

Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

PORTA SYSTEMS CORP  
Form 10-K  
April 15, 2002

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934 [FEE REQUIRED]

For the fiscal year ended December 31, 2001  
-----

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 1-8191  
-----

PORTA SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware  
-----

11-2203988  
-----

(State or other jurisdiction  
of incorporation or organization)

(IRS Employer  
Identification No.)

575 Underhill Boulevard, Syosset, New York  
-----

11791  
-----

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code:

(516) 364-9300  
-----

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value \$.01  
-----

American Stock Exchange  
-----

(Title of Class)

(Name of Exchange on  
which registered)

Securities registered pursuant to Section 12(g) of the Act:

None

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 10K or any amendment to this

# Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Form 10K. [X]

State aggregate market value of the voting stock held by non-affiliates of the registrant: \$997,696 as of March 31, 2002.

Indicate the number of shares outstanding of each of the registrant's class of common stock, as of the latest practicable date: 9,976,964 shares of Common Stock, par value \$.01 per share, as of March 31, 2002.

## DOCUMENTS INCORPORATED BY REFERENCE

None

=====

### Item 1. Business

Porta Systems Corp. develops, designs, manufactures and markets a broad range of standard and proprietary telecommunications equipment and integrated software applications for sale domestically and internationally. Our core products, focused on ensuring communications for service providers worldwide, fall into three categories:

Computer-based operation support systems. Our operations support systems, which we call our OSS systems, focus on the access loop and are components of telephone companies' service assurance and service delivery initiatives. The systems primarily focus on trouble management, line testing, network provisioning, inventory and assignment, and automatic activation, and most currently single ended line qualification for the delivery of xDSL high bandwidth services. We market these systems principally to foreign telephone operating companies in established and developing countries primarily in Asia, South and Central America and Europe.

Telecommunications connection and protection equipment. These systems are used to connect copper-wired telecommunications networks and to protect telecommunications equipment from voltage surges. We market our copper connection equipment and systems to telephone operating companies and customer premise systems providers in the United States and foreign countries.

Signal processing equipment. These products, which we sell principally for use in defense and aerospace applications, support copper wire-based communications systems.

Porta Systems Corp. is a Delaware corporation incorporated in 1972 as the successor to a New York corporation incorporated in 1969. Our principal offices are located at 575 Underhill Boulevard, Syosset, New York 11791; telephone number, 516-364-9300. References to Porta and to "we," "us", "our," and words of like import refer to Porta Systems Corp. and its subsidiaries, unless the context indicates otherwise.

### Forward-Looking Statements

Statements in this Form 10-K annual report may be "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to, statements that express our intentions, beliefs, expectations, strategies, predictions or any other statements relating to our future activities or other future events or conditions. These statements are based on current expectations, estimates and projections about our business based, in part, on assumptions made by

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

management. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may, and probably will, differ materially from what is expressed or forecasted in the forward-looking statements due to numerous factors, including those risks discussed from time to time in this Form 10-K annual report, including the risks described under "Risk Factors" and in other documents which we file with the Securities and Exchange Commission. In addition, such statements could be affected by risks and uncertainties related to our financial conditions, factors which affect the telecommunications industry, market and customer acceptance, competition, government regulations and requirements and pricing, as well as general industry and market conditions and growth rates, and general economic conditions. Any forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Form 10-K.

1 of 31

### Risk Factors

We are incurring losses from our operations, and our losses are continuing. We incurred a net loss of \$14,774,000, or \$1.50 per share (basic and diluted), on sales of \$28,062,000 for 2001, following a loss of \$10,176,000, or \$1.04 per share (basic and diluted) for 2000, our losses are continuing and we expect that our losses will continue unless we are able both to significantly increase our revenue and reduce our expenses. We cannot give assurance that we will be able to operate profitably in the future, and if we are unable to operate profitably, we may be unable to continue in business.

Because of our decreasing revenues together with problems facing both the telecommunications industry and the economy, we may not be able to continue in business. As a result of the deterioration of our operating revenue resulting from both market conditions and our financial condition, we are evaluating various options, including the sale of one or more of our divisions as well as a reorganization under the Bankruptcy Code.

Our independent auditors have included an explanatory paragraph relating to our ability to continue as a going concern in their report on our financial statements. Because of our substantial losses in 2001, 2000 and 1999, our stockholders' deficit of \$ 25,849,000 at December 31, 2001, and our working capital deficit of \$31,236,000 as of December 31, 2001 our auditors included in their report an explanatory paragraph about our ability to continue as a going concern.

We require substantial financing to meet our working capital requirements and our principal lender is providing us with financing at its discretion. We had a working capital deficit at December 31, 2001 of \$31,236,000. As of December 31, 2001, our current liabilities include \$22,095,000 due to our senior lender, all of which is due and payable on December 31, 2002, at which time our agreement with the senior lender will terminate. In addition, subordinated notes in the principal amount of \$6,144,000 plus accrued interest were outstanding as of December 31, 2001. These subordinated notes became due on July 3, 2001. Subsequent to December 31, 2001, the trustee of our subordinated debentures in the principal amount of \$500,000, which will mature on July 1, 2002, served us with a notice of default for failure to pay interest. Our senior lender has prohibited us from making any payments on any of the subordinated debt. At December 31, 2001, we did not have sufficient resources to pay the senior lender when our obligations to the senior lender mature on December 31, 2002, or the subordinated notes, and we do not expect to generate the necessary cash from our operations to enable us to make those payments. Since December 31, 2001, our

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

senior lender has agreed to advance us up to \$1,500,000; however, such advances are at the discretion of the senior lender and are dependent on, among other things, the perception of the senior lender that we are either stemming our losses or effecting a sale of one or more of our divisions. Furthermore, if the Company sells a division, the agreement with the Company's senior lender requires it to pay the net proceeds to the senior lender. As a result of this provision and the Company's obligations to the holders of subordinated debt, unless the lenders consent to the Company retaining a portion of the net proceeds from any sale for its operations, the Company will not receive any significant amount, and may not receive any of the net proceeds from any such sale for working capital. If the senior lender ceases funding our operations, unless we have obtained alternative financing, we will be unable to continue in business. Furthermore, unless we obtain funding from another source, including the sale of one of more of our divisions, we will not be able to pay our senior lender on December 31, 2002, and we may not be able to continue in business. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Because of our failure to pay our subordinated debt, the holders of the subordinated debt may seek to obtain and enforce judgments against us, which could cause a default under our agreement with our senior lender. One holder of subordinated notes has already commenced an action against us seeking payment of his note, and, because of our failure to pay the notes when due, other holders may bring similar actions. If such holders prevail in such actions and seek to enforce a judgment against us, we may be in default under our agreement with our senior lender, and we may seek, or our senior lender may seek or require us to seek, protection under the Bankruptcy Code.

2 of 31

Because of our financial condition, we have not been able to pay our creditors on a timely basis, and some of our creditors have obtained judgments against us. As a result of our continuing financial difficulties, a number of creditors have engaged attorneys or collection agencies or commenced legal actions against us, and some of them have obtained judgments against us, including a former landlord which has obtained a \$400,000 judgment against us. The creditors include five former senior executives who have deferred compensation agreements with us. The total payments due under these agreements are approximately \$1.9 million, of which \$46,000 was due at December 31, 2001 and an additional \$100,000 has become due in 2002. Other claimants who have already either commenced litigation or otherwise sought collection are due approximately \$600,000. If we are unable to reach a settlement with these creditors and others who have not yet brought claims, and these claimants obtain judgments against us or seek to enforce a judgment against us, it may be necessary for us, or our senior lender may require us, to seek protection under the Bankruptcy Code.

Our largest customer has ceased placing orders for OSS products with us and has significantly decreased orders for our copper connection/protection products, which are having a material adverse effect upon our business. Our largest customers are British Telecommunications and Fujitsu Telecommunications LTD, which purchases telecommunications equipment from us for sale to British Telecommunications. Sales to British Telecommunications declined significantly during the past year. British Telecommunications has informally advised us that it will not place orders with us for OSS products until we can demonstrate that we are financially viable. The decline in sales of connection/protection products for British Telecommunications reflects both our financial condition and industry conditions generally. We have not been able to replace the sales made to British Telecommunications and we cannot not give any assurance that we will be able to. The reluctance of British Telecommunications to place orders

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

for OSS products may affect the willingness of other telecommunications companies to order new OSS products from us. The reduced level of our sales resulting from the decline in sales to British Telecommunications is continuing to impair our business, and, if we are not able to replace these sales, or generate new business from British Telecommunications or Fujitsu, we may not be able to continue in business.

Since we sell to telecommunications companies, our sales are affected by economic and other factors that affect that industry, both domestically and internationally. During the past two years, the telecommunications industry has been affected by an international slowdown, and many, if not most, telecommunications companies have scaled back plans for expansion, which has resulted in a significant drop in the requirements for products including products such as our OSS products and our connection/protection products. We cannot assure you that there will be any positive change in the purchasing patterns of telecommunications companies or that we will benefit from any positive change which may occur.

Because of our financial condition, we may not be able to perform on our contracts which may subject us to loss of business and penalties. We are having and we may continue to have difficulty performing our obligations under our contracts, which could result in the cancellation of contracts, the loss of future business and penalties for non-performance.

3 of 31

We are heavily dependent on foreign sales. Approximately 54% of our sales in 2001, 66% of our sales in 2000 and 62% of our sales for 1999, were made to foreign telephone operating companies. In selling to customers in foreign countries, we are exposed to inherent risks not normally present in the case of our sales to United States customers, including extended delays in both completing the installation and receiving the final payment from our customers for our Operational Support Systems contracts, and as well as further risks relating to political and economic changes. Furthermore, our financial condition has impaired our ability to generate new business in the international market as potential customers express concern about our ability to perform.

We have granted to British Telecommunications rights to our technology. Under our agreement with British Telecommunications, we gave British Telecommunications the right to use our connection/protection technology or have products using our technology manufactured for it by others. As a result, British Telecommunication may have the right to use our technology and purchase products based on our technology from others, which has resulted and may continue to result in a significant decline in our sales to British Telecommunications.

We experience difficulties with Operations Support Systems contracts. We experience delays in purchaser acceptance of the Operations Support Systems and our receipt of final contract payments in connection with a number of foreign sales. In addition, we have no steady or predictable flow of orders for Operations Support Systems and the negotiation of a contract for an operations support system is an individualized and highly technical process. These contracts typically contain performance guarantees by us and clauses imposing penalties on us if we do not meet the contractual in-service dates. The installation, testing and purchaser acceptance phases of these contracts may last longer than contemplated by the contracts and, accordingly, amounts due under the contracts may not be collected for extended periods. Furthermore, our Operation Support Systems contracts typically contain performance guarantees by us and clauses imposing penalties if we do not meet "in-service" dates.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Because of our small size and our financial problems, we may have difficulty competing for business. We compete directly with a number of large and small telephone equipment manufacturers in the United States, with Lucent Technologies, Inc. continuing to be our principal United States competitor. Our competitors are using our financial difficulties in successfully competing against us. We anticipate that our loss for 2001, our working capital deficiency and the scheduled expiration of our financing agreement may continue to place us in a competitive disadvantage, particularly in seeking Operations Support Systems contracts, where we frequently deal with national telecommunications companies.

We face significant competition for both foreign and domestic sales. In both foreign and domestic markets, we face considerable competition from other United States and foreign telephone equipment manufacturers most of which are larger and have substantially greater financial resources than us. In addition, if we establish facilities in foreign countries, we face risks associated with currency devaluation, difficulties in either converting local currency into dollars or transferring funds to the United States, local tax and currency regulations and political instability.

We require access to current technological developments. We rely primarily on the performance and design characteristics of our products and we try to offer our products at prices and with warranties that will make our products competitive. Our business could be adversely affected if we cannot obtain licenses for such updated technology or self develop state-of-the-art technology. Because of our financial problems, we are not able to devote any significant effort to research and development, which could increase our difficulties in making sales of our products.

We rely on certain key employees. We may be dependent upon the continued employment of certain key employees, including our senior executive officers. Our failure to retain such employees may have a material adverse effect upon our business. Because of our financial problems we have experienced key personnel losses.

4 of 31

To the extent that these losses continue or are accelerated, we may be unable to provide our customers with necessary service, which could result in the failure to generate new business.

We do not meet the continued listing standards of the American Stock Exchange, and we may be delisted from that exchange. If we are delisted from the American Stock Exchange, our stock will be traded on the OTC Bulletin Board and will be subject to the Securities and Exchange Commission's penny stock rules, which impose additional sales practice requirements on broker-dealers which sell our stock to persons other than established customers and institutional accredited investors. These rules may affect the ability of broker-dealers to sell our common stock and may affect the ability of our stockholders to sell any common stock they may own.

We do not pay dividends on common stock.

### Products

Operations Support Systems. We sell our OSS systems primarily to telephone operating companies in established and developing countries in Asia, South and Central America and Europe, and to a lesser extent, in the United States. Our principal OSS systems are computer-based testing, provisioning, activation and trouble management products which include software and capital equipment and

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

typically sell for prices ranging from several hundred thousand to several million dollars.

The testing products are designed to automatically test for and diagnose problems in customer telephone lines and to notify telephone company service personnel of required maintenance. The associated trouble management system provides automated record keeping (including repair and disposition records) and analyzes these records to enable the telephone company to identify recurring problems and equipment deterioration and to fulfill maintenance service level agreement obligations. The integration of these systems provides a service assurance function for telephone companies.

A major component of the testing system is the "test head," which provides the access to, and tests the required telephone line. We have continually developed our test head capability to meet the changing requirements of the customer loop, and have recently introduced our latest advanced technology platform (sixth generation) product, the MKIII. An enhanced version of the MKIII, the Sherlock, will provide the capability to determine whether customer lines are xDSL capable, enabling telephone companies to expeditiously characterize their outside plant, and optimize their responsiveness to market conditions.

Our other software applications, including the automated assignment of facilities and activation of service, form part of a telephone company's service activation function, and can be integrated with the testing and trouble management systems, to provide a comprehensive access loop capability. In addition, if requested by customers, Porta develops software to meet specific customer requirements, including integration of its systems with telephone company legacy or third party OSS systems.

Our OSS products are complex and, in most applications, incorporate features designed to respond to the purchaser's operational requirements and the particular characteristics of the purchaser's telephone system and operational processes. As a result, the negotiation of a contract for an OSS system is an individualized and highly technical process. In addition, contracts for OSS systems frequently provide for manufacturing, delivery, installation, testing and purchaser acceptance phases, which take place over periods ranging from several months to a year or more. These contracts typically contain performance guarantees by us and clauses imposing penalties if "in-service" dates are not met. The installation, testing and purchaser acceptance phases of these contracts may last longer than contemplated by the contracts and, accordingly, amounts due under the contracts may not be collected for extended periods and, in some instances, may not be collected. Delays in purchaser acceptance of the systems and in our receipt of final contract payments have occurred in connection with a number of foreign sales. In addition, we have not experienced a steady or predictable flow of orders for OSS systems.

5 of 31

Telecommunications Connection Equipment. Our copper connection/protection equipment and systems are used by telephone operating companies, by owners of private telecommunications equipment and by manufacturers and suppliers of telephone central office and customer premises equipment. Products of the types comprising our telecommunications connection equipment are included as integral parts of all domestic and foreign telephone and telecommunications systems. Such products are sold in a worldwide market, which generally grows in proportion to increases in the number of telephone subscribers and owners of private telecommunications equipment, as well as to increases in upgrades to modern digital switching technology such as DSL, ADSL, and ISDN lines.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Our connection equipment consists of connector blocks and protection modules used by telephone companies to interconnect copper-based subscriber lines to switching equipment lines. The protector modules protect central office personnel and equipment from electrical surges. The need for protection products has increased as a result of the worldwide move to digital technology, which is extremely sensitive to damage by electrical overloads, and because private owners of telecommunications equipment now have the responsibility to protect their equipment from damage caused by electrical surges. Line connecting/protecting equipment usually incorporates protector modules to safeguard equipment and personnel from injury due to power surges. Currently, these products include a variety of connector blocks, protector modules and frames used in telephone central switching offices, PBX installations, multiple user facilities and customer premise applications.

We also have developed an assortment of frames for use in conjunction with our traditional line of connecting/protecting products. Frames for the interconnection of copper circuits are specially designed structures which, when equipped with connector blocks and protectors, interconnect and protect telephone lines and distribute them in an orderly fashion allowing access for repairs and changes in line connections. One of our frame products, the CAM frame, is designed to produce computer-assisted analysis for the optimum placement of connections for telephone lines and connector blocks mounted on the frame.

Our copper connection/protection products are used by many of the Regional Bell Operating Companies as well as by independent telephone operating companies in the United States and owners of private telecommunications equipment. These products are also purchased by other companies for inclusion within their systems. In addition, our telecommunications connection products have been sold to telephone operating companies in various foreign countries. This equipment is compatible with existing telephone systems both within and outside the United States and can generally be used without modification, although we do custom design modifications to accommodate the specific needs of our customers.

Signal Processing Products. Our signal processing products include data bus systems and wideband transformers. Data bus systems, which are the communication standard for military and aerospace systems, require an extremely high level of reliability and performance. Wideband transformers are required for ground noise elimination in video imaging systems and are used in the television and broadcast, medical imaging and industrial process control industries.

6 of 31

The table below shows, for the last three fiscal years, the contribution made to our sales by each of its major categories of the telecommunications industry:

Sales by Product Category Years Ended December 31,						
	2001 ----		2000 ----		1999 ----	
(Dollars in thousands)						
OSS Systems	\$ 8,874	32%	\$22,296	44%	\$14,254	37%
Line Connecting /Protecting Equipment	12,756	46%	20,546	40%	18,189	47%



## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Signal Processing	5,737	20%	7,644	15%	6,328	16%
Other	695	2%	654	1%	165	0%
	-----		-----		-----	
Total	\$28,062	100%	\$51,140	100%	\$38,936	100%
	=====		=====		=====	

### Markets

We supply equipment and systems to telephone companies which provides improved services to ensure communication to their customers. In addition, we provide businesses with systems which improve their internal telecommunication systems.

Telephone networks in certain regions of the world, notably Latin America, Eastern Europe and certain areas in the Asia/Pacific region, were designed to carry voice traffic and are not well suited for high-speed data transmissions or for other forms of telecommunications that operate more effectively with digital telecommunications equipment and lines. The telephone networks in these countries are also characterized by a very low ratio of telephone lines to population. Countries with emerging telecommunication networks have to rapidly add access lines in order to increase the availability of telephone service and to significantly upgrade the quality of the lines already in service.

Our OSS systems are designed to meet many of the needs of a rapidly changing telephone network. OSS systems facilitate rapid change and expansion without a comparable increase in the requirement for skilled technicians, while the computerized line test system insures increased quality and rapid maintenance and repair of subscriber local loops. The automated database, which computerizes the inventory and maintenance history of all subscriber lines in service, helps to keep the rapid change under control.

During 2001, approximately 32% of our sales consisted of OSS products and services.

As a telephone company expands the number of its subscriber lines, it also requires additional connection equipment to interconnect and protect those lines in its central offices. We provide a line of copper connection equipment for this purpose. Recent trends towards the transmission of high frequency signals on copper lines are sustaining this market. Less developed countries, such as those with emerging telecommunications networks or those upgrading to digital switching systems, provide a growing market for copper connection and protection equipment.

7 of 31

The increased sensitivity of the newer digital switches to small amounts of voltage requires the telephone company which is upgrading its systems to digital switching systems to also upgrade its central office connection/protection systems in order to meet these more stringent protection requirements. We supply central office connection/protection systems to meet these needs.

During 2001, approximately 46% of our sales were made to customers in this category.

Our line of signal processing products is supplied to customers in the military and aerospace industry as well as manufacturers of medical equipment

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

and video systems. The primary communication standard in new military and aerospace systems is the MIL-STD-1553 Command Response Data Bus, an application which requires an extremely high level of reliability and performance. Products are designed to be application specific to satisfy the requirements of each military or aerospace program.

Our wideband transformers are required for ground noise elimination in video imaging systems and are used in the television and broadcast, medical imaging and industrial process control industries. If not eliminated, ground noise caused by poor electrical system wiring or power supplies, results in significant deterioration in system performance, including poor picture quality and process failures in instrumentation. The wideband transformers provide a cost effective and quick solution to the problem without the need of redesign of the rest of the system.

During 2001, signal processing equipment accounted for approximately 20% of our sales.

### Marketing and Sales

We operate through three business units, which are organized by product line, and with each having responsibility for the sales and marketing of its products.

When appropriate to obtain sales in foreign countries, we may enter into business arrangements and technology transfer agreements covering our products with local manufacturers and participate in manufacturing and licensing arrangements with local telephone equipment suppliers.

In the United States and throughout the world, we use independent distributors in the marketing of all copper based products to the regional bell operating companies and the customer premises equipment market. All distributors marketing copper-based products also market directly competing products. In addition, Porta continues to promote the direct marketing relationships it developed in the past with telephone operating companies.

We had a non-exclusive supply agreement with British Telecommunications covering our connecting/protecting products. This agreement, which did not provide for any purchase commitments by British Telecommunications, expired on August 31, 2001. British Telecommunications purchased line connecting/protecting products amounting to \$3,339,000 (12% of sales) in 2001, \$4,261,000 (8% of sales) in 2000, and \$6,566,000 (17% of sales) in 1999. During these years, we also sold our products to unaffiliated suppliers for resale to British Telecommunications. We have a cross-licensing agreement with British Telecommunications which, in effect, enables British Telecommunications to use certain of our proprietary information to modify or enhance products provided to British Telecommunications and permits British Telecommunications to manufacture or engage others to manufacture those products. Although we have been negotiating with British Telecommunications with respect to a new non-exclusive supply agreement and British Telecommunications has made modest purchases of copper connection/protection products from us, as of the date of this report we have not reached an agreement with British Telecommunications, and we may not be able to enter into such an agreement. If we do not sell products to British Telecommunications, whether pursuant to a supply agreement or otherwise, our business could be impaired.

Our OSS systems historically have been sold to foreign telephone operating companies which are government controlled. Recently, we entered into sales,

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

marketing and management co-operative agreements and strategic alliances with various companies.

During 2000, we entered into a multi-year sales, marketing, and management co-operative agreement with Fujitsu Telecommunications to market Internet infrastructure products. Under the agreement, Fujitsu will sell and market Porta's advanced Internet infrastructure technologies, including ADSL Single Ended Line Qualification System for broadband services and the sixth generation Sherlock remote test unit to telecom service operators in the United Kingdom, principally British Telecommunications, and certain other European countries. During 2001 and 2000, we had sales pursuant to this agreement of \$3,200,000 (11% of sales) and \$12,051,000 (24% of sales), respectively.

Our signal processing products are sold primarily to US military and aerospace prime contractors, and domestic original equipment manufacturers and end users.

The following table sets forth for the last three fiscal years our sales to customers by geographic region:

Sales to Customers By Geographic Region (1)						
Year Ended December 31,						
	2001		2000		1999	
	----		----		----	
(Dollars in thousands)						
North America	\$13,356	48%	\$22,795	45%	\$14,664	38%
United Kingdom	8,060	29%	20,244	40%	15,673	40%
Asia/Pacific	4,552	16%	5,429	10%	4,159	11%
Other Europe	1,761	6%	2,482	5%	3,130	8%
Latin America	288	1%	146	0%	1,257	3%
Other	45	0%	44	0%	53	0%
	-----		-----		-----	
Total Sales	\$28,062	100%	\$51,140	100%	\$38,936	100%
	=====		=====		=====	

(1) For information regarding the amount of sales, operating profit or loss and identifiable assets attributable to each of our divisions and geographic areas, see Note 23 of Notes to the Consolidated Financial Statements.

In selling to customers in foreign countries, we face inherent risks not normally present in the case of sales to United States customers, including increased difficulty in identifying and designing systems compatible with purchasers' operational requirements; extended delays under OSS systems contracts in the completion of testing and purchaser acceptance phases and difficulty in our receipt of final payments and political and economic change. In addition, to the extent that we establish facilities in foreign countries or to the extent that payment is denominated in the local currency, we face risks associated with currency devaluation, inability to convert local currency into dollars, as well as local tax regulations and political instability.

#### Manufacturing

Our computer-based testing products include proprietary testing circuitry and computer programs, which provide platform-independent solutions based on UNIX or UNIX compatible operating systems. The testing products also incorporate disk data storage, teleprinters, file servers and personal computers purchased by us. These products are installed and tested by us at our customers' premises.

At present, our manufacturing operations are conducted at facilities located in Syosset, New York and Matamoros, Mexico. From time to time we also use subcontractors to augment various aspects of our production activities and periodically explore the feasibility of conducting operations at lower cost manufacturing facilities located abroad. In selling to foreign telephone companies, we may be required to provide local manufacturing facilities and, in conjunction with these facilities, we may grant the facility a license to our proprietary technology.

#### Source and Availability of Components

We generally purchase the standard components used in the manufacture of our products from a number of suppliers. We attempt to assure ourselves that the components are available from more than one source. We purchase all of our MKIII test units from two suppliers. We purchase the majority of our workstations and servers used in its OSS systems from Compaq Computer Corporation. However, we could use other computer equipment in our systems if we were unable to purchase Compaq products. Other components, such as personal computers and line printers used in connecting with our electronic products, are readily available from a number of sources.

#### Significant Customers

During 2001, our five largest customers accounted for sales of \$13,444,000, or approximately 48% of sales, and, during 2000, our five largest customers accounted for sales of \$28,323,000, or approximately 55% of sales. Our largest customer in 2001 with sales of \$3,485,000, or approximately 12% of sales was Philippine Long Distance Telephone. Our largest customer in 2000 with sales of \$12,051,000, or approximately 24% of sales was Fujitsu Telecommunications. Our sales to Fujitsu Telecommunications were \$3,200,000, or approximately 11% of sales in 2001. A significant amount of sales of our products for use by British Telecommunications were sold to Fujitsu Telecommunications, as purchasing agent for British Telecommunications. As a result, most of the sales to Fujitsu Telecommunications were for use by British Telecommunications. Direct sales to British Telecommunications were \$3,339,000, or 12% of sales, for 2001 and \$5,098,000, or 10% of sales, for 2000. Any significant interruption or decline in sales to Fujitsu Telecommunications or British Telecommunications may have a materially adverse effect upon our operations. During 2000, sales to a Mexican telephone company were \$5,507,000, or approximately 11% of sales. No other customers account for 10% or more of our sales for either year.

The former Bell operating companies continue to be the ultimate purchasers of a significant portion of our products sold in the United States, while sales to foreign telephone operating companies constitute the major portion of our foreign sales. Our contracts with these customers require no minimum purchases by such customers. Significant customers for the signal processing products include major US aerospace companies, the Department of Defense and original equipment manufacturers in the medical imaging and process control equipment industries. We sell both catalog and custom designed products to these customers. Some contracts are multi-year procurements.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

### Backlog

At December 31, 2001, our backlog was approximately \$6,100,000 compared with approximately \$10,000,000 at December 31, 2000. Of the December 31, 2001 backlog, approximately \$5,000,000 represented orders from foreign telephone operating companies. We expect to ship substantially all of our December 31, 2001 backlog during 2002.

10 of 31

### Intellectual Property Rights

We own a number of domestic utility and design patents and have pending patent applications for these products. In addition, we have foreign patent protection for a number of our products.

From time to time we enter into licensing and technical information agreements under which we receive or grant rights to produce certain subcomponents used in our products. These agreements are for varying terms and provide for the payment or receipt of royalties or technical license fees.

While we consider patent protection important to the development of our business, we believe that our success depends primarily upon our engineering, manufacturing and marketing skills. Accordingly, we do not believe that a denial of any of our pending patent applications, expiration of any of our patents, a determination that any of the patents which have been granted to us are invalid or the cancellation of any of our existing license agreements would have a material adverse effect on our business.

### Competition

The telephone equipment market in which we do business is characterized by intense competition, rapid technological change and a movement to private ownership of telecommunications networks. In competing for telephone operating company business, the purchase price of equipment and associated operating expenses have become significant factors, along with product design and long-standing equipment supply relationships. In the customer premises equipment market, we are functioning in a market characterized by distributors and installers of equipment and by price competition.

We compete directly with a number of large and small telephone equipment manufacturers in the United States, with Lucent Technologies continuing to be our principal United States competitor. Lucent's greater resources, extensive research and development facilities, long-standing equipment supply relationships with the operating companies of the regional holding companies and history of manufacturing and marketing products similar in function to those produced by us continue to be significant factors in our competitive environment.

Currently, Lucent and a number of companies with greater financial resources than us produce, or have the design and manufacturing capabilities to produce, products competitive with our products. In meeting this competition, we rely primarily on the engineered performance and design characteristics of our products to comparable performance or design, and endeavors to offer our products at prices and with warranties that will make our products compete world wide.

In connection with overseas sales of our line connecting/protecting equipment, we have met with significant competition from United States and foreign manufacturers of comparable equipment and we expect this competition to

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

continue. In addition to Lucent, a number of our overseas competitors have significantly greater resources than we do.

We compete directly with a limited number of substantial domestic and international companies with respect to our sales of OSS systems. In meeting this competition, we rely primarily on the features of our line testing equipment, our ability to customize systems and endeavor to offer such equipment at prices and with warranties that make them competitive.

In addition to the quality and price of the products being offered, the financial stability of a supplier, especially for OSS contracts, is a crucial element. Because these contracts require the supplier to spend considerable funds before the project is completed and require ongoing maintenance service, potential customers consider the financial stability of the supplier as a major consideration in awarding a contract. Our financial position, combined with our recent losses, our working capital deficiency and the scheduled expiration of our financing agreement with our senior

11 of 31

lender, and the decision of British Telecommunications not to place orders for new OSS products from us and its reduced level of purchases of copper connection/protection products may place us at a competitive disadvantage in seeking new business and new orders for existing customers.

### Research and Development Activities

We spent approximately \$4,400,000 in 2001, \$5,800,000 in 2000, and \$6,100,000 in 1999 on research and development activities. All research and development was company sponsored and is expensed as incurred. As a result of our financial difficulties, we have scaled down our research and development effort, which could hurt our ability to offer competitive products.

### Employees

As of March 31, 2002, we had 274 employees of which 58 were employed in the United States, 182 in Mexico, 27 in the United Kingdom, 3 in Poland, 3 in Chile, and 1 in China. We believe that our relations with our employees are good, and we have never experienced a work stoppage. Our employees are not covered by collective bargaining agreements, except for our hourly employees in Mexico who are covered by a collective bargaining agreement that expires on December 31, 2002.

### Item 2. Properties

We currently lease approximately 20,400 square feet of executive, sales, marketing and research and development space in Syosset, New York; and 7,000 square feet of office space located in Charlotte, North Carolina, which has been vacated. These facilities represent substantially all of our office, plant and warehouse space in the United States. The Syosset, New York lease expires December 2005, and the Charlotte, North Carolina lease expires in November 2004. The annual rental related to the New York property is approximately \$350,000. All rental expense related to the North Carolina facility was accrued in 2000. During 2001, the Company sold its Glen Cove, New York facility for \$1,850,000 and recognized a gain on the sale of \$684,000, net of expenses of \$180,000.

Our wholly-owned United Kingdom subsidiary leases approximately 34,300 square foot facility in Coventry, England, which facility comprises all of our office, plant and warehouse space. The lease expires in 2019. The aggregate annual rental is approximately \$225,000.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Our wholly-owned Mexican subsidiary owns an approximately 40,000 square foot manufacturing facility in Matamoros, Mexico.

We believe our properties are adequate for our needs.

12 of 31

### Item 3. Legal Proceedings

In July 2001, the holder of a subordinated note in the principal amount of \$500,000 commenced an action against the Company in the United States District Court for the Southern District of New York seeking payment of the principal and accrued interest on their subordinated notes which were payable in July 2001. The payment of the note is subordinated to payment of the Company's senior debt and the Company believes that the subordination provision of the note prohibits payment by the Company. The plaintiffs' motion for a summary judgment was recently denied by the court on the grounds that the terms of the note did not give them permission to obtain a judgment while Porta remained in default to the senior debt holder. The Company's obligations under the subordinated notes are reflected as current liabilities on the Company's balance sheet.

In March 2000, we suspended (with pay) Messrs. Ronald Wilkins and Michael Bahlo, two of our executive officers, from their positions pending completion of our investigation of certain matters that had come to our attention. Prior to the completion of this investigation, however, these two executives accepted positions with another company and thereby voluntarily resigned from their positions with us. In February 2001, these two executives, together with a third former executive officer, Mr. Michael Lamb, who similarly resigned from his position with us, filed suit in the Supreme Court for the State of New York, County of New York, entitled Ronald Wilkins, Michael Bahlo and Michael Lamb v. Porta Systems Corp., Index No 600677/01. The complaint asserts various claims against us based on the allegation that each of these three executives was improperly terminated from his employment without cause, and seeks compensatory damages, liquidating damages and attorney's fees. We have filed an answer and counterclaim against the plaintiffs. We believe that we have valid defenses to the claims and intend to defend this action vigorously and to assert counterclaims against these former executives.

In July 1996, an action was commenced against Porta and certain present and former directors in the Supreme Court of the State of New York, New York County by certain stockholders and warrant holders of Porta who acquired their securities in connection with the acquisition by Porta of Aster Corporation. The complaint alleges breach of contract against Porta and breach of fiduciary duty against the directors arising out of an alleged failure to register certain restricted shares and warrants owned by the plaintiffs. The complaint seeks damages of \$413,000; however, counsel for the plaintiff has advised Porta that additional plaintiffs may be added and, as a result, the amount of damages claimed may be substantially greater than the amount presently claimed. Porta believes that the defendants have valid defenses to the claims. Discovery is proceeding, although there has been no significant activity in this matter subsequent to December 31, 1999.

13 of 31

### Item 4. Submission of Matters to a Vote of Securities Holders

During the fourth quarter of 2001, no matters were submitted to a vote of

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

security holders of the Company.

### Part II

#### Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

Our common stock is traded on the American Stock Exchange, Inc. under the symbol PSI. The following table sets forth, for 2000 and 2001, the quarterly high and low sales prices for our common stock on the consolidated transaction reporting systems for American Stock Exchange listed issues.

		High ----	Low ---
2000	First Quarter	\$4.88	\$0.81
	Second Quarter	3.63	1.56
	Third Quarter	2.00	0.88
	Fourth Quarter	1.00	0.38
2001	First Quarter	\$1.06	\$0.22
	Second Quarter	0.40	0.21
	Third Quarter	0.30	0.10
	Fourth Quarter	0.17	0.05

We did not declare or pay any cash dividends in 2001 or 2000. It is our present policy to retain earnings, if any, to finance the growth and development of the business, and therefore, we do not anticipate paying cash dividends on its common stock in the foreseeable future. In addition, Porta's agreement with its senior lender prohibits it from paying cash dividends on its common stock.

As of March 12, 2002, we had approximately 983 stockholders of record and the closing price of our common stock was \$0.10.

We did not issue any unregistered securities during 2001.

We do not meet the continued listing standards of the American Stock Exchange, and we may be delisted from that exchange. If we are delisted from the American Stock Exchange, our stock will be traded on the OTC Bulletin Board and will be subject to the Securities and Exchange Commission's penny stock rules.

14 of 31

#### Item 6. Selected Financial Data

The following table sets forth certain selected consolidated financial information. For further information, see the Consolidated Financial Statements and other information set forth in Item 8 and Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in Item 7:

Year Ended December 31,  
-----

2001 ----	2000 ----	1999 ----
--------------	--------------	--------------

(In thousands, except per share)

Income Statement Data:



## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Sales	\$ 28,062	\$ 51,140	\$ 38,936	\$
Operating income (loss)	(11,453)	(5,153)	(9,709)	
Debt conversion expense	--	--	--	
Income (loss) before discontinued operations and extraordinary item	(14,774)	(10,176)	(13,686)	
Net income (loss)	(14,774)	(10,176)	(13,686)	
Basic per share amounts:				
Continuing operations	\$ (1.50)	\$ (1.04)	\$ (1.44)	\$
Net income (loss)	\$ (1.50)	\$ (1.04)	\$ (1.44)	\$
Diluted per share amounts:				
Continuing operations	\$ (1.50)	\$ (1.04)	\$ (1.44)	\$
Net income (loss)	\$ (1.50)	\$ (1.04)	\$ (1.44)	\$
Cash dividends declared	--	--	--	
Number of shares used in calculating net income (loss) per share-basic	9,878	9,763	9,489	
Number of shares used in calculating net income (loss) per share-diluted	9,878	9,763	9,489	
Balance Sheet Data:				
Total assets	\$ 17,833	\$ 34,174	\$ 43,448	\$
Working capital (deficiency)	\$ (31,236)	\$ (24,152)	\$ 6,135	\$
Long-term debt excluding current maturities	\$ -0-	\$ 376	\$ 21,902	\$
Stockholders' equity (deficit)	\$ (25,849)	\$ (10,792)	\$ (1,387)	\$

15 of 31

### Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

#### Critical Accounting Policies and Estimates

Financial Reporting Release No. 60, which was recently released by the Securities and Exchange Commission, requires all companies to include a discussion of critical accounting policies and methods used in the preparation of financial statements. Note 1 of Notes to Consolidated Financial Statements, included elsewhere on this annual report on Form 10-K, includes a summary of the significant accounting policies and methods used in the preparation of our consolidated financial statements. We believe the following critical accounting policies affect the significant judgements and estimates used in the preparation of our financial statements:

#### Use of Estimates

The preparation of financial statements in accordance with generally

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these consolidated financial statements are the estimated allowance for doubtful accounts receivable, inventory reserves, percentage of completion for long-term contracts, goodwill valuation and the deferred tax asset valuation allowance. Actual results could differ from those and other estimates.

### Revenue Recognition

Revenue, other than from long-term contracts for specialized products, is recognized when a product is shipped. Revenues and earnings relating to long-term contracts for specialized products are recognized on the percentage-of-completion basis primarily measured by the attainment of milestones. Anticipated losses, if any, are recognized in the period in which they are identified.

### Goodwill

Goodwill represents the difference between the purchase price and the fair market value of net assets acquired in business combinations treated as purchases. Goodwill is amortized on a straight-line basis over the estimated useful life as determined by events and circumstances of the business combination that gave rise to the goodwill. We assess the recoverability of unamortized goodwill using the undiscounted projected future cash flows from the related businesses.

16 of 31

Our consolidated statements of operations for the three years ended December 31, 2001, 2000 and 1999, respectively, as a percentage of sales is as follows:

	Years Ended December 31,		
	2001	2000	1999
	----	----	----
Sales	100%	100%	100%
Cost of sales	71%	70%	74%
	----	----	----
Gross Profit	29%	30%	26%
Selling, general and administrative expenses	33%	28%	35%
Research and development expenses	16%	12%	16%
Goodwill impairment	21%	--	--
	----	----	----
Operating loss	(41%)	(10%)	(25%)
Interest expense	(16%)	(9%)	(9%)
Gain on sale of assets	2%	--	--
Other	1%	(1%)	1%
			----
Loss before income taxes, equity in net loss of joint venture and minority interest	(54%)	(20%)	(33%)
Income tax benefit (expense), equity in net loss of joint venture and minority interest	1%	--	(2%)

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

	----	----	----
Net loss	(53%)	(20%)	(35%)
	====	====	====

17 of 31

### Results of Operations

Years Ended December 31, 2001 and 2000

Our sales for 2001 were \$28,062,000 compared to \$51,140,000 in 2000, a decrease of \$23,078,000 (45%). The decrease in revenue is attributed to the decline in sales from all divisions.

OSS sales for 2001 were \$8,874,000, compared to 2000 sales of \$22,296,000, a decrease of \$13,422,000 (60%). The decline in sales from 2000 to 2001 is attributed to the completion during 2000 of certain sales contracts secured during 1999 and failure to secure new contracts as a result of the negative impact of reduced opportunities in Europe, delays we encountered in obtaining software from a vendor necessary to complete certain contracts and our financial difficulties. We expect to recognize the balance of the revenue from the in process OSS contracts during 2002. Sales of OSS systems are not made on a recurring basis to customers, but are the result of extended negotiations that frequently cover many months and do not always result in a contract. In addition, OSS contracts may include conditions precedent, such as the customer obtaining financing or bank approval, and the contracts are not effective until the conditions are satisfied.

Line connection/protection equipment sales for 2000 decreased approximately \$7,790,000 (38%) from \$20,546,000 in 2000 to \$12,756,000 in 2001. The reduced sales level reflected a decrease in volume of sales to United States, United Kingdom and Mexican customers. The results were adversely affected by the general slowdown in the telecommunications industry.

Signal processing revenue for 2001 compared to 2000 decreased by \$1,907,000 (25%) from \$7,644,000 to \$5,737,000. The decrease in sales primarily reflects delays in the receipt of certain anticipated contracts and a general slowdown in the order rate from customers during 2001.

Gross margin decreased from 30% in 2000 to 29% in 2001. The decrease in gross margin is primarily attributed to the lower sales volume in the OSS division causing inefficiency resulting from our inability to absorb our fixed expenses associated with the OSS contracts over our revenue base.

Selling, general and administrative expenses decreased by \$5,257,000 (36%) from \$14,573,000 in 2000 to \$9,316,000 in 2001. The decrease from 2000 to 2001 primarily reflects reduced professional legal expenses and decreased expenses reflecting our reorganization of our sales and marketing efforts of the OSS division.

Research and development expenses decreased by \$1,403,000 (24%) from \$5,830,000 in 2000 to \$4,427,000 in 2001. The decreased expense in 2001 resulted from our efforts to reduce our expenses primarily related to the OSS business.

In December 2001, we determined that \$5,802,000 of goodwill associated with our OSS business unit was impaired, and we recorded an impairment loss in that amount. This assessment was based on the continued decline in sales and losses generated by the business unit over the past several years and the declining prospects for additional sales of the products based on the older

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

technology that originally gave rise to the goodwill. In addition, there are presently no negotiations in progress for the sale of the OSS division.

As a result of the above, we had an operating loss of \$11,453,000 in 2001 versus operating loss of \$5,153,000 in 2000.

Interest expense for 2001 decreased by \$20,000 from \$4,500,000 for 2000 to \$4,480,000 in 2001.

18 of 31

### Results of Operations (continued)

During 2001, we sold our Glen Cove, New York facility for \$1,850,000 and recognized a gain on the sale of \$684,000, net of expenses of \$180,000. Of the net proceeds of \$1,670,000, \$474,000 was used to reduce outstanding principal and \$350,000 to reduce outstanding interest obligations to our senior lender. We retained the remaining proceeds of \$846,000 for working capital purposes.

As of December 31, 2001, we had a net income tax benefit of \$203,000 which is comprised of income tax expense of \$58,000 and benefit of \$261,000. The benefit reflects the reduction of an accrual for potential tax liability to one of our subsidiaries that had previously operated in Puerto Rico as a result of the expiration of the statute of limitations.

As the result of the foregoing, the 2001 net loss was \$14,774,000, \$1.50 per share (basic and diluted), compared with a net loss of \$10,176,000, \$1.04 per share (basic and diluted) for 2000.

Our losses are continuing into 2002, and we cannot give any assurance that we will be able to operate profitably in the future. As a result of the deterioration of our operating revenue resulting from both market conditions and our financial condition, we are evaluating various options, including the sale of one or more of our divisions as well as a reorganization under the Bankruptcy Code.

### Years Ended December 31, 2000 and 1999

Our sales for 2000 were \$51,140,000 compared to \$38,936,000 in 1999, an increase of \$12,204,000 (31%). The increase in revenue is attributed principally to completion of contracts from our OSS division, although all divisions achieved increased revenues in 2000 as compared to 1999.

OSS sales for 2000 were \$22,296,000, compared to 1999 sales of \$14,254,000, an increase of \$8,042,000 (56%). During 2000, OSS sales resulted primarily from the completion of OSS contracts, which were secured during the latter part of 1999. We expect to complete revenue recognition from these OSS contracts in 2001. Sales of OSS systems are not made on a recurring basis to customers, but are the result of extended negotiations that frequently cover many months and do not always result in a contract. In addition, OSS contracts may include conditions precedent, such as the customer obtaining financing or bank approval, and the contracts are not effective until the conditions are satisfied.

Line connection/protection equipment sales for 2000 increased approximately \$2,357,000 (13%) from \$18,189,000 in 1999 to \$20,546,000 in 2000. The improved sales level reflected an increase in volume of sales to United States and Mexican customers, which were offset by a decrease in sales to customers in the United Kingdom.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Signal processing revenue for 2000 compared to 1999 increased by \$1,316,000 (21%) from \$6,328,000 to \$7,644,000. The increase in sales primarily reflects accommodations made to customers where requested delays in deliveries in 1999 of orders were shipped during 2000.

Gross margin increased from 26% in 1999 to 30% in 2000. The increase in gross margin is primarily attributed to the higher sales volume in the OSS division. However, the increase in revenue was still not satisfactory in completely eliminating the inefficiency resulting from our inability to absorb our fixed expenses associated with the OSS contracts over our revenue base. This improvement in gross margin was slightly offset by a lower gross margin in connection/protection products in 2000 compared to 1999 due to changes in product mix.

Selling, general and administrative expenses increased by \$970,000 (7%) from \$13,603,000 in 1999 to \$14,573,000 in 2000. The increase from 1999 to 2000 primarily reflects higher than anticipated professional legal expenses due primarily to litigation involving us, particularly litigation and settlement of a dispute with a vendor.

19 of 31

### Results of Operations (continued)

Research and development expenses decreased by \$260,000 (4%) from \$6,090,000 in 1999 to \$5,830,000 in 2000. The decreased expense in 2000 resulted from the completion during 2000 of certain efforts to develop new products primarily related to the OSS business.

As a result of the above, we had an operating loss of \$5,153,000 in 2000 versus operating loss of \$9,709,000 in 1999. The reduced operating loss for 2000 reflects continued profitability in our line connection/protection equipment and signal processing divisions, and a reduction of the operating loss in our OSS division from \$10,650,000 in 1999 to \$6,201,000 in 2000.

Interest expense for 2000 increased by \$929,000 from \$3,571,000 for 1999 to \$4,500,000 in 2000. This change is attributable primarily to increased levels of borrowing from the Company's senior lender and non cash interest expense associated with the issuance and re-pricing of warrants held by the senior lender and subordinated note holders (See Notes 7 and 9 of Notes to Consolidated Financial Statements).

During 2000, we requested the early termination of our obligations to a number of current and former executive officers regarding the funding of split dollar life insurance policies in order to obtain approximately \$1,200,000 of premiums paid by us into the policies. Due to the early termination, we agreed to forfeit approximately \$600,000 of premiums and terminate our interest in the policies which amount was charged to other expenses during 2000.

As the result of the foregoing, the 2000 net loss was \$10,176,000, \$1.04 per share (basic and diluted), compared with a net loss of \$13,686,000, \$1.44 per share (basic and diluted) for 1999.

### Liquidity and Capital Resources

At December 31, 2001, we had cash and cash equivalents of \$1,204,000 compared with \$2,366,000 at December 31, 2000. Our working capital deficit was \$31,236,000 at December 31, 2001 compared to a working capital deficit of \$24,152,000 at December 31, 2000. The working capital deficit reflects the current liabilities to the senior and subordinated lenders together with the

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

effect of the reduced level of business, which resulted in reduced cash, receivables and inventory. During 2001, we used \$3,779,000 of cash to support our operations. Our principal source of funds during 2001 was borrowings from our senior lender.

As of December 31, 2001, our debt includes \$22,095,000 of senior debt which matured on January 7, 2002, and \$6,144,000 of subordinated debt which became due on July 3, 2001. We were unable to pay the interest payment on the subordinated notes of approximately \$1,358,000 which represents interest from July 2000 through December 2001. At December 31, 2001, we did not have sufficient resources to pay either the senior lender or the subordinated lenders and it is unlikely that we can generate such cash from our operations, and our senior lender has precluded us from making payments on the subordinated debt.

20 of 31

### Liquidity and Capital Resources (continued)

On March 1, 2002, our senior lender and we agreed to an amended and restated loan and security agreement whereby a new term loan was established with a maximum principal amount of \$1,500,000. The agreement allows us to draw monies subject to our senior lender's receipt and approval of a weekly disbursement budget. Obligations under the new term loan shall bear interest at 12%. Secondly, the agreement establishes all indebtedness prior to March 1, 2002 as an old term loan in the amount of \$22,610,000, which includes the balance due at December 31, 2001 plus accrued interest through March 1, 2002. The old term loan shall bear no interest until such time as the senior lender in its sole discretion notifies us that interest shall be payable. Both the new and old term loans expire on December 31, 2002. As part of this agreement, the senior lender continues to preclude us from making any payments on indebtedness to any subordinated creditors except to pay accounts payable in the ordinary course of business. The \$1,500,000 being advanced by our senior lender is being advanced at the discretion of the senior lender and such advances are dependent on, among other things, the perception of the senior lender that we are either stemming our losses or effecting a sale of one or more of our divisions. If the senior lender ceases funding our operations, unless we have obtained alternative financing, we will be unable to continue in business. Furthermore, unless we obtain funding from another source, including the sale of one or more of our divisions, we will not be able to pay our senior lender on December 31, 2002, and we may not be able to continue in business.

As of December 31, 2001, we had remaining outstanding \$382,000 of 6% Debentures, net of original issue discount of \$3,000, which mature July 2, 2002. The face amount of the outstanding 6% Debentures was \$385,000. The interest accrued on the 6% Debentures is payable on July 1 of each year. Due to the restriction imposed by our senior lender precluding us from making any payments on indebtedness to any subordinated debt holder, we were unable to pay the interest due on July 1, 2001. Thus, interest due at December 31, 2001 was \$35,000. Additionally, we have been notified by the trustee that the non-payment of the interest caused an event of default.

As of December 31, 2001, we had outstanding \$6,144,000 of subordinated notes, all of which became due during 2001. We did not have the resources to pay, and we did not pay, either the principal or interest on the subordinated notes and are restricted by our senior lender from making such payments. The holder of a subordinated note in the principal amount of \$500,000 has commenced an action seeking payment of the principal and interest on his note. However, the court recently denied the holder's motion for a summary judgment on the grounds that the terms of the note did not give him permission to obtain a judgment while we remained in default to the senior debt holder.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

As a result of our continuing financial difficulties:

- o we are having and we may continue to have difficulty performing our obligations under our contracts, which could result in the cancellation of contracts or the loss of future business and penalties for non-performance; and
- o a number of creditors, including one holder of our subordinated notes, as discussed above, have engaged attorneys or collection agencies or commenced legal actions against us, and some of them have obtained judgments against us, including a former landlord who has obtained a \$400,000 judgment against us.

The creditors include five former senior executives who have deferred compensation agreements with us. The total payments due under these agreements are approximately \$1.9 million, of which \$46,000 was due at December 31, 2001 and an additional \$100,000 has become due in 2002. Other claimants who have already either commenced litigation or otherwise sought collection or who have obtained judgments against us are due approximately \$600,000. If we are unable to reach a settlement with these creditors and others who have not yet brought claims, and these claimants obtain judgments against us or, in the case of creditors who have already

21 of 31

obtained judgments, if the creditors seek to enforce the judgment, it may be necessary for us, or our senior lender may require us, to seek protection under the Bankruptcy Code.

We are seeking to address our need for liquidity by exploring alternatives, including the possible sale of one or more of our divisions. During 2000 and 2001 we were engaged in discussions with respect to the possible sale of our divisions; however, those negotiations were terminated without an agreement having been reached. Although we are engaged in preliminary discussions with respect to the sale of one of our divisions, we have not signed any agreements with respect to such a sale, and we cannot give any assurance that we will be able to sell any divisions on reasonable terms, if at all. Furthermore, if we sell a division, we anticipate that a substantial portion of the net proceeds will be made to our senior lender and we will not receive any significant amount of working capital from such a sale. During 2001 and early 2002, we have taken steps to reduce overhead and headcount. We will continue to look to reduce costs while we seek additional business from new and existing customers. Our senior lender has precluded us from making any payments on indebtedness to any subordinated creditors. Because of our present stock price, it is highly unlikely that we will be able to raise funds through the sales of our equity securities, and our financial condition prevents us from issuing debt securities. In the event that we are unable to extend our debt obligations and sell one or more of our divisions, we cannot assure you that we will be able to continue in operations. Furthermore, we believe that our losses and our financial position are having and will continue to have an adverse effect upon our ability to develop new business as competitors and potential customers question our ability both to perform our obligations under any agreements we may enter and to continue in business. We have been informally advised by British Telecommunications, which is one of our largest customers that, because of our financial position, it will not place orders with us for OSS products until we can demonstrate that we are financially viable. However, this customer continues to place orders for OSS maintenance and modest orders for line test products. The loss of this customer would have a material adverse effect upon our operations. In addition, our auditors included in their report an explanatory

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

paragraph about our ability to continue as a going concern.

### Item 7A. Quantitative and Qualitative Disclosure About Market Risk.

Although we conduct operations outside of the United States, most of our contracts and sales are dollar denominated. A portion of the revenue from our United Kingdom operations and the majority of our United Kingdom expenses are denominated in Sterling. Any Sterling-denominated receipts are promptly converted into United States dollars. We do not engage in any hedging or other currency transactions. For 2002, the currency translation adjustment was not significant in relation to our total revenue.

### Item 8. Financial Statements and Supplementary Data.

See Exhibit I

### Item 9. Changes In and Disagreements With Accountants On Accounting and Financial Disclosure.

Not Applicable

22 of 31

Part III

### Item 10. Directors and Executive Officers

Set forth below is information concerning our directors:

Name -----	Principal Occupation or Employment -----	Director Since -----
William V. Carney(1)	Chairman of the board and chief executive officer	1970
Michael A. Tancredi	Senior vice president, secretary and treasurer	1970
Warren H. Esanu(1,2)	Of counsel to Esanu Katsky Korins & Siger, LLP, attorneys at law	1997
Herbert H. Feldman(1,2)	President, Alpha Risk Management, Inc., independent risk management consultants	1989
Marco M. Elser	Managing director of Elser & Co., an investment advisory firm	2000

(1) Member of the executive committee.

(2) Member of the audit and compensation committees.

Mr. Carney has been chairman of the board and chief executive officer since October 1996. He was vice chairman from 1988 to October 1996, senior vice president from 1989 to October 1996, chief technical officer since 1990 and secretary from 1977 to October 1996. He also served as senior vice president-mechanical engineering from 1988 to 1989, senior vice president-connector products from 1985 to 1988, senior vice



## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

president-manufacturing from 1984 to 1985 and senior vice president-operations from 1977 to 1984.

Mr. Tancredi has been senior vice president, secretary and treasurer since January 1997. He has been vice president-administration since 1995 and treasurer since 1978, having served as vice president-finance and administration from 1989 to 1995 and vice president-finance from 1984 to 1989.

Mr. Esanu has been a director since April 1997 and also served as a director from 1989 to 1996. He was also our chairman of the board from March 1996 to October 1996. He has been of counsel to Esanu Katsky Korins & Siger, LLP, attorneys at law, for more than the past five years. Mr. Esanu is also a founding partner and chairman of Paul Reed Smith Guitars Limited Partnership (Maryland), a leading manufacturer of premium-priced electrical guitars. He is also a senior officer and director of a number of privately held real estate investment and management companies.

Mr. Elser has been the managing director of Elser & Co., an investment advisory firm more than the past five years. He has also been associated with Northeast Securities, a US-based broker dealer and is responsible for the Italian office, which he founded in 1994.

Mr. Feldman has been president of Alpha Risk Management, Inc., independent risk management consultants, for more than the past five years.

23 of 31

Set forth is information concerning our executive officers:

Name of Executive Officer -----	Position -----	Age ---
William V. Carney	Chairman of the board and chief executive officer	65
Michael A. Tancredi	Senior vice president, secretary and treasurer	72
Edward B. Kornfeld	Senior vice president-operations and chief financial officer	58
David L. Rawlings	Senior vice president	58

All of our officers serve at the pleasure of the board of directors. Messrs. Carney and Tancredi are also members of the board of directors as stated above. There is no family relationship between any of the executive officers listed below.

Mr. Kornfeld, 58, has been senior vice president-operations since 1996 and chief financial officer since October 1995. He was vice president-finance from October 1995 until 1996. For more than five years prior thereto, Mr. Kornfeld held positions with several companies for more than five years, including Excel Technology Inc. (Quantronix Corp.) and Anorad Corporation.

Mr. Rawlings, 58, has been vice president since March 1996. Mr. Rawlings was assistant vice president of research and development-copper products from 1992 until March 1996.

Item 11. Executive Compensation

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

The following table shows the compensation we paid to our chief executive officer and the four most highly compensated executive officers, other than the chief executive officer, whose salary and bonus earned exceeded \$100,000 for the year ended December 31, 2001.

24 of 31

### SUMMARY COMPENSATION TABLE

Name and Principal Position -----	Year ----	Annual Compensation -----		Long-Term Compensation -----  (Awards)	Restricted Stock Awards (Dollars) -----	Op (N --
		Salary -----	Bonus -----	-----		
William V. Carney, Chairman of the board and chief executive officer	2001	\$240,000	--	--		
	2000	240,000	--	--		
	1999	240,000	--	--		
Edward B. Kornfeld, Senior vice president - operations and chief financial officer	2001	192,000	--	--		
	2000	192,000	--	--		
	1999	192,000	--	--		
David Rawlings, Senior vice president, connector division	2001	146,750	--	--		
	2000	142,000	--	--		1
	1999	131,119	--	--		
Prem Chandran, Senior vice president, signal division	2001	135,750	--	--		
	2000	131,000	--	--		1
	1999	120,119	--	--		

25 of 31

In 2002, Mr. Chandran resigned as an officer.

"All Other Compensation" includes a payment to the executive's account pursuant to our 401(k) Plan, premiums paid with respect to the equity split dollar program (in 2000 and 1999), group life insurance in amounts greater than that available to all employees and special long term disability coverage.

Set forth below is a chart that shows, for 2001, the components of "All Other Compensation" listed in the Summary Compensation Table.

	Mr. Carney -----	Mr. Kornfeld -----	Mr. Rawlings -----	Mr. Chandran -----
401(k) Match	\$ 2,550	\$ 2,550	\$ 2,021	\$ 1,856

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Supplemental Insurance	5,431	2,322	2,322	810
------------------------	-------	-------	-------	-----

Certain of our officers named in the summary compensation table or their affiliates are parties to employment or other agreements providing for compensation during and after their employment.

**Employment Agreements.** We have entered into employment agreements with Messrs. Carney and Kornfeld. The agreements continue on a year-to-year basis, for January 1 of each year, unless terminated on prior notice of not less than 120 days for Mr. Carney and 90 days for Mr. Kornfeld. Salary is determined by the board, except that the salary may not be reduced except as a part of a salary reduction program applicable to all executive officers. Upon death or termination of employment as a result of a disability, the officer or his estate is to receive a payment equal to three months salary. Upon a termination without cause, Mr. Carney is entitled to receive his then current salary for 36 months, and Mr. Kornfeld is entitled to receive his then current salary for six months plus one month for each full year of service up to a maximum aggregate of 24 months. In the event that an executive is covered by an executive severance agreement, including the salary continuation agreements (as described below), which provides for payments upon termination subsequent to a "change of control," the executive would be entitled to the greater of the severance arrangements as described in this paragraph or the severance payments under the executive severance agreements.

**Salary Continuation Agreements.** We are party to salary continuation agreements with Messrs. Carney and Kornfeld. The salary continuation agreements provide that, in the event that a change of control occurs and the executive's employment with us is subsequently terminated by us other than for cause, death or disability, or is terminated by the executive as a result of a substantial alteration in the executive's duties, compensation or other benefits, the executive shall be entitled to the payment of an amount equal to his monthly salary at the rate in effect as of the date of his termination (or, if higher, as in effect immediately prior to the change in control) plus the pro rata monthly amount of his most recent annual bonus paid immediately before the change of control multiplied by 36 in the case of Mr. Carney and 24 in the case of Mr. Kornfeld. For purposes of the salary continuation agreements, a change of control is defined as one which would be required to be reported in response to the proxy rules under the Securities Exchange Act of 1934, as amended, the acquisition of beneficial ownership, directly or indirectly, by a person or group of persons of our securities representing 25% or more of the combined voting power of our then outstanding securities, or, during any period of two consecutive years, if individuals who at the beginning of such period constituted the board cease for any reason to constitute at least a majority thereof unless the election of each new director was nominated or ratified by at least two-thirds of the directors then still in office who were directors at the beginning of the period. The change of control must occur during the term of the salary continuation agreement, which in each case is currently through December 31, 2001 and is renewed automatically unless we give timely notice prior to January 1 of any year of our election not to renew the agreement. If such a change of control occurs during the effectiveness of the salary continuation agreement, any termination of such covered employee during the 18 months following the change of control will result in the payment of the compensation described above.

26 of 31

### Item 12. Principal Holders of Securities and Security Holdings of Management

The following table and discussion provides information as to the shares of common stock beneficially owned on March 15, 2002 by:

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

- o each director;
- o each officer named in the summary compensation table;
- o each person owning of record or known by us, based on information provided to us by the persons named below, to own beneficially at least 5% of our common stock; and
- o all officers and directors as a group.

Name -----	Shares of Common Stock Beneficially Owned -----	Percentage of Outstanding Common Stock -----
William V. Carney	303,021	3.0%
Michael A. Tancredi	114,238	1.1%
Warren H. Esanu	116,500	1.1%
Herbert H. Feldman	71,000	*
Marco M. Elser	360,324	3.6%
Edward B. Kornfeld	114,317	1.1%
David Rawlings	27,820	*
Prem Chandran	25,240	*
All directors and officers as a group (12 individuals)	1,216,906	12.2%

-----  
\* Less than 1%

The shares for all officers and directors as a group do not include shares owned by Mr. Chandran, who is no longer an officer.

Except as otherwise indicated each person has the sole power to vote and dispose of all shares of common stock listed opposite his name.

The number of shares owned by our directors and officers named in the summary compensation table includes shares of common stock which are issuable upon exercise of options and warrants that are exercisable at March 15, 2002 or will become exercisable within 60 days after that date. Set forth below is the number of shares of common stock issuable upon exercise of those options and warrants for each of these directors and officers.

Name -----	Shares -----
William V. Carney	180,000
Michael A. Tancredi	75,000
Warren H. Esanu	61,500
Herbert H. Feldman	51,000
Marco M. Elser	5,000
Edward B. Kornfeld	88,000
David Rawlings	27,820
Prem Chandran	25,240
All officers and directors as a group	564,325

27 of 31

The shares of common stock issuable upon exercise of Mr. Esanu's options and warrants include warrants to purchase 12,500 shares of common stock issuable upon warrants held by Elmira Realty Management Corp. pension and profit sharing plan. Mr. Esanu has the sole voting and dispositive power with respect to shares issuable upon exercise of these warrants. All other directors and officers named in the table hold only options.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

### Item 13. Certain Relationships and Related Transactions

During 2001, Warren H. Esanu, a director, served as a member of our audit and compensation committees. During 2001, the law firm of Esanu Katsky Korins & Siger, LLP, to which Mr. Esanu is of counsel, provided legal services to us, for which it received fees of \$486,220. Esanu Katsky Korins & Siger, LLP is continuing to render legal services to us during 2002.

### Part IV

### Item 14. Exhibits, Financial Statements Schedules and Reports on Form 8-K.

(a) Document filed as part of this Annual Report on Form 10-K:

(i) Financial Statements.

See Index to Consolidated Financial Statements under Item 8 hereof.

(ii) Financial Statement Schedules.

None

Schedules not listed above have been omitted for the reasons that they were inapplicable or not required or the information is given elsewhere in the financial statements.

Separate financial statements of the registrant have been omitted since restricted net assets of the consolidated subsidiaries do not exceed 25% of consolidated net assets.

(b) Reports on Form 8-K

None.

28 of 31

(c) Exhibits

Exhibit No.	Description of Exhibit
-----	-----
3.1	Certificate of Incorporation of the Company, as amended to date, incorporated by reference to Exhibit 4 (a) of the Company's Annual Report on Form 10-K for the year ended December 31, 1991.
3.2	Certificate of Designation of Series B Participating Convertible Preferred Stock, incorporated by reference to Exhibit 3.2 of the Company's Annual Report on Form 10-K for the year ended December 31, 1995.
3.3	By-laws of the Company, as amended to date, incorporated by reference to Exhibit 3.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 1995.
4.1	Amended and Restated Loan and Security Agreement dated as of November 28, 1994, between the Company and Foothill ("Foothill") Capital Corporation, incorporated by reference to Exhibit 2 to the Company's Current Report on Form 8-K dated November 30, 1994.
4.2	Amendment Number One dated February 13, 1995 to the Amended and

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Restated Loan and Security Agreement dated as of November 28, 1994 between the Company and Foothill, incorporated by reference to Exhibit 4.7 of the Company's Annual Report on Form 10K for the year ended December 31, 1995.

- 4.3 Amendment Number Two dated March 30, 1995 to the Amended and Restated Loan and Security Agreement dated as of November 28, 1994 between the Company and Foothill, incorporated by reference to Exhibit 4.7.2 of the Company's Annual Report on Form 10K for the year ended December 31, 1995.
- 4.4 Amended and Restated Secured Promissory Note dated February 13, 1995, incorporated by reference to Exhibit 4.9 of the Company's Annual Report on Form 10K for the year ended December 31, 1995.
- 4.5 Amendment Number Three to Amended and Restated Loan and Security Agreement dated March 12, 1996, between the Company and Foothill, incorporated by reference to Exhibit 4.11 of the Company's Annual Report on Form 10K for the year ended December 31, 1995.
- 4.6 Warrant to Purchase Common Stock of the Company dated November 28, 1994 executed by the Company in favor of Foothill, incorporated by reference to Exhibit 6 to the Company's Current Report on Form 8-K dated November 30, 1994.
- 4.7 Lockbox Operating Procedural Agreement dated as of November 28, 1994 among Chemical Bank, the Company and Foothill, incorporated by reference to Exhibit 7 to the Company's Current Report on Form 8-K dated November 30, 1994.

29 of 31

### Exhibits (continued)

Exhibit No.	Description of Exhibit
4.8	Combined Amendment No. Four dated as of March 1, 2002 to Amended and Restated Loan and Security agreement between Foothill and the Company.
10.1	Form of Executive Salary Continuation Agreement, incorporated by reference to Exhibit 19 (cc) of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1985.
10.2	Lease dated December 17, 1990 between the Company and LBA properties, Inc., incorporated by reference to Exhibit 10 (d) of the Company's annual report on Form 10-K for the year ended December 31, 1990.
10.3	Employee Stock Bonus Program filed as Exhibit 4.3 to the Form S-8 dated February 12, 1999 and incorporated herein by reference.
10.4	1999 Stock Option Plan filed as Exhibit A to the Proxy Statement for the 1999 Annual Meeting to Stockholders and incorporated herein by reference.
10.5	1996 Stock Option Plan filed as Exhibit A to the Proxy Statement for the 1996 Annual Meeting to Stockholders and incorporated herein by reference.

**Edgar Filing: PORTA SYSTEMS CORP - Form 10-K**

- 10.6      1998 Stock Option Plan filed as Exhibit 4.2 to the Form S-8 dated December 3, 1998 and incorporated herein by reference.
- 10.7      Senior Officers and Directors Stock Purchase Program filed as Exhibit 4.2 to the Form S-8 dated February 12, 1999 and incorporated herein by reference.
- 10.8      Employee Stock Purchase Plan filed as Exhibit 4.1 to the Form S-8 dated February 12, 1999 and incorporated herein by reference.
- 22        Subsidiaries of the Company, incorporated by reference to Exhibit 22.1 of the Company's Annual Report on Form 10K for the year ended December 31, 1995.
- 23        Consent of Independent Auditors.

30 of 31

SIGNATURES

Pursuant to the requirements of Section 13 or 15(b) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PORTA SYSTEMS CORP.

Dated April 12, 2002

By /s/ William V. Carney

-----  
William V. Carney  
Chairman of the Board and  
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated. Each person whose signature appears below hereby authorizes William V. Carney and Edward B. Kornfeld or either of them acting in the absence of the others, as his true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution for him and in his name, place and stead, in any and all capacities to sign any and all amendments to this report, and to file the same, with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission.

Signature	Title	Date
/s/ William V. Carney ----- William V. Carney	Chairman of the Board, Chief Executive Officer and Director (Principal Executive Officer)	April 1
/s/ Edward B. Kornfeld ----- Edward B. Kornfeld	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	April 1
_____ Warren H. Esanu	Director	April 1

Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

/s/ Michael A. Tancredi ----- Michael A. Tancredi	Director	April 1
/s/ Herbert H. Feldman ----- Herbert H. Feldman	Director	April 1
/s/ Marco Elser ----- Marco Elser	Director	April 1

31 of 31

Exhibit I

Item 8. Financial Statements and Supplementary Data

Index	Page
Report of Independent Certified Public Accountants	F-2
Consolidated Financial Statements and Notes:	
Consolidated Balance Sheets, December 31, 2001 and 2000	F-3
Consolidated Statements of Operations and Comprehensive Loss, Years Ended December 31, 2001, 2000 and 1999	F-4
Consolidated Statements of Stockholders' Equity (Deficit), Years Ended December 31, 2001, 2000 and 1999	F-5
Consolidated Statements of Cash Flows for the Years Ended December 31, 2001, 2000 and 1999	F-6
Notes to Consolidated Financial Statements	F-7

F-1

Report of Independent Certified Public Accountants

The Board of Directors and  
Stockholders of Porta Systems Corp.  
Syosset, New York

We have audited the accompanying consolidated balance sheets of Porta Systems Corp. and subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of operations and comprehensive loss, stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.



Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Porta Systems Corp. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has suffered substantial losses from operations in 2001, 2000 and 1999 and, as of December 31, 2001, has a stockholders' deficit of \$25,849,000 and a working capital deficit of \$31,236,000. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ BDO SEIDMAN, LLP  
-----  
BDO SEIDMAN, LLP

Melville, New York  
March 15, 2002

F-2

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
Consolidated Balance Sheets  
December 31, 2001 and 2000  
(in thousands, except shares and par value)

Assets  
-----

Current assets:

Cash and cash equivalents  
Accounts receivable - trade, less allowance for doubtful  
accounts of \$2,168 in 2001 and \$2,477 in 2000  
Inventories  
Prepaid expenses and other current assets

Total current assets

Property, plant and equipment, net  
Goodwill, net of amortization of \$1,501 in 2001 and \$5,003 in 2000  
Other assets

Total assets

Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Liabilities and Stockholders' Deficit

Current liabilities:

Senior debt  
Subordinated notes  
6% Convertible subordinated debentures  
Accounts payable  
Accrued expenses  
Accrued interest payable  
Accrued commissions  
Accrued deferred compensation  
Income taxes payable  
Short-term loans

Total current liabilities

6% Convertible subordinated debentures  
Deferred compensation  
Income taxes payable  
Other long-term liabilities  
Minority interest

Total long-term liabilities

Total liabilities

Commitments and contingencies

Stockholders' deficit:

Preferred stock, no par value; authorized 1,000,000 shares, none issued  
Common stock, par value \$.01; authorized 20,000,000 shares,  
issued 9,947,421 and 9,817,165 shares in 2001 and 2000, respectively  
Additional paid-in capital  
Accumulated deficit  
Accumulated other comprehensive loss:  
Foreign currency translation adjustment

Treasury stock, at cost, 30,940 shares

Total stockholders' deficit

Total liabilities and stockholders' deficit

See accompanying notes to consolidated financial statements.

F-3

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
Consolidated Statements of Operations and  
Comprehensive Loss Years ended December  
31, 2001, 2000 and 1999  
(in thousands, except per share amounts)

Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

	2001 -----
Sales	\$ 28,062
Cost of sales	19,970 -----
Gross profit	8,092 -----
Selling, general and administrative expenses	9,316
Research and development expenses	4,427
Goodwill impairment	5,802 -----
Total expenses	19,545 -----
Operating loss	(11,453)
Interest expense	(4,480)
Interest income	31
Gain on sale of assets	684
Other income (expense), net	191 -----
Loss before income taxes, equity in net loss of joint venture and minority interest	(15,027)
Income tax benefit (expense)	203
Equity in net loss of joint venture	(175)
Minority interest	225 -----
Net loss	\$ (14,774) =====
Other comprehensive income (loss):	
Foreign currency translation adjustments	(360) -----
Comprehensive loss	\$ (15,134) =====
Basic per share amounts:	
Net loss per share of common stock	\$ (1.50) =====
Weighted average shares of common stock outstanding	9,878 =====
Diluted per share amounts:	
Net loss per share of common stock	\$ (1.50) =====
Weighted average shares of common stock outstanding	9,878

=====

See accompanying notes to consolidated financial statements.

F-4

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
 Consolidated Statements of Stockholders' Equity (Deficit)  
 Years ended December 31, 2001, 2000 and 1999  
 (In thousands)

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive	Accumulated Deficit
	No. of Shares	Par Value Amount		(Loss)	
Balance at December 31, 1998	9,485	\$95	\$75,135	\$ (3,754)	\$ (57,273)
Net loss 1999	--	--	--	--	(13,686)
Common stock issued	154	1	119	--	--
Warrants re-priced	--	--	56	--	--
Collection of receivable from directors and officers under stock purchase program	--	--	--	--	--
Foreign currency translation adjustment	--	--	--	(142)	--
Balance at December 31, 1999	9,639	96	75,310	(3,896)	(70,959)
Net loss 2000	--	--	--	--	(10,176)
Common stock issued	178	2	174	--	--
Warrants issued or re-priced	--	--	496	--	--
Foreign currency translation adjustment	--	--	--	99	--
Balance at December 31, 2000	9,817	98	75,980	(3,797)	(81,135)
Net loss 2001	--	--	--	--	(14,774)
Common stock issued	130	1	37	--	--
Warrants re-priced	--	--	39	--	--
Foreign currency translation adjustment	--	--	--	(360)	--
Balance at December 31, 2001	9,947	\$99	\$76,056	\$ (4,157)	\$ (95,909)

See accompanying notes to consolidated financial statements

F-5

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
 Consolidated Statements of Cash Flows (Note 22)  
 Years ended December 31, 2001, 2000 and 1999  
 (In thousands)

	2001
	-----
Cash flows from operating activities:	
Net loss	\$ (14,774)
Adjustments to reconcile net loss to net cash used in operating activities:	
Non-cash financing expenses	123
Gain on sale of assets	(684)
Non-cash compensation expense	--
Depreciation and amortization	1,909
Goodwill impairment	5,802
Amortization of debt discounts	6
Minority interest	(225)
Equity in loss of joint venture	175
Changes in operating assets and liabilities:	
Accounts receivable	3,141
Inventories	1,944
Prepaid expenses	278
Other assets	867
Accounts payable, accrued expenses and other liabilities	(2,341)
	-----
Net cash used in operating activities	(3,779)
	-----
Cash flows from investing activities:	
Repayment of receivables from stock purchase program	--
Net proceeds from the sale of assets	1,670
Capital expenditures, net	(196)
	-----
Net cash provided by (used in) investing activities	1,474
	-----
Cash flows from financing activities:	
Proceeds from senior debt	2,222
Repayments of senior debt	(873)
Proceeds from subordinated debentures and warrants	--
Proceeds from the exercise of options and warrants	38
Proceeds (repayments) of notes payable/short-term loans	10
	-----
Net cash provided by financing activities	1,397
	-----
Effect of exchange rate changes on cash	(254)
	-----
Increase (decrease) in cash and cash equivalents	(1,162)
Cash and equivalents - beginning of year	2,366
	-----
Cash and equivalents - end of year	\$ 1,204
	=====

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

See accompanying notes to consolidated financial statements.

F-6

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements  
December 31, 2001 and 2000

### (1) Summary of Significant Accounting Policies

#### Nature of Operations and Principles of Consolidation

Porta Systems Corp. ("Porta" or the "Company") designs, manufactures and markets systems for the connection, protection, testing and administration of public and private telecommunications lines and networks. The Company has various patents for copper and software based products and systems that support voice, data, image and video transmission. Porta's principal customers are the U.S. regional telephone operating companies and foreign telephone companies.

The accompanying consolidated financial statements include the accounts of Porta and its majority-owned or controlled subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

#### Revenue Recognition

Revenue, other than from long-term contracts for specialized products, is recognized when a product is shipped. Revenues and earnings relating to long-term contracts for specialized products are recognized on the percentage-of-completion basis primarily measured by the attainment of milestones. Anticipated losses, if any, are recognized in the period in which they are identified.

#### Concentration of Credit Risk

Financial instruments, which potentially subject Porta to concentrations of credit risk, consist principally of cash and accounts receivable. At times such cash in banks exceeds the FDIC insurance limit.

As discussed in notes 18 and 23, substantial portions of Porta's sales are to customers in foreign countries. The Company's credit risk with respect to new foreign customers is reduced by obtaining letters of credit for a substantial portion of the contract price, and by monitoring credit exposure related to each customer.

#### Cash Equivalents

The Company considers investments with original maturities of three months or less at the time of purchase to be cash equivalents. Cash equivalents consist of commercial paper.

#### Inventories

Inventories are stated at the lower of cost (on the average or first-in, first-out methods) or market.

#### Property, Plant and Equipment

Property, plant and equipment are carried at cost. Leasehold improvements

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

are amortized over the term of the lease. Depreciation is computed using the straight-line method over the related assets' estimated lives.

(Continued)

F-7

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

#### Deferred Computer Software

Software costs incurred for specific customer contracts are charged to cost of sales at the time revenues on such contracts are recognized. Software development costs relating to products the Company offers for sale are deferred in accordance with Statement of Financial Accounting Standards (SFAS) No. 86 "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed." These costs are amortized to cost of sales over the periods that the related product will be sold, up to a maximum of four years. Amortization of computer software costs, which all relate to products the Company offers for sale, amounted to approximately \$0, \$0, and \$82,000 in 2001, 2000 and 1999, respectively.

#### Goodwill

Goodwill represents the difference between the purchase price and the fair market value of net assets acquired in business combinations treated as purchases. Goodwill is amortized on a straight-line basis over the estimated useful life as determined by events and circumstances of the business combination that gave rise to the goodwill. The Company assesses the recoverability of unamortized goodwill using the undiscounted projected future cash flows from the related businesses (note 6).

#### Income Taxes

Deferred income taxes are recognized based on the differences between the tax bases of assets and liabilities and their reported amounts in the financial statements that will result in taxable or deductible amounts in future years. Further, the effects of tax law or rate changes are included in income as part of deferred tax expense or benefit for the period that includes the enactment date (note 15).

#### Foreign Currency Translation

Assets and liabilities of foreign subsidiaries are translated at year-end rates of exchange, and revenues and expenses are translated at the average rates of exchange for the year. Gains and losses resulting from translation are accumulated in a separate component of stockholders' equity. Gains and losses resulting from foreign currency transactions (transactions denominated in a currency other than the functional currency) are included in comprehensive income or loss.

#### Net Loss Per Share

Basic net loss per share is based on the weighted average number of shares outstanding. Diluted net loss per share is based on the weighted average number of shares outstanding plus the dilutive effect of potential shares of common stock, as if such shares had been issued. For 2001, 2000 and 1999, no dilutive potential shares of common stock were added to compute diluted loss per share because the effect was anti-dilutive.

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements, Continued

Reclassifications

Certain reclassifications have been made to conform prior years' consolidated financial statements to the 2001 presentation.

Accounting for Stock-Based Compensation

The Company follows the Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation". Porta has elected not to implement the fair value based accounting method for employee stock options, but has elected to disclose the pro-forma net income and earnings per share as if such method had been used to account for stock-based compensation cost as described in the Statement.

Accounting for the Impairment of Long-Lived Assets

The Company follows the Statement of Financial Accounting Standard No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of". Porta believes that there is no impairment of its long-lived assets except for goodwill as discussed in note 6.

Use of Estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these consolidated financial statements are the estimated allowance for doubtful accounts receivable, inventory reserves, percentage of completion for long-term contracts, goodwill valuation and the deferred tax asset valuation allowance. Actual results could differ from those and other estimates.

New Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets" effective for fiscal years beginning after December 15, 2001. It also issued SFAS No. 143, "Accounting for Obligations Associated with the Retirement of Long-Lived Assets" in August 2001 and SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" in October 2001.

SFAS141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interests method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that the Company recognize acquired intangible assets apart from goodwill if the acquired intangible assets meet certain criteria. SFAS 141 applies to all business combinations initiated after June 30, 2001 and for purchase



## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

business combinations completed on or after July 1, 2001. It also requires, upon adoption of SFAS 142, that the Company reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

(Continued)

F-9

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

SFAS142 requires, among other things, that companies no longer amortize goodwill, but instead, test goodwill for impairment at least annually. In addition, SFAS 142 requires that the Company identify reporting units for the purposes of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets, and cease amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life should be tested for impairment in accordance with the guidance in SFAS 142. SFAS 142 is required to be applied in fiscal years beginning after December 15, 2001 to all goodwill and other intangible assets recognized at that date, regardless of when those assets were initially recognized. SFAS 142 requires the Company to complete a transitional goodwill impairment test six months from the date of adoption. The Company is also required to reassess the useful lives of other intangible assets within the first interim quarter after adoption of SFAS 142. The Company's previous business combinations were accounted for using the purchase method. As of December 31, 2001, the net carrying amount of goodwill is \$3,761,000. Currently, the Company is assessing, but has not yet determined, how the adoption of SFAS 141 and SFAS 142 will impact its financial position and results of operations.

SFAS143 establishes standards for the reporting of obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It also provides accounting guidance for legal obligations associated with the retirement of tangible long-lived assets. SFAS 143 is effective for fiscal years beginning after June 15, 2002 with early adoption permitted. The Company expects that the provisions of SFAS 143 will not have a material effect on its consolidated results of operations.

SFAS144 establishes a single accounting model for the impairment or disposal of long-lived assets and new standards for reporting discontinued operations. The provisions of SFAS 144 are effective in fiscal years beginning after December 15, 2001 and in general are to be applied prospectively. The Company is currently evaluating the provisions of SFAS 144 but does not expect they will have a material effect on its consolidated results of operations upon adoption.

#### (2) Liquidity

As of December 31, 2001, Porta's debt included \$22,095,000 of senior debt, which matured on January 7, 2002, and \$6,144,000 of subordinated debt, which matured on July 3, 2001. The Company was unable to pay the principal (\$6,144,000) or interest (\$1,358,000) on the subordinated notes. The amount of interest represents interest from July 2000 through December 2001. At December 31, 2001, the Company did not have sufficient resources to pay either the senior lender or the subordinated lenders and it is likely that it cannot generate such cash from its operations, and the

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

senior lender had precluded the Company from making payments on the subordinated debt.

(Continued)

F-10

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

On March 1, 2002, the Company and its senior lender agreed to an amended and restated loan and security agreement whereby a new term loan was established with a maximum principal amount of \$1,500,000. The agreement allows the Company to draw monies subject to the senior lender's receipt and approval of a weekly disbursement budget. However, the advances are at the discretion of the senior lender. Obligations under the new term loan bear interest at 12% per annum. The amended agreement establishes all indebtedness prior to March 1, 2002 as an old term loan in the amount of \$22,610,000, which includes the balance due at December 31, 2001 plus accrued interest through March 1, 2002. The old term loan shall bear no interest until such time as the senior lender in its sole discretion notifies the Company that interest shall be payable. Both the new and old term loans are payable on December 31, 2002. As part of this agreement, the senior lender continues to preclude the Company from making any payments on indebtedness to any subordinated creditors, but the Company is not prohibited from paying accounts payable in the normal course of business. The agreement also requires the Company to diligently pursue the sale of one or more of its divisions and pay the net proceeds from such sale to the senior lender, which may not leave the Company with sufficient capital for its operations.

The \$1,500,000 being advanced by the Company's senior lender is being advanced at the discretion of the senior lender and such advances are dependent on, among other things, the perception of the senior lender that the Company is either stemming its losses or effecting a sale of one or more of its divisions. If the senior lender ceases funding Porta's operations, unless it has obtained alternative financing, the Company will be unable to continue in business. Furthermore, unless the Company obtains funding from another source, including the sale of one or more of its divisions, Porta will not be able to pay its senior lender on December 31, 2002, and Porta may not be able to continue in business.

As of December 31, 2001, the Company had remaining outstanding \$382,000 of 6% Debentures, net of original issue discount of \$3,000, which mature July 2, 2002. The face amount of the outstanding 6% Debentures was \$385,000. The interest accrued on the 6% Debentures is payable on July 1 of each year. Due to the restriction imposed by the Company's senior lender precluding it from making any payments on indebtedness to any subordinated debt holder, the Company was unable to pay the interest due on July 1, 2001. Thus, interest due at December 31, 2001 was \$35,000. Additionally, the trustee has notified the Company that the non-payment of the interest caused an event of default.

As of December 31, 2001, the Company had outstanding \$6,144,000 of subordinated notes, all of which became due during 2001. The Company did not have the resources to pay, and it did not pay, either the principal or interest on the subordinated notes and is restricted by its senior lender from making such payments. The holder of a subordinated note in the principal amount of \$500,000 has commenced an action seeking payment of the principal and interest on his note. However, the court recently denied

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

the holder's motion for a summary judgment on the grounds that the terms of the note did not give him permission to obtain a judgment while the Company remained in default to the senior debt holder.

(Continued)

F-11

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

As a result of its continuing financial difficulties:

- o the Company is having and may continue to have difficulty performing its obligations under its contracts, which could result in the cancellation of contracts or the loss of future business and penalties for non-performance; and
- o a number of creditors, including one holder of Porta's subordinated notes, as discussed above, have engaged attorneys or collection agencies or commenced legal actions against the Company, and some of them have obtained judgments against the Company, including a former landlord who has obtained a \$400,000 judgment against the Company.

The creditors include five former senior executives who have deferred compensation agreements with the Company. The total payments due under these agreements are approximately \$1.9 million, of which \$46,000 was due at December 31, 2001 and an additional \$100,000 has become due in 2002. Other claimants who have already either commenced litigation or otherwise sought collection or have obtained a judgment against the Company are due approximately \$600,000. If Porta is unable to reach a settlement with these creditors and others who have not yet brought claims, and these claimants obtain judgments against the Company or seek to enforce judgments against the Company, it may be necessary for it, or its senior lender may require it, to seek protection under the Bankruptcy Code.

The Company is seeking to address its need for liquidity by exploring alternatives, including the possible sale of one or more of its divisions. During 2000 and 2001, the Company was engaged in discussions with respect to the possible sale of its divisions; however, those negotiations were terminated without an agreement having been reached. Although the Company is engaged in preliminary discussions with respect to a sale of one of its divisions, the Company has not signed any agreements with respect to such a sale, and it may not be able to sell any of its divisions on reasonable terms. Furthermore, if the Company sells a division, the agreement with the Company's senior lender requires it to pay the net proceeds to the senior lender. As a result of this provision and the Company's obligations to the holders of subordinated debt, unless the lenders consent to the Company retaining a portion of the net proceeds from any sale for its operations, the Company will not receive any significant amount, and may not receive any of the net proceeds from any such sale for working capital. During 2001 and early 2002, the Company has taken steps to reduce overhead and headcount. The Company will continue to look to reduce costs while it seeks additional business from new and existing customers. Because of its present stock price, it is highly unlikely that the Company will be able to raise funds through the sales of its equity securities, and Porta's financial condition prevents it from issuing debt securities. In the event that the Company is unable to extend its debt obligations and sell one or more of its divisions, it cannot be assured that the Company will be able to continue in operations. Furthermore, the Company believes that its losses and its financial position are having and will continue to

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

have an adverse effect upon its ability to develop new business as competitors and potential customers question its ability both to perform its obligations under any agreements it may enter and to continue in business. The Company has been informally advised by British Telecommunications, which is one of its largest customers that, because of Porta's financial position, this customer will not place orders with the Company for its OSS products until it can demonstrate that it is financially viable. However, this customer continues to place orders for OSS maintenance and modest orders for line test products. The loss of this customer would have a material adverse effect upon the Company's operations.

F-12

These financial statements have been prepared assuming that the Company will continue as a going concern and, accordingly, do not include any adjustments that might result from the outcome of the uncertainties described above.

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements, Continued

(3) Accounts Receivable

Accounts receivable included approximately \$500,000 and \$0 at December 31, 2001 and 2000, respectively, of revenues earned but not yet contractually billable relating to long-term contracts for specialized products. All such amounts at December 31, 2001 are expected to be billed in 2002. In addition, accounts receivable included approximately \$311,000 and \$1,197,000 at December 31, 2001 and 2000, respectively, of retainage balances due on various long-term contracts. All such amounts, net of reserves, at December 31, 2001 are expected to be collected in 2002 and all such amounts, net of reserves, at December 31, 2000, were collected in 2001. The allowance for doubtful accounts receivable was \$2,168,000 and \$2,477,000 as of December 31, 2001 and 2000, respectively. The allowance for doubtful accounts was increased by provisions of \$0, \$730,000, and \$1,070,000 and decreased by write-offs of \$309,000, \$132,000, and \$106,000 for the years ended December 31, 2001, 2000, and 1999, respectively.

(4) Inventories

Inventories consist of the following: December 31,

	2001	2000
	----	----
Parts and components	\$3,217,000	4,973,000
Work-in-process	192,000	543,000
Finished goods	1,797,000	1,634,000
	-----	-----
	\$5,206,000	7,150,000
	=====	=====

(5) Property, Plant and Equipment

Property, plant and equipment consists of the following:

	December 31		
	-----	-----	
	2001	2000	Estimated
	----	----	useful lives
	-----	-----	-----

Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

Land	\$ 132,000	246,000	--
Buildings	1,060,000	2,284,000	30 years
Machinery and equipment	7,221,000	8,870,000	3-10 years
Furniture and fixtures	2,557,000	2,700,000	8 years
Transportation equipment	84,000	133,000	4 years
Tools and molds	4,108,000	4,124,000	8 years
Leasehold improvements	822,000	858,000	Term of lease
	-----	-----	
	15,984,000	19,215,000	
Less accumulated depreciation and amortization	13,656,000	14,660,000	
	-----	-----	
	\$2,328,000	4,555,000	
	=====	=====	

During 2001, the Company sold its Glen Cove, New York facility for \$1,850,000 and recognized a gain on the sale of \$684,000, net of expenses of \$180,000. Of the net proceeds of \$1,670,000, \$474,000 was used to reduce outstanding principal and \$350,000 to reduce outstanding interest obligations to the Company's senior lender. The Company retained the remaining proceeds of \$846,000 for working capital purposes.

(Continued)

F-13

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements, Continued

(6) Goodwill

As of December 31, 2001 and 2000, unamortized goodwill was \$3,761,000 and \$10,357,000, respectively. In December 2001, the Company determined that \$5,802,000 of goodwill associated with its OSS business unit was impaired and as such recorded an impairment loss. This assessment was based on the continued decline in sales and losses generated by the business unit over the past several years and the declining prospects for additional sales of the products based on the older technology that originally gave rise to the goodwill. Additionally, there are presently no ongoing negotiations regarding the sale of the OSS division.

During 2000 and 1999, in view of recent competitive developments in the telecommunications market place and Porta's changing business model in response, management reassessed the useful life of certain of its goodwill. At that time, in management's opinion, there was no impairment in the carrying value of this long-lived intangible asset (based upon an analysis of undiscounted future cash flows), and management determined that the useful life of the goodwill should be shortened to be more reflective of the current rate of technology change and competitive conditions. Accordingly, management changed the estimated useful life of certain goodwill from an original life of 40 years to a remaining life of 13 years in 1999 and 10 years in 2000, which changes were applied prospectively from the fourth quarters of 1999 and 2000. These changes in accounting estimate increased amortization expense in 2000 and in 1999 by approximately \$25,000 and \$58,000, respectively.

Goodwill associated with one of Porta's other business units of \$3,761,000 is amortized on a straight-line basis over a remaining life of 29 years. The Company has determined that there is no impairment of this asset.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

### (7) Senior Debt

On December 31, 2001 and 2000, Porta's senior debt consisted of debt under its credit facility in the amount of \$22,095,000 and \$20,596,000, respectively, and a non-interest bearing deferred funding fee note payable to the senior lender in the amounts of \$0 and \$150,000, respectively. As of December 31, 2001, the total outstanding principal balance was due on January 7, 2002, and has been classified as a current liability. (See Note 2)

(Continued)

F-14

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

During 2000, the Company and its senior lender agreed to extend the loan and security agreement to July 3, 2001. As part of the agreement, Porta agreed to reduce the exercise price of outstanding warrants to purchase 471,000 shares of common stock held by its senior lender to \$2.00 per share. The value of the reduction of the warrant price was \$169,000 which was recorded as deferred financing expense and additional paid in capital in 2000. In addition, during 2000, the Company and its senior lender agreed to increase the revolving line maximum by \$2,000,000 from \$9,000,000 to \$11,000,000 through January 1, 2001. As of December 31, 2000, the Company had borrowed \$1,160,000 under the increased revolving line. As consideration, the Company issued to its senior lender a five-year warrant to purchase 100,000 shares of common stock at \$2.00 per share. The value of the warrants issued was \$129,000 which was recorded as deferred financing expense and additional paid in capital in 2000. The balance of the facility is comprised of a term loan. The credit facility is secured by substantially all of Porta's assets. All obligations, except undrawn letters of credit, letter of credit guarantees and the deferred fee notes, bear interest at 12%. The Company incurs a fee of 2% per annum on the average balance of letter of credit guarantees outstanding. In connection with the senior lender's waiver of non-compliance during 2000, the Company reduced from \$2.00 per share to \$1.00 per share, the exercise price of warrants to purchase 571,000 shares of common stock which are held by the lender. The value of the reduction in exercise price was \$59,000 and recorded as deferred financing expense and additional paid in capital. Based upon the warrant transactions during 2000, additional non-cash interest expense of \$289,000 was recognized. The agreement also provided for loan principal payments of \$400,000 on the last day of each quarter during the term of the agreement. As part of the agreement, the loan amortization shall first be applied to the non-interest bearing notes payable until these notes are paid in full and then to the term loan. The agreement also requires the Company to pay additional principal payments if its cash flow exceeds certain amounts. A monthly facility fee payment of \$50,000 continuing to the end of the agreement is also required.

On January 2, 2001, Porta did not have the resources to repay the \$1,160,000 of principal due. In March 2001, the senior lender agreed to allow the Company to defer the repayment of borrowings related to the increased maximum, defer all monthly facility fees and the April 1, 2001 principal payment to the earlier of the termination of the agreement of July 3, 2001 or the sale of one or more of the divisions of the Company. The agreement also precluded the Company from making any payments on indebtedness to any subordinated creditors, although it permits payment of accounts payable in the ordinary course of business.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

In April 2001, the Company and its senior lender agreed to add all current and future interest due, which will be computed at 14%, to the principal balance through the loan expiration date. As consideration, the Company agreed to reduce the exercise price of the outstanding warrants to purchase approximately 570,000 shares of common stock held by its senior lender to \$0.25 per share. The value of the reduction in exercise price was \$39,000, which was recorded as interest expense and additional paid in capital.

On the July 3, 2001, the loan expiration date, the Company did not have the resources to repay the loan, at which time the senior lender and the Company executed an extension agreement for approximately a one month period, which extensions continued monthly through February 2002.

(Continued)

F-15

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

Subsequent to December 31, 2001, the senior lender agreed to an amended and restated loan and security agreement whereby a new term loan was established with a maximum principal amount of \$1,500,000. The agreement allows the Company to draw monies subject to the senior lender's receipt and approval of a weekly disbursement budget. Any advances under this agreement are subject to the discretion of the senior lender. Obligations under the new term loan bear interest at 12%, which interest shall accrue monthly and be applied to the principal until September 1, 2002 when interest for the month of August 2002 shall be paid and interest shall continue to be paid each subsequent month. The agreement provides that all indebtedness prior to March 1, 2002 is reflected as an old term loan in the amount of \$22,610,000, which includes the principal balance due at December 31, 2001 plus accrued interest through March 1, 2002. The old term loan bears no interest until such time as the senior lender in its sole discretion notifies the Company that interest shall be payable. Both the new and old term loans are due on December 31, 2002. Additionally, the senior lender has prohibited the Company from making any payments on indebtedness to any subordinated creditors, but the Company is not prohibited from paying accounts payable in the ordinary course of business. Finally, the agreement allows for standby letters of credit not to exceed a maximum of \$573,000.

#### (8) 6% Convertible Subordinated Debentures

As of December 31, 2001 and 2000 Porta had outstanding \$382,000 and \$376,000 of its 6% convertible subordinated debentures due July 1, 2002 (the "Debentures"), net of original issue discount of \$3,000 and \$9,000, respectively. The face amount of the outstanding Debentures was \$385,000 at both December 31, 2001 and 2000. The Debentures are convertible at any time prior to maturity into Common Stock of the Company at a conversion rate of 8.333 shares for each \$1,000 face amount of Debentures, subject to adjustment under certain circumstances. The Company has not paid interest on these Debentures since July 2000, and its senior lender prohibits it from making any payments of principal and interest (note 7). At December 31, 2001 and 2000, accrued interest on the debentures was \$35,000 and \$12,000, respectively. Subsequent to December 31, 2001, the trustee of the Debentures gave notice to the Company that it was in default under the indenture and the Debentures.

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

### (9) Subordinated Notes

As of December 31, 2001 and 2000, \$6,144,000 of Subordinated Notes were outstanding. As of December 31, 2001, \$6,144,000 of principal and \$1,358,000 of accrued interest were due and payable. However, Porta did not have the resources to pay the \$6,144,000 principal and \$1,358,000 of interest due on the subordinated debt. In addition, the senior lender had precluded the Company from making payments on the subordinated debt (note 7). During 2001, one of the noteholders unsuccessfully attempted to obtain a judgment compelling the Company to pay the past due Notes and related interest (note 21).

(Continued)

F-16

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

During December 1999, Porta (a) extended its maturity date of the \$6,000,000 outstanding principal amount of Subordinated Notes to January 3, 2001 with the right to extend the maturity date to July 3, 2001 if Porta achieves certain financial results, (b) increased the interest rate of the Subordinated Notes to 14% per annum during the initial term and to 15% during the extended term, (c) reduced the exercise price of the previously issued Series B and C Warrants to \$1.00 per share, (d) granted the holders of the Subordinated Notes the right to a payment in kind option, whereby the note holder has the right to receive interest in the form of a new subordinated note in the principal amount equal to 125% of the interest then due, with the new subordinated note bearing interest at the rate of 125% of the then current interest rate of the Subordinated Notes, and (e) agreed that, if Porta extends the maturity date of the Subordinated Notes to July 3, 2001, it will issue to the noteholders New Warrants to purchase a total of 300,000 shares of Common Stock at the average closing price of the Common Stock for five trading days preceding January 3, 2001. As a result of the amendment to the Subordinated Notes, Porta recorded a discount of approximately \$56,000 relating to the re-pricing of the warrants and additional interest expense for Noteholders who elected the paid in kind option at December 31, 1999 of approximately \$13,000.

In connection with a further amendment of the Subordinated Notes in April 2000, the Company agreed to issue to the noteholders New Warrants to purchase an aggregate of 127,500 shares of Common Stock at \$3.00 per share, the value of which was determined to be \$140,000 and recorded as deferred financing expenses and additional paid in capital in 2000. Additional non-cash interest expense of \$84,000 was recorded during 2000 in connection with this transaction.

### (10) Joint Venture

The Company has a 50% interest in a joint venture agreement with a Korean partner. Unless otherwise terminated in accordance with the joint venture agreement, the joint venture will terminate on December 31, 2010. The Company's option to acquire an additional 1% interest of the joint venture, for approximately \$190,000 expired during 2001. Prior to October 1, 2001, the Company consolidated the operations of the joint venture since the Company could obtain a controlling interest at its election and the joint venture was entirely dependent on the Company for the products it sells and receives management assistance from the Company. The joint



## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

venture partner's interest is shown as a minority interest through September 30, 2001. Based on the expiration of the option agreement, the reduced volume of products sold to the joint venture and reduced level of management assistance provided to the joint venture, Porta's share of the losses on its investment have been recorded on the equity method effective October 1, 2001. As such losses are in excess of Porta's investment, and Porta does not guaranty such excess losses, the investment in the joint venture is carried at \$0 as of December 31, 2001.

### (11) Stockholders' Equity

Porta had outstanding warrants to its senior lender to purchase 571,152 shares of common stock, which are immediately exercisable at \$0.25 per share and for which 471,152 expire on November 30, 2002 and 100,000 expire on June 6, 2005.

Porta had outstanding to an investment banker warrants to purchase 400,000 shares of common stock at \$1.56 per share which expire April 2002.

(Continued)

F-17

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

See Note 9 in connection with the issuance of the Series B and C Warrants as part of the private placement of the subordinated Notes and the amendment of the terms of the Subordinated Notes and Series B and C Warrants.

As of December 31, 2001, Porta had stock purchase warrants outstanding to purchase 15,000 shares of common stock at an exercise price of \$1.8125 per share until May 2005 of which warrants to purchase 10,000 shares of common stock are immediately exercisable.

Under a 1984 Employee Incentive Plan, Porta provided an opportunity for certain employees of the Company and its subsidiaries to acquire subordinated convertible debentures. As a result, as of December 31, 1998, there was \$13,000 of employee promissory notes receivable outstanding, of which the maturity date has been extended to April 1999. During 1998, the Board of Directors approved a reduction in the original issue price of the debentures to the then current market rate of the common stock, approximately \$1.38 per share, which common stock was held by Porta as collateral for the notes. Accordingly, the related receivable from employees was reduced from \$307,000 to \$13,000 to reflect the new valuation. The reduction on the original issue resulted in a non-cash compensation charge in 1998 of \$298,000. During 1999, all of the receivables from employees were paid.

### (12) Stockholder Rights Plan

Porta has a Stockholder Rights Plan in which preferred stock purchase rights were distributed to stockholders as a dividend at the rate of one right for each common share. This plan has expired.

### (13) Employee Benefit Plans

Porta has deferred compensation agreements with certain present and former officers and employees, with benefits commencing at retirement equal to 50% of the employee's base salary, as defined. Payments under the

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

agreements will be made for a period of fifteen years following the earlier of attainment of age 65 or death. During 2001, 2000 and 1999, Porta accrued approximately \$166,000, \$180,000 and \$180,000, respectively, under these agreements.

In 1986, Porta established the Porta Systems Corp. 401(k) Savings Plan for the benefit of eligible employees, as defined in the Savings Plan. Participants contribute a specified percentage of their base salary up to a maximum of 15%. Porta will match a participant's contribution by an amount equal to 25% of the first 6% contributed by the participant. A participant is 100% vested in the balance to his credit. For the years ended December 31, 2001, 2000 and 1999, Porta's contribution amounted to \$54,000, \$72,000 and \$93,000, respectively.

In 1999, Porta established the Employee Stock Purchase Plan for the benefit of eligible employees, as defined in the Purchase Plan, which permits employees to purchase Porta's common stock at discounts up to 10%. Porta has reserved 1,000,000 shares of Porta stock for issuance under the plan. During 2001 and 2000, 130,256 and 84,804 shares, respectively, were issued pursuant to the Purchase Plan. Subsequent to December 31, 2001, Porta issued approximately 29,500 shares of stock to the participants of the Purchase Plan.

Porta does not provide any other post-retirement benefits to any of its employees.

(Continued)

F-18

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

#### (14) Incentive Plans

During 1999, Porta established an Employee Stock Bonus Plan whereby stock may be given to non-officers or directors to recognize the contributions of employees. A maximum of 100,000 shares of common stock is reserved for issuance pursuant to the Bonus Plan. During 1999 Porta issued 4,250 shares of common stock pursuant to the Bonus Plan and recorded a charge of approximately \$8,000. No shares of common stock were issued pursuant to the Bonus Plan during 2001 and 2000.

Porta's 1986 Stock Incentive Plan ("1986 Plan"), expired in March 1996, although options granted prior to the expiration date remain in effect in accordance with their terms. Options granted under the 1986 Plan may be incentive stock options, as defined in the Internal Revenue Code, or options that are not incentive stock options. The exercise prices for all options granted were equal to the fair market value at the date of grant.

Porta's 1996 Stock Incentive Plan ("1996 Plan") covers 450,000 shares of common stock. Incentive stock options cannot be issued subsequent to ten years from the date the 1996 Plan was approved. Options under the 1996 Plan may be granted to key employees, including officers and directors of the Company and its subsidiaries, except that members and alternate members of the stock option committee are not eligible for options under the 1996 Plan. The exercise prices for all options granted were equal to the fair market value at the date of grant and vest as determined by the board of directors. In addition, the 1996 Plan provides for the automatic grant to non-management directors of non-qualified options to purchase

## Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

2,000 shares on May 1st of each year commencing May 1, 1996, based upon the average closing price of the last ten trading days of April of each year.

Porta's 1998 Non-Qualified Stock Option Plan ("1998 Plan") covers 450,000 shares of common stock. Options under the 1998 Plan may be granted to key employees, including officers and directors of the Company and its subsidiaries. The exercise prices for all options granted were equal to the fair market value at the date of grant and vest as determined by the board of directors.

Porta's 1999 Incentive and Non-Qualified Stock Option Plan ("1999 Plan") covers 400,000 shares of common stock. Incentive stock options cannot be issued subsequent to ten years from the date the 1999 Plan was approved. Options under the 1999 Plan may be granted to key employees, including officers and directors of the Company and its subsidiaries, except that members and alternate members of the stock option committee are not eligible for options under the 1999 Plan. The exercise prices for all options granted were equal to the fair market value at the date of grant and vest as determined by the board of directors. In addition, the 1999 Plan provides for the automatic grant to non-management directors of non-qualified options to purchase 5,000 shares on May 1st of each year commencing May 1, 1999, based upon the average closing price of the last ten trading days of April of each year; provided, however, that the non-management directors will not be granted non-qualified options pursuant to the 1999 Plan for any year to the extent options are granted under the 1996 Plan for such year.

(Continued)

F-19

### PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

During 1999, pursuant to an employment contract with an officer, Porta issued options to purchase 15,000 shares of common stock at \$1.75 per share. The exercise prices approximated market value on the date of issuance. The options expire in May 2005. As of December 31, 2001, 10,000 of the options are vested.

Porta applies APB Opinion 25, "Accounting for Stock Issued to Employees" ("APB 25") and related Interpretations in accounting for the 1999, 1998, 1996 and 1986 Plans. Under APB 25, no compensation cost is recognized for options granted to employees at exercise prices greater than or equal to fair market value of the underlying common stock at the date of grant.

Porta has adopted the disclosure only provisions of Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation" ("SFAS No.123") which requires the Company to provide, beginning with 1995 grants, pro forma information regarding net income (loss) and net income (loss) per common share (basic and diluted) as if compensation costs for Porta's stock option plans had been determined in accordance with the fair value method prescribed in SFAS No.123. If Porta had elected to recognize compensation costs based on fair value of the options granted at grant date as prescribed by SFAS No. 123, net loss and net loss per share (basic and diluted) would have been increased to the pro forma amounts indicated below:

(Dollars in thousands, except per share data)

Edgar Filing: PORTA SYSTEMS CORP - Form 10-K

	2001 ----	2000 ----	1999 ----
Pro forma net loss	\$ (14,787)	\$ (10,393)	\$ (14,280)
Pro forma net loss per share (basic and diluted)	\$ (1.50)	\$ (1.06)	\$ (1.50)

The weighted-average fair values of options granted were \$0.23, \$ 1.62 and \$1.36 per share in 2001, 2000 and 1999, respectively.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions for 2001, 2000 and 1999:

	2001 ----	2000 ----	1999 ----
Dividends:	\$0.00 per share	\$0.00 per share	\$0.00 per share
Volatility:	100%	57.64%-68.70%	45.80%-80.00%
Risk-free interest:	4.22%-5.48%	5.54%-6.53%	4.50%-6.40%
Expected term:	5 - 9.6 years	5 years	5 years

(Continued)

F-20

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements, Continued

A summary of the status of Porta's stock option plans as of December 31, 2001, 2000, and 1999, and changes during the years ending on those dates is presented below:

	2001 -----		2000 -----		
	Shares Under Option -----	Weighted Average Exercise Price -----	Shares Under Option -----	Weighted Average Exercise Price -----	Sh Un Op -----
Outstanding beginning of year	949,713	\$2.55	870,538	\$2.51	9
Granted	55,000	0.29	108,500	3.12	
Exercised	--		(6,000)	1.50	
Forfeited	(203,008)	2.58	(23,325)	2.80	(
Outstanding end of year	801,705	\$3.96	949,713	\$2.55	8
Options exercisable at year-end	698,105		807,780		7

The following table summarizes information about stock options outstanding under the stock option plans at December 31, 2001:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Outstanding at 12/31/01	Remaining Contractual Life	Weighted-average Exercise Price	Exercisable at 12/31/01	Weighted Exer

