 30 percent and recorded an impairment of its investment due to Momentum's weaker than expected financial results. The Company wrote this investment down by $.4 million, to $.4 million at December 31, 2003, the Company's estimate of the investment's fair value at that date. During 2002, a loss of $.1 million was recorded reflecting the allocation of Momentum's net loss to the Company.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2004, the Company's primary source of liquidity included cash, cash equivalents and investments of $25.6 million. The Company had working capital of $41.6 million at December 31, 2004.

Cash generated by operating activities was $.6 million for 2004. This amount included net income of $2.8 million, non-cash adjustments (depreciation and amortization of $2.6 million, inventory reserves of $.9 million, a note receivable valuation charge of $3.0 million, and a gain on the sale of Company's investment in Momentum of $1.5 million). Cash used in operations due to changes in operating assets and liabilities included increases (accounts receivable of $1.9 million and inventory of $1.4 million) and decreases (accounts payable and accrued expenses of $1.0 million, and income taxes payable of $2.5 million). The uses of cash from the operating activities primarily relate to an increase in sales and production volumes.

Cash used by investing activities during 2004 amounted to $5.9 million. The largest use of cash in investing activities was the Company's acquisition of Map