

PORTA SYSTEMS CORP  
Form 10-Q  
November 14, 2006

**SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the transition period from.....to.....  
Commission file number 1-8191

**PORTA SYSTEMS CORP.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

11-2203988  
(I.R.S. Employer  
Identification No.)

6851 Jericho Turnpike, Suite 170, Syosset, New York  
(Address of principal executive offices)

11791  
(Zip Code)

516-364-9300  
(Company's telephone number, including area code)

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

Yes  No

Indicate by a check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer; see definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of Exchange Act. Check one:

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

Common stock (par value \$0.01) 10,075,561 shares as of October 24, 2006



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

## PORTA SYSTEMS CORP. AND SUBSIDIARIES

## Consolidated Balance Sheets

(In thousands, except shares and par value)

| <u>Assets</u>  | September<br>30,<br>2006<br>(Unaudited) | December<br>31,<br>2005 |
|--|---|-------------------------|
| Current assets:  |   |                         |
| Cash and cash equivalents  | \$ 1,355                                | \$ 1,254                |
| Accounts receivable - trade, less allowance for doubtful accounts<br>of \$256 in 2006 and \$256 in 2005                        | 6,355                                   | 3,471                   |
| Inventories  | 3,916                                   | 4,541                   |
| Prepaid expenses and other current assets  | 796                                     | 446                     |
| Assets of discontinued operations  | 415                                     | 588                     |
| <b>Total current assets</b>  | <b>12,837</b>                           | <b>10,300</b>           |
| Property, plant and equipment, net   | 1,447                                   | 1,351                   |
| Goodwill, net  | 2,961                                   | 2,961                   |
| Other assets   | 44                                      | 49                      |
| <b>Total assets</b>  | <b>\$ 17,289</b>                        | <b>\$ 14,661</b>        |
| Liabilities and Stockholders' Deficit  |   |                         |
| Current liabilities:   |   |                         |
| Senior debt  | \$ 23,816                               | \$ 24,675               |
| Subordinated notes   | 6,144                                   | 6,144                   |
| 6% convertible subordinated debentures   | 385                                     | 385                     |
| Accounts payable   | 5,767                                   | 4,035                   |
| Accrued expenses and other   | 2,050                                   | 1,567                   |
| Other accrued interest payable   | 5,891                                   | 5,180                   |
| Liabilities of discontinued operations   | 514                                     | 2,033                   |
| <b>Total current liabilities</b>   | <b>44,567</b>                           | <b>44,019</b>           |
| Deferred compensation  | 781                                     | 827                     |
| <b>Total long-term liabilities</b>   | <b>781</b>                              | <b>827</b>              |
| <b>Total liabilities</b>   | <b>45,348</b>                           | <b>44,846</b>           |
| 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<br>10,075,561 shares in 2006 and 10,084,577 shares in 2005 | 101                                     | 101                     |
| Additional paid-in capital   | 76,124                                  | 76,124                  |
| Accumulated deficit  | (97,596)                                | (99,895)                |
| Accumulated other comprehensive loss:  |   |                         |
| Foreign currency translation adjustment  | (4,750)                                 | (4,577)                 |
|  | (26,121)                                | (28,247)                |
| Treasury stock, at cost, 30,940 shares   | (1,938)                                 | ( 1,938)                |

|   |           |           |
|---|-----------|-----------|
| Total stockholders' deficit                 | (28,059)  | (30,185)  |
| Total liabilities and stockholders' deficit | \$ 17,289 | \$ 14,661 |

See accompanying notes to unaudited consolidated financial statements.

PORTA SYSTEMS CORP. AND SUBSIDIARIES  
 Unaudited Consolidated Statements of Operations and Comprehensive Income  
 (In thousands, except per share amounts)

|  | Nine Months Ended     |                       |
|--|-----------------------|-----------------------|
|  | September 30,<br>2006 | September 30,<br>2005 |
| Sales  | \$ 25,039             | \$ 22,504             |
| Cost of sales  | 16,593                | 13,626                |
| Gross profit   | 8,446                 | 8,878                 |
| Selling, general and administrative expenses                     | 4,090                 | 3,939                 |
| Research and development expenses                                | 1,164                 | 981                   |
| Total expenses   | 5,254                 | 4,920                 |
| Operating income   | 3,192                 | 3,958                 |
| Interest expense, net  | (848)                 | (957)                 |
| Other income, net  | 2                     | 4                     |
| Income from continuing operations before income taxes            | 2,346                 | 3,005                 |
| Income tax expense   | (92)                  | (106)                 |
| Income from continuing operations before discontinued operations | 2,254                 | 2,899                 |
| Discontinued operations:   |                       |                       |
| Loss from discontinued operations (net of zero taxes)            | (245)                 | (702)                 |
| Net income   | \$ 2,009              | \$ 2,197              |
| Other comprehensive loss:  |                       |                       |
| Foreign currency translation adjustments                         | (173)                 | (263)                 |
| Comprehensive income   | \$ 1,836              | \$ 1,934              |
| Basic income (loss) per common share:                            |                       |                       |
| Continuing operations  | \$ 0.22               | \$ 0.29               |
| Discontinuing operations   | (0.02)                | (0.07)                |
|  | \$ 0.20               | \$ 0.22               |
| Weighted average shares outstanding                              | 10,076                | 10,021                |
| Diluted income (loss) per common share:                          |                       |                       |
| Continuing operations  | \$ 0.22               | \$ 0.29               |
| Discontinuing operations   | (0.02)                | (0.07)                |
|  | \$ 0.20               | \$ 0.22               |
| Weighted average shares outstanding                              | 10,104                | 10,054                |

See accompanying notes to unaudited consolidated financial statements.



PORTA SYSTEMS CORP. AND SUBSIDIARIES  
 Unaudited Consolidated Statements of Operations and Comprehensive Income  
 (In thousands, except per share amounts)

|  | Three Months Ended    |                       |
|--|-----------------------|-----------------------|
|  | September 30,<br>2006 | September 30,<br>2005 |
| Sales  | \$ 9,018              | \$ 6,875              |
| Cost of sales  | 6,036                 | 4,429                 |
| Gross profit   | 2,982                 | 2,446                 |
| Selling, general and administrative expenses                     | 1,386                 | 1,450                 |
| Research and development expenses                                | 408                   | 331                   |
| Total expenses   | 1,794                 | 1,781                 |
| Operating income   | 1,188                 | 665                   |
| Interest expense, net  | (261)                 | (312)                 |
| Other income, net  | --                    | 3                     |
| Income from continuing operations before income taxes            | 927                   | 356                   |
| Income tax expense   | (22)                  | (83)                  |
| Income from continuing operations before discontinued operations | 905                   | 273                   |
| Discontinued operations:   |                       |                       |
| Loss from discontinued operations (net of zero taxes)            | (87)                  | (166)                 |
| Net income   | \$ 818                | \$ 107                |
| Other comprehensive loss:  |                       |                       |
| Foreign currency translation adjustments                         | (47)                  | (155)                 |
| Comprehensive income (loss)                                      | \$ 771                | \$ (48)               |
| Per share data:  |                       |                       |
| Basic income (loss) per common share:                            |                       |                       |
| Continuing operations  | \$ 0.09               | \$ 0.03               |
| Discontinued operations  | (0.01)                | (0.02)                |
|  | \$ 0.08               | \$ (0.01)             |
| Weighted average shares outstanding                              | 10,076                | 10,054                |
| Diluted income (loss) per common share                           |                       |                       |
| Continuing operations  | \$ 0.09               | \$ 0.03               |
| Discontinued operations  | (0.01)                | (0.02)                |
|  | \$ 0.08               | \$ (0.01)             |

|                                     |        |        |
|-------------------------------------|--------|--------|
| Weighted average shares outstanding | 10,103 | 10,089 |
|-------------------------------------|--------|--------|

See accompanying notes to unaudited consolidated financial statements.



PORTA SYSTEMS CORP. AND SUBSIDIARIES  
 Unaudited Consolidated Statements of Cash Flows  
 (In thousands)

|  | Nine Months Ended        |                       |
|--|--------------------------|-----------------------|
|  | September<br>30,<br>2006 | September 30,<br>2005 |
| Cash flows from operating activities of continuing operations:   |                          |                       |
| Net income   | \$ 2,009                 | \$ 2,197              |
| Loss from discontinued operations  | 245                      | 702                   |
| Adjustments to reconcile net income to net cash provided by operating activities of continuing operations: |                          |                       |
| Depreciation and amortization  | 193                      | 991                   |
| Changes in operating assets and liabilities:   |                          |                       |
| Accounts receivable  | (2,883)                  | (1,425)               |
| Inventories  | 625                      | 90                    |
| Prepaid expenses and other current assets  | (349)                    | (704)                 |
| Other assets   | 4                        | 5                     |
| Accounts payable, accrued expenses and other liabilities   | 2,879                    | 753                   |
| Net cash provided by continuing operations   | 2,723                    | 2,609                 |
| Net cash used in operations of discontinued operations   | (1,406)                  | (1,520)               |
| Net cash from operations   | 1,317                    | 1,089                 |
| Cash flows from investing activities:  |                          |                       |
| Capital expenditures, net  | (149)                    | (1,223)               |
| Net cash used in investing of discontinued operation   | (184)                    | 770                   |
| Net cash used in investing activities  | (333)                    | (453)                 |
| Cash flows from financing activities:  |                          |                       |
| Increase in senior debt  | 154                      | 261                   |
| Repayments of senior debt  | (1,013)                  | (675)                 |
| Net cash used in financing activities  | (859)                    | (414)                 |
| Effect of exchange rate changes on cash  | (24)                     | (196)                 |
| Increase in cash and cash equivalents  | 101                      | 26                    |
| Cash and cash equivalents - beginning of the year  | 1,254                    | 2,040                 |
| Cash and cash equivalents - end of the period  | \$ 1,355                 | \$ 2,066              |
| Supplemental cash flow disclosure:   |                          |                       |
| Cash paid for interest expense   | \$ 159                   | \$ 680                |
| Cash paid for income taxes   | \$ 74                    | \$ 98                 |

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|   |    |     |    |    |
|---|----|-----|----|----|
| Common stock issued for accrued director fees | \$ | --- | \$ | 66 |
|---|----|-----|----|----|

See accompanying notes to unaudited consolidated financial statements.

Page 5 of 22

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PORTA SYSTEMS CORP. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

**Note 1: Management's Responsibility For Interim Financial Statements Including All Adjustments Necessary For Fair Presentation**

Management acknowledges its responsibility for the preparation of the accompanying interim consolidated financial statements which reflect all adjustments, consisting of normal recurring adjustments, considered necessary in its opinion for a fair statement of its consolidated financial position and the results of its operations for the interim period presented. These consolidated financial statements should be read in conjunction with the summary of significant accounting policies and notes to consolidated financial statements included in the Company's Form 10-K annual report for the year ended December 31, 2005. 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 within. The audit opinion included in the December 31, 2005 Form 10-K annual report contained an explanatory paragraph regarding the Company's ability to continue as a going concern. The factors which resulted in the explanatory paragraph are continuing. Results for the third quarter or the first nine months of 2006 are not necessarily indicative of results for the year.

**Note 2: Inventories**

Inventories, from continuing operations, are stated at the lower of cost (on the average or first-in, first-out method) or market. The composition of inventories at the end of the respective periods is as follows (net of reserve of \$2,630,000 for 2006 and \$2,583,000 for 2005):

|                      | September 30,<br>2006 |    | December 31,<br>2005 |
|----------------------|-----------------------|----|----------------------|
|                      | (in thousands)        |    |                      |
| Parts and components | \$ 2,690              | \$ | 3,192                |
| Work-in-process      | 790                   |    | 459                  |
| Finished goods       | 436                   |    | 890                  |
|                      | \$ 3,916              | \$ | 4,541                |

**Note 3: Senior and Subordinated Debt**

On September 30, 2006, the Company's liability to the holder of its senior debt was \$23,816,000. During the fourth quarter of 2004, SHF IX LLC, an affiliate of Minnesota-based Stonehill Financial, LLC, purchased the Company's senior debt of approximately \$25,000,000 from Wells Fargo Foothill, Inc. The Company has made payments through September 30, 2006 totaling \$2,137,500 as required by amendments and extensions of the loan agreement, of which \$490,259 was applied to interest and \$1,647,241 was applied to principal. On October 3, 2006, the Company entered into an agreement with SHF IX, LLC, which amended its Amended and Restated Loan and Security Agreement, dated as of November 28, 1994, as amended, to extend the maturity of the Company's senior debt to November 30, 2006, subject to the Company's reaching an agreement with the senior debt holder and attaining certain milestones discussed in the following paragraph. The agreement provides for monthly payments of \$112,500 to the senior debt and provides for the Company to pay the legal expenses and certain other expenses of the senior debt holder. As part of the extension, the senior debt holder agreed to continue the current deferral of interest on most of the senior debt.

As a condition to the extension, the Company agreed to continue to take steps to effect a restructuring of the senior debt in a manner which results in a reduction of a significant portion of the senior debt and the issuance of equity to the senior debt holder. Additionally, the Company would attempt to achieve a restructuring of debt which is junior to the senior debt. The agreement required that the Company reaches an agreement with the senior debt holder for such restructuring by October 31, 2006 and meets certain other milestones directed at effecting such restructuring. The Company is currently negotiating the terms of such agreement with the senior debt holder. As a result of the Company's failure to reach an agreement by October 31, 2006, the senior debt holder has the right to immediately accelerate the maturity date.

As previously announced, the Company has retained an investment banker and is actively seeking an investor. The Company cannot give any assurance that it will be able to obtain an investor on terms that are acceptable to the senior debt holder or otherwise reach an agreement with the senior debt holder regarding a restructuring of the senior debt. In the event that the Company is successful in negotiating an agreement with an investor and the senior debt holder, it is likely that the Company will be required to issue a significant number of shares of common stock or convertible securities which would result in very significant dilution to the Company's present stockholders. However, the Company cannot give any assurance that any such restructuring will be consummated, if at all, outside of bankruptcy reorganization.

As of September 30, 2006, the Company's short-term debt also included \$6,144,000 of subordinated debt, which became due on July 3, 2001, and \$385,000 of 6% debentures, which became due on July 2, 2002. Accrued interest on the subordinated notes was approximately \$5,746,000, which represents interest from July 2000 through September 30, 2006, and accrued interest on the 6% debentures was \$144,000 and is reflected in "*Other Accrued Interest Payable*" in the accompanying Consolidated Balance Sheet. The Company is precluded by the holder of its senior debt from paying any principal or interest on the subordinated debt.

#### **Note 4: Accounting for Stock Based Compensation**

Incentive awards are provided to employees under the terms of our 1998 Non-Qualified Stock Option Plan and our 1999 Incentive and Non-Qualified Stock Option Plan (the "1998 Plan" and "1999 Plan", respectively). 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 under the 1998 Plan are equal to the fair market value at the date of grant and vest as determined by the board of directors. 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 are equal to the fair market value at the date of grant and vest as determined by the board of directors, which is historically determined as six months. 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. Options under both the 1998 and 1999 Plans have expiration terms between 5 and 10 years.

Effective January 1, 2006, the Company adopted the provisions of FAS No. 123(R), "Share-Based Payment" ("FAS123(R)"). Under FAS123(R), share-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as expense over the requisite service period. The Company adopted the provisions of FAS123(R) using a modified prospective application. Under this method, compensation cost is recognized for all share-based payments granted, modified or settled after the date of adoption, as well as for any unvested awards that were granted prior to the date of adoption. Prior periods are not revised for comparative purposes. There was no stock-based compensation expense for the three and nine months ended September 30, 2006 as all options are either fully vested or will vest in future periods.

Stock option activity through the nine months ended September 30, 2006 is as follows:

|  | Options  | Weighted<br>Average<br>Exercise<br>Price Per<br>Share | Weighted<br>Average<br>Remaining<br>Term | Aggregate<br>Intrinsic<br>Value |
|--|----------|---|--|---------------------------------|
| <b>Outstanding at January 1, 2006</b>    | 337,780  | \$ 1.39   | 2.73                                     | \$ --                           |
| Granted                                  | --       | --  | --                                       | --                              |
| Forfeited                                | (28,500) | 3.31  | --                                       | --                              |
| Exercised                                | --       | --  | --                                       | --                              |
| <b>Outstanding at March 31, 2006</b>     | 309,280  | \$ 1.22   | 2.71                                     | \$ 3,240                        |
| Granted                                  | 20,000   | 0.11  | 9.84                                     | --                              |
| Forfeited                                | (2,000)  | 3.69  | --                                       | --                              |
| Exercised                                | --       | --  | --                                       | --                              |
| <b>Outstanding at June 30, 2006</b>      | 327,280  | \$ 1.13   | 2.91                                     | \$ 5,690                        |
| Granted                                  | --       | --  | --                                       | --                              |
| Forfeited                                | (5,000)  | 0.30  | --                                       | --                              |
| Exercised                                | --       | --  | --                                       | --                              |
| <b>Outstanding at September 30, 2006</b> | 322,280  | \$ 1.15   | 2.71                                     | \$ 4,290                        |
| <b>Exercisable at September 30, 2006</b> | 302,280  | \$ 1.21   | 2.25                                     | \$ 3,690                        |

Prior to the beginning of fiscal 2006, the Company did not record compensation expense for its stock based compensation plans, as such treatment was permitted under the provisions of Accounting Principles Board (“APB”) Opinion No. 25 “Accounting for Stock Issued to Employees,” related interpretations, and SFAS 123, “Accounting for Stock-Based Compensation.” The Company provided the requisite pro forma disclosures and complied with provisions of SFAS 148, “Accounting for Stock-Based Compensation—Transition and Disclosures.” For the three and nine months ended September 30, 2006, there was no pro-forma disclosure as there were no unvested options.

Presented in the table below are the options granted, weighted average fair value using a Black Sholes pricing model and total compensation charges, net of estimated forfeitures:

|  | <b>Options<br/>Granted</b> | <b>Weighted<br/>Average<br/>Black<br/>Scholes<br/>Value</b> | <b>Compensation<br/>Charge</b> |
|--|----------------------------|---|--------------------------------|
| Options granted subsequent to SFAS 123R                      | 20,000                     | \$ .0432  | \$ 0                           |
| Non-vested options granted prior to adoption<br>of SFAS 123R | ---                        | ---   | ---                            |
| Total  | 20,000                     | \$ .0432  | \$ 0                           |

The fair value of each option award is estimated based on the date of the grant using a Black Scholes option valuation model. Expected volatility is based on the historical volatility of the price of the Company's stock. The risk-free interest rate is based on the U.S. Treasury issues with a term equal to the expected life of the options. The Company uses historical data to estimate expected dividend yield, expected life and forfeiture rates. The value of the options granted during the nine months ended September 30, 2006 was based on the following weighted average assumptions:

|                                     |
|-------------------------------------|
| Expected 5%<br>volatility           |
| Risk-free 4.99%<br>interest<br>rate |
| Expected 0%<br>dividend<br>yield    |
| Expected 10<br>life years           |

As of September 30, 2006, there were approximately \$874 of unrecognized stock compensation charges related to options granted under our plans that will be recognized in the fourth quarter of 2006 when the 2006 grant vests.

A summary of our non-vested shares as of September 30, 2006 and changes during the nine months ended September 30, 2006 is presented below:

|                                     | <b>Shares</b> | <b>Weighted<br/>Average<br/>Grant Date<br/>Fair Value</b> |
|-------------------------------------|---------------|---|
| Non-vested as of January 1, 2006    | ---           | ---   |
| Granted                             | 20,000        | \$ 0.11   |
| Vested                              | ---           | ---   |
| Forfeited                           | ---           | ---   |
| Non-vested as of September 30, 2006 | 20,000        | \$ 0.11   |

#### Note 5: Segment Data

The Company has two reportable segments: Line Connection and Protection Equipment ("Line") whose products interconnect copper telephone lines to switching equipment and provide fuse elements that protect telephone equipment and personnel from electrical surges, and Signal Processing ("Signal") whose products are used in data communication devices that employ high frequency transformer technology.

Due to continuing losses in the Operating Support Systems (“OSS”) division, combined with difficulties in marketing OSS products in view of our financial condition, the Company decided to exit this operating segment in December, 2003. We currently limit our OSS activities to the performance of contractual maintenance and warranty services which are anticipated to expire in June, 2007 (see Note 8). It is currently anticipated that these services will cease by June 2007. Effective as of June 30, 2006 the assets and liabilities, and results of operations, of the OSS division have been segregated and reported separately as discontinued operations, on the Consolidated Financial Statements present in this Form 10-Q. OSS was engaged in the business whose products automate the testing, provisioning, maintenance and administration of communication networks and the management of support personnel and equipment. Currently we limit OSS activities to the performance of contractual maintenance and warranty services.

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The factors used to determine the above segments focused primarily on the types of products and services provided, and the type of customer served. Each of these segments is managed separately from the others, and management evaluates segment performance based on operating income.

There has been no significant change, from December 31, 2005, in the basis of measurement of segment revenues and profit or loss, and no significant change in the Company's assets for the Line and Signal reporting segments.

|                                   | Nine Months Ended     |                       | Three Months Ended    |                       |
|-----------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                   | September<br>30, 2006 | September<br>30, 2005 | September<br>30, 2006 | September<br>30, 2005 |
| Sales:                            |                       |                       |                       |                       |
| Line                              | \$ 21,027,000         | \$ 17,868,000         | \$ 7,532,000          | \$ 5,588,000          |
| Signal                            | 3,731,000             | 4,517,000             | 1,324,000             | 1,263,000             |
| Total of Continuing<br>Operations | \$ 24,758,000         | \$ 22,385,000         | \$ 8,856,000          | \$ 6,851,000          |
| Segment profit:                   |                       |                       |                       |                       |
| Line                              | \$ 3,956,000          | \$ 4,054,000          | \$ 1,341,000          | \$ 945,000            |
| Signal                            | 1,067,000             | 1,875,000             | 462,000               | 488,000               |
| Total of Continuing<br>Operations | \$ 5,023,000          | \$ 5,929,000          | \$ 1,803,000          | \$ 1,433,000          |

The following table reconciles segment totals to consolidated totals:

|   | Nine Months Ended     |                       | Three Months Ended    |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September<br>30, 2006 | September 30,<br>2005 | September 30,<br>2006 | September 30,<br>2005 |
| Sales:  |                       |                       |                       |                       |
| Total revenue for reportable<br>segments        | \$ 24,758,000         | \$ 22,385,000         | \$ 8,856,000          | \$ 6,851,000          |
| Other revenue                                   | 281,000               | 119,000               | 162,000               | 24,000                |
| Consolidated total revenue                      | \$ 25,039,000         | \$ 22,504,000         | \$ 9,018,000          | \$ 6,875,000          |
| Operating income (loss):                        |                       |                       |                       |                       |
| Total segment income<br>for reportable segments | \$ 5,023,000          | \$ 5,929,000          | \$ 1,803,000          | \$ 1,433,000          |
| Corporate and unallocated                       | (1,831,000)           | (1,971,000)           | (615,000)             | (768,000)             |
| Consolidated total<br>operating income          | \$ 3,192,000          | \$ 3,958,000          | \$ 1,188,000          | \$ 665,000            |



**Note 6: Legal Proceedings**

In April 2006, the Company commenced a legal action against a former officer of one of its operating divisions and against his current employer. The Company asserts that the former officer breached his duties to the Company and engaged in unfair competition by using the Company's confidential and proprietary information and trade secrets to manufacture and sell products which are identical in all material respects to those sold by the division which he managed on behalf of the Company. At this time, the Company cannot predict the outcome of this litigation.

**Note 7: New accounting pronouncements**

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155 (FASB No. 155), Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and No. 140. The objectives of this statement is to a) simplify accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid financial instruments that contains an embedded derivative that otherwise would require bifurcation and b) eliminate the interim guidance in Statement No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets, which provides that beneficial interests in securitized assets are not subject to the provisions of Statement No. 133. Statement No. 155 is effective for fiscal years beginning after September 15, 2006. The adoption of this statement is not expected to have a material effect on our financial position or results of operations.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156 (FASB No. 156), Accounting for Servicing Financial Assets an amendment of FASB Statement No. 140. The objective of this statement amends Statement No. 140 to require that all separately recognized servicing assets and servicing liabilities be initially measured at fair value. Statement No. 156 is effective for fiscal years beginning after September 15, 2006. The adoption of this statement is not expected to have a material effect on our financial position or results of operations.

In June 2006, the FASB issued Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109. The objective of this interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for the fiscal years beginning after December 15, 2006. The adoption of this statement is not expected to have a material effect on our financial position or results of operations.

In September 2006, FASB issued SFAS No. 157, "Fair Value Measurements," which provides enhanced guidance for using fair value to measure assets and liabilities. SFAS No. 157 establishes a common definition of fair value, provides a framework for measuring fair value under U.S. GAAP and expands disclosures requirements about fair value measurements. SFAS No. 157 is effective for financial statements issued in fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. . The adoption of this statement is not expected to have a material effect on our financial position or results of operations.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R)," which requires recognition of a net liability or asset to report the funded status of defined benefit pension and other postretirement plans on the balance sheet and recognition (as a component of other comprehensive income) of changes in the funded status in the year in which the changes occur. Additionally, SFAS No. 158 requires measurement of a plan's assets and obligations as of the balance sheet date and additional annual disclosures in the notes to the financial statements. The recognition and disclosure provisions of SFAS No. 158 are effective for fiscal years ending after December 15, 2006, while the requirement to measure a plan's assets and obligations as of the balance sheet date is effective for fiscal years ending after December 15, 2008. The Company is currently evaluating the effect this statement may have on our future results of operations.



**Note 8: Discontinued operations****Operating Support Systems (“OSS”)**

In December, 2003, the Company decided to wind down its OSS business. This decision was made because of continuing losses combined with difficulties in marketing OSS products in view of our financial condition. The Company anticipates the discontinuation of this business by June 30, 2007. Effective as of June 30, 2006, the OSS operating segment is reported in the Consolidated Financial Statements as a discontinued operation. Currently, its operating activities are limited to the performance of contractual maintenance and warranty services.

The following amounts related to OSS have been segregated from the Company’s continuing operations and are reported as assets and liabilities of discontinued operations in the consolidated balance sheet:

|   | September 30,<br>2006 | December 31, 2005   |
|---|-----------------------|---------------------|
| Assets of discontinued operations:                  |                       |                     |
| Prepaid expenses                                    | \$ 28,000             | \$ 35,000           |
| Accounts receivable                                 | 15,000                | 184,000             |
| Inventories   | 342,000               | 311,000             |
| Property, plant and equipment                       | 29,000                | 57,000              |
| Other assets  | 1,000                 | 1,000               |
| <b>Total assets of discontinued operations</b>      | <b>\$ 415,000</b>     | <b>\$ 588,000</b>   |
| Liabilities of discontinued operations:             |                       |                     |
| Accounts payable and accrued expenses               | \$ 514,000            | \$ 2,033,000        |
| <b>Total liabilities of discontinued operations</b> | <b>\$ 514,000</b>     | <b>\$ 2,033,000</b> |

Results of operations for OSS have been segregated from continuing operations and are reflected as discontinued operations approximately as follows:

|                                   | Nine Months Ended<br>September 30, |              |
|-----------------------------------|------------------------------------|--------------|
|                                   | 2006                               | 2005         |
| Revenues                          | \$ 276,000                         | \$ 557,000   |
| Loss from discontinued operations | \$ (245,000)                       | \$ (702,000) |

|                                   | Three Months Ended<br>September 30, |              |
|-----------------------------------|-------------------------------------|--------------|
|                                   | 2006                                | 2005         |
| Revenues                          | \$ 80,000                           | \$ 146,000   |
| Loss from discontinued operations | \$ (87,000)                         | \$ (166,000) |

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

The Company's consolidated statements of operations for the periods indicated below, shown as a percentage of sales, are as follows:

|  | Nine Months Ended<br>September 30, |      | Three Months Ended<br>September 30, |      |
|--|------------------------------------|------|-------------------------------------|------|
|  | 2006                               | 2005 | 2006                                | 2005 |
| Sales  | 100%                               | 100% | 100%                                | 100% |
| Cost of sales                                | 66%                                | 61%  | 67%                                 | 64%  |
| Gross profit                                 | 34%                                | 39%  | 33%                                 | 36%  |
| Selling, general and administrative expenses | 16%                                | 18%  | 15%                                 | 21%  |
| Research and development expenses            | 5%                                 | 4%   | 4%                                  | 5%   |
| Operating income                             | 13%                                | 18%  | 13%                                 | 10%  |
| Interest expense - net                       | (3%)                               | (4%) | (3%)                                | (5%) |
| Other  | 0%                                 | 0%   | 0%                                  | 0%   |
| Discontinued operations                      | (1%)                               | (3%) | (1%)                                | (2%) |
| Net income                                   | 8%                                 | 10%  | 9%                                  | 2%   |

The Company's sales by product line for the periods ended September 30, 2006 and 2005 are as follows:

|                                      | Nine Months Ended September 30,<br>\$(000) |      |           |      |
|--------------------------------------|--|------|-----------|------|
|                                      | 2006                                       |      | 2005      |      |
| Line connection/protection equipment | \$ 21,027                                  | 84%  | \$ 17,868 | 79%  |
| Signal Processing                    | 3,731                                      | 15%  | 4,517     | 20%  |
| Other                                | 281  | 1%   | 119       | 1%   |
|                                      | \$ 25,039                                  | 100% | \$ 22,504 | 100% |

|                                      | Three Months Ended September 30,<br>\$(000) |     |          |     |
|--------------------------------------|---|-----|----------|-----|
|                                      | 2006  |     | 2005     |     |
| Line connection/protection equipment | \$ 7,532                                    | 84% | \$ 5,588 | 81% |
| Signal Processing                    | 1,324                                       | 15% | 1,263    | 18% |

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|       |          |      |          |      |
|-------|----------|------|----------|------|
| Other | 162      | 1%   | 24       | 1%   |
|       | \$ 9,018 | 100% | \$ 6,875 | 100% |

Page 13 of 22

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## **Overview**

We operate in the telecommunications industry, and our customer base consists largely of government-owned and privately-owned telecommunications companies. Our line connection and protection equipment (“Line”) interconnects copper telephone lines to switching equipment and provides fuse elements that protect telephone equipment and personnel from electrical surges. Our signal processing (“Signal”) equipment is used in data communication devices that employ high frequency transformer technology.

Our Line equipment is designed to connect copper-wired telecommunications networks and to protect telecommunications equipment from voltage surges. We market this equipment primarily to telephone operating companies outside the United States and through distribution to designers, engineers and installers in the United States. Our Line division operated at a profit for the three and nine months ended September 30, 2006 and September 30, 2005. We market Signal equipment principally for use in defense and aerospace applications. The Signal division generated operating profit for the three and nine months ended September 30, 2006 and the comparable periods of 2005. We recognize revenue from Line and Signal products when the product is shipped.

We currently limit our OSS activities to the performance of contractual maintenance and warranty services which are anticipated to expire in June, 2007 (see Note 8). Effective as of June 30, 2006, the Company’s Consolidated Results of Operations present the OSS division as discontinued operations.

On September 30, 2006, our liability to the holder of our senior debt was \$23,816,000. The most recent extension, which extended the maturity date, subject to our attaining certain milestones, from September 30, 2006 to November 30, 2006, requires us to continue to make monthly payments of \$112,500. The most recent extension also includes a number of milestones to the continuation of efforts towards a restructure in a manner which would enable the holder of the senior debt to receive significant payments on account of the senior debt including reaching an agreement with the sub-debt holder regarding restructuring of the senior and junior debts by October 31, 2006. Although the Company continues to negotiate with the senior debt holder, this milestone was not achieved by October 31, 2006. Therefore, the senior debt holder may demand immediate payment of the debt and declare a default. If the holder of the senior debt demands payment of all or a significant portion of the loan, we will not be able to continue in business and it is likely that we will seek protection under the Bankruptcy Code.

## **Results of Continuing Operations**

The below narratives discuss the activities of our continuing operations.

Line equipment sales for the nine months ended September 30, 2006, compared to the nine months ended September 30, 2005 increased by \$3,159,000 (18%) from \$17,868,000 to \$21,027,000. Sales for the three months ended September 30, 2006 increased by \$1,944,000 (35%) from \$5,588,000 for the same period in 2005 to \$7,532,000 for the same period in 2006. The increase in sales for the nine and the three months in 2006 is primarily the result of increased sales volume to British Telecommunications as a result of British Telecommunications’ continuing rollout of DSL lines, and its implementation of the local loop unbundling program, demanded by regulators in the United Kingdom to enable third party providers of the telephone service to gain access to British Telecommunications’ systems.

Signal sales for the nine months ended September 30, 2006 were \$3,731,000, compared to \$4,517,000 in the same period of 2005, a decrease of \$786,000 (17%). Sales for the three months ended September 30, 2006 compared to the same period in 2005, increased by \$61,000 (5%) from \$1,263,000 to \$1,324,000. The decline in Signal revenue from the first nine months of 2006 resulted primarily from sluggish order rates from the military sector in the first six months of 2006. In addition, the revenue for the nine months ended September 30, 2005 was positively impacted by product shipments to customers whose 2004 backlogged orders were not shipped in 2004 due to the Company's cash constraints at that time. Sales for the third quarter and nine months of 2006 represent shipments of current orders and backlog.

Gross margin for the nine months ended September 30, 2006 was 34% compared to 39% for the nine months ended September 30, 2005. Gross margin for the quarter ended September 30, 2006 was 33% compared to 36% for the quarter ended September 30, 2005. This decrease for the nine months was attributable to a change in products sold to British Telecommunications (from the higher gross margin DSL products to the lower margin local loop unbundling products), short-term manufacturing inefficiencies at our assembly facility in Mexico during the second quarter, and additional freight costs associated with on-time deliveries to customers. The quarter ended September 30, 2006 was negatively impacted primarily by additional freight costs and, to a lesser extent, the continuation of sales to British Telecommunications of lower margin products.

Selling, general and administrative expenses increased by \$151,000 (4%) from \$3,939,000 to \$4,090,000 for the nine months ended September 30, 2006 compared to the same period in 2005. For the quarter ended September 30, 2006 selling, general and administrative expenses decreased by \$64,000 (4%) from \$1,450,000 in 2005 to \$1,386,000 in 2006. The increase for the nine months ended September 30, 2006 relates primarily to increased expenses in our Line segment for salaries and advertising as our marketing activities for Line were increased during the first quarter of 2006. These increases in Line expenses were partially offset by a decrease in general and administrative expenses relating to a 2005 lease agreement in the United Kingdom which was settled in the fourth quarter 2005.

For the nine months ended September 30, 2006 compared to the same period in 2005, research and development expenses increased by \$183,000 (19%) to \$1,164,000 from \$981,000. For the quarter ended September 30, 2006 compared to the same period in 2005, research and development expenses increased by \$77,000 (23%) to \$408,000 from \$331,000. The increase for the quarter and nine months resulted primarily from increased spending by our Line connection/protection division of approximately \$55,000 for the quarter and \$160,000 for the nine months to enhance our existing Line products and develop new products.

As a result of the above, for the nine months ended September 30, 2006, we had an operating income from continuing operations of \$3,192,000 compared with \$3,958,000 in the same period of 2005. We had an operating income of \$1,188,000 for the quarter ended September 30, 2006 as compared with \$665,000 in the same period of 2005.

We continue to accrue interest on obligations to the holder of \$1,206,000 of our senior debt, which represents interest on senior debt that we incurred subsequent to March 2002. In addition, there is outstanding an old term loan, in the principal amount of \$22,610,000, that accrues no interest until such time as the holder of the debt, in its sole discretion, notifies us that interest, at a rate of 12%, or a default rate of 14%, shall be payable. The holder of the senior debt has not required us to pay interest on this amount.

Income tax expense for the nine months ended September 30, 2006 relates to state and foreign taxes.

As a result of the foregoing, we generated net income, from continuing operations, of \$2,254,000, \$0.22 per share (basic and diluted), for the nine months ended September 30, 2006, compared with \$2,899,000, \$0.29 per share (basic and diluted), in 2005. The net income for the three months ended September 30, 2006, from continuing operations, was \$905,000, \$0.09 per share (basic and diluted), compared with \$273,000, \$0.03 per share (basic and diluted) in 2005.

## **DISCONTINUED OPERATIONS**

### **Operating Support Systems (“OSS”)**

In December, 2003, the Company decided to wind down its OSS business. This decision was made because of continuing losses combined with difficulties in marketing OSS products in view of our financial condition. The Company anticipates the discontinuation of this business by June 30, 2007. Effective as of June 30, 2006, the OSS operating segment is reported in the Consolidated Financial Statements as a discontinued operation. Currently, its operating activities are limited to the performance of contractual maintenance and warranty services. (See Note 8 to the unaudited consolidated financial statements.)

### **Liquidity and Capital Resources**

At September 30, 2006, we had cash and cash equivalents of \$1,355,000 compared with \$1,254,000 at December 31, 2005. Our working capital deficit at September 30, 2006 was \$31,730,000 compared to a working capital deficit of \$33,719,000 at December 31, 2005, a reduction of \$1,989,000 in our working capital deficit since December 31, 2005. This decrease in the working capital deficiency reflects our improved accounts receivable balance for the nine months ended September 30, 2006. During the nine months of 2006, we made payments to the holder of our senior debt of \$1,012,500 of which approximately \$154,000 was applied to interest and the remaining \$859,000 was applied to principal.

As of September 30, 2006, our debt includes \$23,816,000 of senior debt, which may become immediately due if the holder of the senior debt calls a default, \$6,144,000 of subordinated debt that became due on July 3, 2001, and \$385,000 of 6% debentures that became due on July 2, 2002. We were unable to pay the interest due on the subordinated notes of approximately \$5,746,000 that represents interest from July 2000 through September 2006, or the interest on the subordinated debentures of approximately \$144,000. We have been notified by the trustee of 6% debentures that the non-payment of the principal and interest caused an event of default. At September 30, 2006, we did not have sufficient resources to pay either the senior lender or the subordinated lenders; it is unlikely that we can generate such cash from our operations, and our senior lender has precluded us from making any payments on the subordinated debt.

On October 3, 2006, the Company entered into an agreement with SHF IX, LLC, which amended its Amended and Restated Loan and Security Agreement, dated as of November 28, 1994, as amended, to extend the maturity of the Company's senior debt to November 30, 2006, subject to the Company's reaching an agreement with the senior debt holder and attaining certain milestones discussed in the following paragraph. The agreement provides for monthly payments of \$112,500 to the senior debt and provides for the Company to pay the legal expenses and certain other expenses of the senior debt holder. As part of the extension, the senior debt holder agreed to continue the current deferral of interest on most of the senior debt.



As a condition to the extension, the Company agreed to continue to take steps to effect a restructuring of the senior debt in a manner which results in a reduction of a significant portion of the senior debt and the issuance of equity to the senior debt holder. Additionally, the Company would attempt to achieve a restructuring of debt which is junior to the senior debt. The agreement requires that the Company reaches an agreement with the senior debt holder for such restructuring by October 31, 2006 and meets certain other milestones directed at effecting such restructuring. As the Company failed to reach an agreement with the senior debt holder by October 31, 2006, the senior debt holder has the right to immediately accelerate the maturity date. The Company continues to negotiate with the holder of the senior debt to effect such an agreement.

As previously announced, the Company has retained an investment banker and is actively seeking an investor. The Company cannot give any assurance that it will be able to obtain an investor on terms that are acceptable to the senior debt holder or otherwise reach an agreement with the senior debt holder regarding a restructuring of the senior debt. In the event that the Company is successful in negotiating an agreement with an investor and the senior debt holder, it is likely that the Company will be required to issue a significant number of shares of common stock or convertible securities which would result in very significant dilution to the Company's present stockholders. However, the Company cannot give any assurance that any such restructuring will be consummated, if at all, outside of bankruptcy reorganization.

We have sought to address our need for liquidity by exploring alternatives, including the possible sale of one or more of our divisions. During 2004 and 2005, 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, and we may not be able to sell those divisions on acceptable, if any, terms. Furthermore, if we sell a division, we anticipate that a substantial portion, if not all, of the net proceeds will be paid to the holder of our senior debt, and we will not receive any significant amount of working capital from such a sale. We continue our efforts to reduce costs while we seek additional business from new and existing customers, or seek to sell one or more of our divisions. As a result of the significant reduction in the operations of our OSS division, we do not believe that we will be able to sell that division on terms which would generate any significant cash. Further, the dependence of our copper business on several significant customers, principally British Telecommunications, are major factors which may impair our ability to sell the copper division or our business as a whole or may affect the terms on which we would be able to sell the business.

### **Forward Looking Statements**

Statements contained in this Form 10-Q include forward-looking statements that are subject to risks and uncertainties. In particular, statements in this Form 10-Q that state the Company's intentions, beliefs, expectations, strategies, predictions or any other statements relating to our future activities or other future events or conditions are "forward-looking statements." Forward-looking statements are subject to risks, uncertainties and other factors, including, but not limited to, those identified under "Risk Factors," in our Form 10-K for the year ended December 31, 2005 and those described in "Management's Discussion and Analysis of Financial Conditions and Results of Operations" in our Form 10-K and this Form 10-Q, and those described in any other filings by us with the Securities and Exchange Commission, as well as general economic conditions and economic conditions affecting the telecommunications industry, any one or more of which could cause actual results to differ materially from those stated in such statements.

**Item 3. Quantitative and Qualitative Disclosure About Market Risk.**

We conduct certain operations outside the United States. A substantial portion of our revenue and expenses from our United Kingdom operations 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.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of our disclosure controls and procedures. Based on his evaluation, the Chief Executive Officer and Chief Financial Officer has concluded that our disclosure controls and procedures are effective.

**Changes in Internal Control over Financial Reporting**

There has been no change in our internal control over financial reporting that occurred during the fiscal quarter covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

In April 2006, the Company commenced a legal action against a former officer of one of its operating divisions and against his current employer. The Company asserts that the former officer breached his duties to the Company and engaged in unfair competition by using the Company's confidential and proprietary information and trade secrets to manufacture and sell products which are identical in all material respects to those sold by the division which he managed on behalf of the Company. At this time, the Company cannot predict the outcome of this litigation.

**Item 1 A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part 1, "Item 1A. Risk Factors," in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**Item 3. Defaults Upon Senior Securities.**

See Note 3 of Notes to Unaudited Consolidated Financial Statements and “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources” for information concerning defaults on our subordinated debt and the status of our senior debt.

**Item 6. Exhibits**

Exhibits

- 31.1 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

PORTA SYSTEMS CORP.

Dated: November 14, 2006

By

/s/ Edward B. Kornfeld

Edward B. Kornfeld

Chief Executive Officer

and Chief Financial Officer