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PERFORMANCE TECHNOLOGIES INC \DE\
Form 10-Q
May 14, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the Quarter Ended March 31, 2004
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 0-27460

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

Delaware 16-1158413
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation of organization)

205 Indigo Creek Drive, Rochester, New York 14626
(Address of principal executive offices) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No .

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

The number of shares outstanding of the registrant's common stock was 12,752,010 as of April 30, 2004.

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

ASSETS

	March 31, 2004 ----- (unaudited)	December 31, 2003 -----
Current assets:		
Cash and cash equivalents	\$24,085,000	\$29,589,000
Accounts receivable, net	10,464,000	7,857,000
Inventories, net	6,353,000	5,443,000
Prepaid expenses and other assets	471,000	626,000

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Deferred taxes	1,714,000	1,714,000
	-----	-----
Total current assets	43,087,000	45,229,000
Property, equipment and improvements, net	2,359,000	2,432,000
Software development costs, net	3,184,000	2,597,000
Notes receivable from unconsolidated companies	2,300,000	1,000,000
Investment in unconsolidated company	414,000	402,000
Goodwill	5,474,000	
	-----	-----
Total assets	\$56,818,000	\$51,660,000
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	\$ 1,812,000	\$ 1,231,000
Income taxes payable	1,835,000	1,760,000
Accrued expenses	4,338,000	4,019,000
	-----	-----
Total current liabilities	7,985,000	7,010,000
Deferred taxes	698,000	698,000
	-----	-----
Total liabilities	8,683,000	7,708,000
	-----	-----
Stockholders' equity:		
Preferred stock - \$.01 par value; 1,000,000 shares authorized; none issued		
Common stock - \$.01 par value; 50,000,000 shares authorized; 13,260,038 shares issued	133,000	133,000
Additional paid-in capital	12,823,000	12,863,000
Retained earnings	41,238,000	40,532,000
Treasury stock - at cost; 543,913 and 811,049 shares held at March 31, 2004 and December 31, 2003, respectively	(6,030,000)	(9,536,000)
Accumulated other comprehensive loss	(29,000)	(40,000)
	-----	-----
Total stockholders' equity	48,135,000	43,952,000
	-----	-----
Total liabilities and stockholders' equity	\$56,818,000	\$51,660,000
	=====	=====

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

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

Three Months Ended
March 31,
2004 2003

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Cash flows from operating activities:		
Net income	\$ 1,557,000	\$ 257,000
Non-cash adjustments:		
Depreciation and amortization	759,000	570,000
In-process research and development	218,000	
Equity in (income) loss of unconsolidated company	(12,000)	26,000
Other	35,000	60,000
Changes in operating assets and liabilities, net of acquisition:		
Accounts receivable	(2,137,000)	(1,169,000)
Inventories	105,000	(1,840,000)
Prepaid expenses and other assets	158,000	510,000
Accounts payable and accrued expenses	95,000	168,000
Income taxes payable	74,000	62,000
	-----	-----
Net cash provided (used) by operating activities	852,000	(1,356,000)
	-----	-----
Cash flows from investing activities:		
Purchases of property, equipment and improvements	(95,000)	(101,000)
Capitalized software development costs	(520,000)	(278,000)
Loan to unconsolidated company	(1,300,000)	
Business acquisition	(7,044,000)	
Purchase of marketable securities		5,000
Other		(33,000)
	-----	-----
Net cash used by investing activities	(8,959,000)	(407,000)
	-----	-----
Cash flows from financing activities:		
Proceeds from exercise of stock options	2,603,000	
Purchase of treasury stock		(174,000)
	-----	-----
Net cash provided (used) by financing activities	2,603,000	(174,000)
	-----	-----
Net decrease in cash and cash equivalents	(5,504,000)	(1,937,000)
Cash and cash equivalents at beginning of period	29,589,000	22,077,000
	-----	-----
Cash and cash equivalents at end of period	\$24,085,000	\$20,140,000
	=====	=====

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

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PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 FOR THE THREE MONTHS ENDED MARCH 31, 2004
 (Unaudited)

Note A - Basis of Presentation

The unaudited Consolidated Financial Statements of Performance Technologies, Incorporated and Subsidiaries (the "Company") have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, the Consolidated Financial Statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. Certain reclassifications have been made to prior periods in order to conform with current year presentation. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. The results for the interim periods are not necessarily indicative of the results to be expected for the year. The accompanying Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements of the Company as of December 31, 2003, as reported in its Annual Report on Form 10-K filed with the Securities and Exchange Commission.

Note B - Stock-Based Compensation and Earnings Per Share

At March 31, 2004, the Company had stock options outstanding under three stock option plans and restricted stock awards outstanding under one plan. The Company accounts for the stock option plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no stock-based compensation cost has been recognized in net income for the stock option plans. Had compensation cost for the stock option plans been determined based on the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," the Company's net income (loss) and earnings per share would have been as follows:

	Three Months Ended March 31, 2004	2003
	-----	-----
Net income, as reported	\$ 1,557,000	\$ 257,000
Add: Restricted stock compensation expense	15,000	
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(459,000)	(274,000)
Pro forma net income (loss)	\$ 1,113,000	\$ (17,000)
	=====	=====
Earnings per share:		
Basic - as reported	\$.12	\$.02
	=====	=====
Basic - pro forma	\$.09	\$.00
	=====	=====

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Diluted - as reported	\$.11	\$.02
	=====	=====
Diluted - pro forma	\$.08	\$.00
	=====	=====

The assumptions for annual vesting of stock options were generally 33% per year for stock options granted in 2004 and 2003. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2004 and 2003, respectively: Dividend yield of 0%; expected volatility of 68% and 67%, risk-free interest rate of 2.1% and 2.0%, and expected lives of three years.

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per share calculations reflect the assumed exercise of dilutive stock options and unvested restricted stock, applying the treasury stock method. Dilutive earnings per share calculations exclude the effect of approximately 166,000 and 1,924,000 options for the three months ended March 31, 2004 and 2003, respectively, since such options have an exercise price in excess of the average market price of the Company's common stock for the respective periods.

During the three months ended March 31, 2004, 257,000 common shares were issued upon exercise of stock options.

Note C - Inventories, net

Inventories consisted of the following:

	March 31, 2004	December 31, 2003
	-----	-----
Purchased parts and components	\$ 4,845,000	\$ 3,836,000
Work in process	2,870,000	3,434,000
Finished goods	2,441,000	1,969,000
	-----	-----
	10,156,000	9,239,000
Less: reserve for inventory obsolescence	(3,803,000)	(3,796,000)
	-----	-----
Net	\$ 6,353,000	\$ 5,443,000
	=====	=====

Note D - Accrued Expenses

Restructuring Programs

During 2002, the Company consolidated the engineering operations of its Raleigh, North Carolina facility into its Ottawa, Canada Signaling Group. The initial restructuring charge recorded in 2002 for lease commitments included certain estimates for expected future sublease receipts. Due to market conditions in the Raleigh, North Carolina area, the Company recorded an incremental restructuring charge of \$118,000 in the fourth quarter 2003, which related to a revised estimate of the sublease receipts expected through the remaining term of this lease, which expires in 2005. The Company did not record any restructuring charges during the first quarter 2004 or the first quarter 2003.

Payments totaling \$31,000 were made during the quarter under the existing lease obligation reducing the accrued restructuring balance from \$146,000 at December 31, 2003, to \$115,000 at March 31, 2004.

Warranty Obligations

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The Company has warranty obligations in connection with the sale of certain of its products. The warranty period for its products is generally one year. The costs incurred to provide for these warranty obligations are estimated and recorded as an accrued liability at the time of sale. The Company estimates its future warranty costs based on product-based historical performance rates and related costs to repair. The changes in the Company's accrued warranty obligations for the first quarter 2004 were as follows:

Accrued warranty obligations at December 31, 2003	\$ 233,000
Actual warranty experience	(106,000)
Warranty provisions	118,000

Accrued warranty obligations at March 31, 2004	\$ 245,000
	=====

Note E - Acquisition

On January 23, 2004, the Company acquired substantially all of the assets and assumed certain liabilities of Mapletree Networks, Inc., a company that provides voice, data and fax processing technology to original equipment manufacturers. These new products incorporated into the Company's integrated platform strategy, enable the Company to compete more effectively in the voice over IP and wireless communications applications markets. In accordance with the purchase agreement, the Company paid \$6,625,000 at closing and incurred approximately \$400,000 of other acquisition related costs. The Company accounted for the acquisition under the provisions of SFAS No. 141, "Business Combinations." Accordingly, the purchase price was allocated to the respective assets and liabilities based upon their estimated fair values at the acquisition date. Acquired in-process research and development amounted to \$218,000 and was charged to operations during the first quarter 2004. The excess of the purchase price over the fair value of the net assets acquired is included in goodwill on the accompanying Consolidated Balance Sheet. Operating results of the acquired entity have been included in the Consolidated Statement of Income from the date of acquisition.

In connection with the acquisition, the Company agreed to pay an additional \$1,625,000 if the operations of Mapletree Networks (on a standalone basis as operated by the Company) achieve certain milestones through December 31, 2004. Any future payments will be recorded as additional purchase price and included as goodwill. The purchase price is also subject to adjustment based upon certain factors, as defined in the agreement.

Note F - Investment

On February 18, 2004, the Company entered into an agreement to invest up to \$3.0 million in InSciTek Microsystems, Inc. (InSciTek), an unrelated company, in the form of an interest bearing convertible note. The Company invested \$1.3 million in conjunction with execution of the agreement. The balance of the investment will be made in two stages during the next twelve months based upon meeting certain sales performance criteria. If all stages of the investment are made, the Company will have the option to acquire ownership of InSciTek during a future specified period. The note bears interest at 10% annually and is convertible into shares of common stock of InSciTek. All unpaid accrued interest and all outstanding principal is payable in full on December 31, 2008.

Note G - Recently Issued Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities," an Interpretation of Accounting Research Bulletin (ARB) No. 51, "Consolidated Financial Statements." FIN 46 addresses the consolidation by business enterprises of variable interest entities (VIEs) either: (1) that do not have sufficient equity investment at risk to permit the entity to finance its activities without additional subordinated financial

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support, or (2) in which the equity investors lack an essential characteristic of a controlling financial interest. In December 2003, the FASB completed deliberations of proposed modifications to FIN 46 (Revised Interpretations) resulting in multiple effective dates based on the nature and creation date of the VIE. The Revised Interpretations must be applied to all VIEs no later than the end of the first interim or annual reporting period ending after March 15, 2004. However, prior to the required application of the Revised Interpretations, its provisions must be adopted by the end of the first interim or annual reporting period that ends after December 15, 2003 (for the year ended December 31, 2003 for the Company) for VIEs considered to be special purpose entities (SPEs). SPEs for this provision include any entity whose activities are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements. The adoption of FIN 46 did not have an impact on the Company's financial position.

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

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

Critical Accounting Estimates and Assumptions

In preparing the financial statements in accordance with Generally Accepted Accounting Principles (GAAP), management is required to make estimates and assumptions that have an impact on the assets, liabilities, revenue and expense amounts reported. These estimates can also affect supplemental information disclosures by the Company, including information about contingencies, risk and financial condition. The Company believes, given current facts and circumstances, its estimates and assumptions are reasonable, adhere to GAAP, and are consistently applied. Inherent in the nature of an estimate or assumption is the fact that actual results may differ from estimates and estimates may vary as new facts and circumstances arise. The critical accounting policies, judgments and estimates that management believes have the most significant effect on the financial statements are set forth below:

- o Revenue Recognition
- o Software Development Costs
- o Valuation of Inventories
- o Income Taxes
- o Product Warranty
- o Impairment of Investments

Revenue Recognition: The Company recognizes revenue in accordance with the SEC Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition." The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sale price is fixed or determinable, and collectability is reasonably assured. Additionally, the Company sells its products on terms which transfer title and risk of loss at a specified location, typically shipping point. Accordingly, revenue recognition from product sales, which represents the majority of the Company's revenue, occurs when all factors are met, including transfer of title and risk of loss, which occurs upon shipment by the Company. Revenue earned from arrangements for

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software systems requiring significant production, modification, or customization of software is recognized over the contract period as performance milestones are fulfilled. If all conditions of revenue recognition are not met, the Company defers revenue recognition. Revenue from consulting and other services is recognized at the time the services are rendered. Any anticipated losses on contracts are charged to operations as soon as such losses are determined. Revenue from software maintenance contracts is recognized ratably over the contractual period. The Company believes that the accounting estimate related to revenue recognition is a "critical accounting estimate" because the Company's terms of sale can vary, and management exercises judgment in determining whether to defer revenue recognition. Such judgments may materially affect net sales for any period. Management exercises judgment within the parameters of GAAP in determining when contractual obligations are met, title and risk of loss are transferred, sales price is fixed or determinable and collectability is reasonably assured.

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

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

Income Taxes: The Company accounts for income taxes using the asset and liability approach which requires recognition of deferred tax liabilities and

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

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

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

Overview

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

The Company markets its products through its direct worldwide sales force under a variety of brand names including IPnexus(TM), Advanced Managed Platforms, Intelligent Shelf Manager, NexusWare(TM), SEGway(TM), and UniPorte Software Architecture(TM) products.

The Company's IPnexus product line is based on open systems architectures and consists of a wide range of embedded building blocks which can be mixed and matched to construct packet-based integrated platforms. IPnexus products include Advanced Managed Platforms, the Intelligent Shelf Manager and NexusWare. Customers select the appropriate platform, components and software to fit system and application requirements with full confidence that all elements have been designed and engineered to function together. The Company's SEGway signaling products provide a signaling bridge between traditional telephone networks and the growing IP packet-switched network architectures of today. When used in

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conjunction with softswitches, media gateways and application servers, SEGway signaling products can provide the call control functionality or service processing capabilities of traditional Public Switched Telephone Network switches. UniPorte Software Architecture products provide voice, data and fax processing technology using digital signal processors (DSP).

Historically, the Company's growth has been generated through a combination of internal growth and acquisition of new products or complementary technologies. On January 23, 2004, the Company acquired substantially all of the assets of Mapletree Networks, Inc. (Mapletree), a company that provides voice, data and fax processing technology to original equipment manufacturers. The Company paid \$7.0 million, including cash and the assumption of certain debt at closing of \$6.6 million, other acquisition costs of \$.4 million and also agreed to pay an additional \$1.6 million if the operations of Mapletree (on a stand-alone basis as operated by the Company) achieve certain milestones.

On February 18, 2004, the Company entered into an agreement to invest up to an aggregate of \$3.0 million in InSciTek Microsystems, Inc. (InSciTek), in the form of an interest bearing convertible note. The Company invested \$1.3 million in conjunction with execution of the agreement. The balance of the investment will be made in two stages during the next twelve months based upon meeting certain sales performance criteria. If the Company makes the remaining investment, it will have the option to acquire ownership of InSciTek during a future specified period. The note bears interest at 10% annually and is convertible into shares of common stock of InSciTek. All unpaid accrued interest and all outstanding principal is payable in full on December 31, 2008.

Strategy: Since its founding in 1981, the Company has consistently designed innovative embedded products and solutions that focus on attributes such as reduced time-to-market, enhanced performance, high availability and cost advantages for its customers.

Management implemented a new product strategy during 2003 that repositioned the Company as a supplier of fully managed, system-level platform solutions to the embedded systems marketplace. An important milestone in this strategy was achieved in September 2003 with the introduction of the IPnexus Advanced Managed Platform product line. This new family of platform solutions specifically addresses equipment manufacturers' requirements for an increased level of system integration and services from suppliers. These new platforms also enable equipment manufacturers' downsized engineering staffs to improve time-to-market for their new products. The Company's strategy addresses this trend by enabling customers to replace proprietary or legacy platforms with the latest generation of fully managed platform functionality. This new product strategy resulted in improved financial performance by the Company during 2003. During 2004, the Company will integrate the products acquired through the Voice Technology Group (formerly Mapletree Networks) into this strategy.

Financial Information

As noted above, the Company acquired substantially all of the assets of Mapletree Networks (the Voice Technology Group, or VTG) on January 23, 2004. Beginning in the first quarter 2004, the Company's revenue and expenses reflect the operations of the Voice Technology Group.

In the first quarter 2004, a non-recurring expense for in-process research and development amounting to \$.2 million after-tax, or \$.02 per diluted share, affected the comparability of net income to the first quarter 2003. Management believes that the Company's results excluding non-recurring expense provide better comparability of continuing operations because non-recurring expenses result from facts and circumstances that vary in frequency, amounts, and cause.

Revenue in the first quarter 2004 amounted to \$15.6 million, compared to \$11.0

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million in the corresponding quarter a year earlier. The Voice Technology Group contributed \$1.2 million to revenue in the first quarter 2004.

On a GAAP earnings basis, net income for the first quarter 2004 amounted to \$1.6 million, or \$.11 per diluted share, compared to net income of \$.3 million, or \$.02 per diluted share for the first quarter 2003, based on 13.6 million and 12.2 million shares outstanding, respectively.

On a Non-GAAP earnings basis, net income for the first quarter 2004 amounted to \$1.8 million, or \$.13 per diluted share excluding non-recurring expense, based on 13.6 million shares outstanding. During the first quarter 2004, the Company completed the purchase of Mapletree Networks and recorded in-process research and development costs associated with this acquisition in the amount of \$.2 million (after-tax), or \$.02 per diluted share. Net income for the first quarter 2003 amounted to \$.3 million, or \$.02 per diluted share, based on 12.2 million shares outstanding.

Cash and marketable securities amounted to \$24.1 million at March 31, 2004, compared to \$29.6 million at December 31, 2003, and no long-term debt existed at either date.

Forward Looking Guidance for the Second Quarter 2004 (published April 27, 2004):

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

During the first quarter 2004, the newly acquired Voice Technology Group generated revenue of \$1.2 million and was approximately break-even on an operating basis. However, GAAP purchase accounting for the Mapletree Networks acquisition reduced the Company's first quarter earnings by \$.02 per diluted share. At the acquisition date, Mapletree had a significant amount of finished goods inventory which, in accordance with GAAP purchase accounting, was written up to fair market value as of that date and, as a result, minimal profit will be realized on the sale of this specific inventory. The Company estimates that it will take two additional quarters for this finished goods inventory to be sold and will likely impact the Company's earnings by \$.01 per share in each of the next two quarters.

In the second quarter 2004, the Voice Technology Group's financial results are expected to reduce the Company's earnings by approximately \$.02 to \$.03 per share due to the write-up of the finished goods inventory and additional investments in sales and marketing to accelerate their growth. Management believes the VTG operations will be accretive to the Company's earnings during the fourth quarter 2004.

During the second quarter 2004, the Company's revenue is forecasted to reflect a higher volume of computing products and a lower volume of signaling and access products than in the first quarter 2004. Computing products have significantly lower gross margins than signaling and access products.

Based upon the current business mix, the current backlog, and review of sales forecasts, management expects revenue to be in the range of \$15.0 million to \$16.5 million in the second quarter 2004. Gross margin is expected to be approximately 48.5% to 50.5%. Including the operating results of the Voice Technology Group, diluted earnings per share in the second quarter is expected to be \$.07 to \$.12. Excluding the operating results of the Voice Technology Group, diluted earnings per share in the second quarter is expected to be \$.10 to \$.14. The effective income tax rate for the second quarter is expected to be 31%.

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

Key Performance Indicators:

The Company's integrated platform and component products are incorporated into current and next-generation embedded systems infrastructure. Traditionally, "design wins" have been an important metric for management to judge the Company's product acceptance in its marketplace. Design wins, if implemented, reach production volumes at varying rates, generally beginning 12 to 18 months after the design win occurs. A variety of risks such as schedule delays, cancellations, changes in customer markets and economic conditions can adversely affect a design win before production is reached, or during deployment.

During the first quarter 2004, the Company was notified of four design wins by its customers. These new design wins were for its integrated platform solutions (with multiple products) (2), and individual component design wins for IPnexus Access (1) and Voice Technology products (1). During the first quarter of 2003, the Company was informed of three design wins. These design wins were for its integrated platform solutions (with multiple products) (1), and individual component design wins for its IPnexus Access (1), and SEGway Signaling products (1). Not all design wins are expected to result in production orders. The Company believes that the increase in design wins in the first quarter 2004, compared to the first quarter 2003 was due to an increase in new design activity that began in the second half of 2003.

Management believes another key indicator for the Company's business is the volume of orders received from the Company's customers. During weak economic periods, customer's visibility deteriorates causing delays in the placement of orders. While forward-looking visibility on customer orders continues to be very limited, shipments to customers in the first quarter of 2004 amounted to \$15.6 million (including the new VTG products) and \$14.4 million (excluding the new VTG products), compared to \$11.0 million in the first quarter 2003. As previously indicated, revenue for the second quarter 2004 is expected to be in the range of \$15.0 million to \$16.5 million, compared to \$12.6 million in the second quarter 2003.

Quarter Ended March 31, 2004, Compared with the Quarter Ended March 31, 2003

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

	Three Months Ended March 31,	
	2004	2003
Sales	100.0%	100.0%
Cost of goods sold	48.7	54.7
Gross profit	51.3	45.3
Operating expenses:		
Selling and marketing	10.5	12.3
Research and development	16.6	20.9
General and administrative	8.7	9.6
In-process research and development	1.4	

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Total operating expenses	37.2	42.8
Income from operations	14.1	2.5
Other income, net	0.9	1.1
Income before income taxes and equity in income (loss) of unconsolidated company	15.0	3.6
Income tax provision	5.1	1.1
Income before equity in income (loss) of unconsolidated company	9.9	2.5
Equity in income (loss) of unconsolidated company	0.1	(0.2)
Net income	10.0%	2.3%

Sales. Total revenue for the first quarter 2004 amounted to \$15.6 million, compared to \$11.0 million for the same quarter in 2003, an increase of 42%. For the first quarter 2004, the Voice Technology Group contributed \$1.2 million, or 8%, to revenue. In the first quarter 2004, the Company had two customers that each represented greater than 10% of sales, and the four largest customers represented 49% of sales. During the first quarter 2003, the Company had two customers that each comprised greater than 10% of revenue and the Company's four largest customers represented 54% of sales. Shipments to customers outside of North America represented 22% and 24% of sales during the first quarter 2004 and 2003, respectively.

For the periods indicated, the Company's products are grouped into four distinct categories in one market segment: Communications (network access, signaling and voice) products, Computing products, IPnexus switching products and other products. Revenue from each product category is expressed as a percentage of sales for the three months ending March 31, 2004 and 2003:

	Three Months Ended March 31,	
	2004	2003
Communications products	58%	34%
Computing products	30%	51%
IPnexus switching products	11%	13%
Other products	1%	2%
Total	100%	100%

Communications products: Network access products provide a connection between embedded systems platforms and a variety of networks and are used to control the network and/or process information being transported over networks. Many of the Company's signaling products enable the transport of signaling messages over packet-switched (IP) networks. The newly acquired Voice Technology products enable voice, data and fax processing for communications applications. Revenue from this category in the first quarter 2004 amounted to \$9.1 million, compared to \$3.9 million in the first quarter 2003, an increase of 133%. Revenue from Voice Technology products totaled \$1.2 million in the first quarter 2004. The remaining increase of \$4.0 million is the result of increased shipments to the Company's customers resulting from a general improvement in the business

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environment of the Company's target markets.

Computing products: Computing products include a range of single board computers, a variety of embedded system chassis and associated chassis management products. These products enable the Company to provide integrated platform solutions incorporating multiple components from the Company's portfolio. Revenue from computing products declined by \$1.1 million, or 19%, to \$4.6 million in the first quarter 2004, from \$5.7 million in first quarter 2003. The net decrease in revenue was primarily attributable to a decline in orders from one large customer.

IPnexus switching products: The Company's IPnexus switch product family has been designed for the embedded systems market and is based on the PICMG 2.16 systems architecture. The Company offers nine distinct switch models to customers. Revenue from this product category increased 21% to \$1.7 million in the first quarter 2004, from \$1.4 million in the first quarter 2003. Revenue growth in this category is a result of the rising adaptation of the PICMG 2.16 systems architecture which utilizes Ethernet switches. As more customers move into production with this architecture, the Company believes this product category will continue to grow.

Other products: This revenue is primarily related to legacy products. Many of these products are project oriented and shipments can fluctuate on a quarterly basis. The Company expects this revenue to continue to decline in the future.

Gross profit. Gross profit consists of sales, less cost of goods sold including material costs, manufacturing expenses, amortization of software development costs, expenses associated with engineering contracts and technical support function expenses. Gross margin was 51.3% and 45.3% of sales in the first quarter 2004 and 2003, respectively. When comparing quarter-over-quarter gross margin performance, the change in the product mix improved the gross margin during the first quarter 2004 because communications products have better margins than computing products. In addition, the higher volume of products shipped from the Rochester manufacturing facility (network access, switch, signaling and certain single board computer products) in the first quarter 2004, compared to the first quarter 2003, resulted in fixed manufacturing overhead being spread over more units produced. Offsetting these increases, the gross margin on the Voice Technology products was less than its expected range due to acquisition accounting for Mapletree Networks, which required a write-up of the purchased inventory to fair value at the date of acquisition.

Total Operating Expenses. Total operating expenses were \$5.8 million and \$4.7 million for the first quarter 2004 and 2003, respectively. The operating expenses associated with the Voice Technology Group are included in the first quarter 2004 results from the date of acquisition and are the primary factor in the overall increase in operating expenses from the first quarter 2003 to the first quarter 2004.

Selling and marketing expenses were \$1.6 million and \$1.4 million for the first quarter 2004 and 2003, respectively. The increase in selling and marketing expense is primarily attributable to staff increases, higher commissions on increased volumes and expenses associated with the Voice Technology Group.

Research and development expenses were \$2.6 million and \$2.3 million for the first quarter 2004 and 2003, respectively. The increase in research and development expense of \$0.3 million is primarily a result of the additional expenses associated with the Voice Technology Group. The Company capitalizes certain software development costs which reduced the amount of software development charged to operating expenses. Amounts capitalized were \$0.5 million and \$0.3 million during the first quarter 2004 and 2003, respectively.

General and administrative expenses were \$1.3 million in the first quarter 2004,

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compared to \$1.1 million in the first quarter 2003. The increase in general and administrative expense is primarily attributable to increased staff expense, higher corporate governance costs and expenses associated with the Voice Technology Group.

In-process research and development expense amounted to \$.2 million and zero for the first quarter 2004 and 2003, respectively. This amount represents a one-time charge for in-process research and development costs associated with the Mapletree Networks acquisition that were expensed in accordance with Financial Accounting Standards Board Interpretation No. 4 "Applicability of SFAS No. 2 to Business Combinations Accounted for by the Purchase Method." This charge relates to research and development projects that had not reached technological feasibility at the time of the acquisition.

Other income, net. Other income primarily consists of interest income from marketable securities and cash equivalents. The funds are primarily invested in high quality municipal, U.S. Treasury and corporate obligations with maturities of less than one year. Other income also includes interest income earned from notes receivable from unconsolidated companies.

Income taxes. The Company's effective income tax rate is a combination of federal, state and foreign tax rates and is generally lower than statutory rates because it includes benefits derived from the Company's international operations, research activities, tax exempt interest and foreign sales. For the first quarter 2004 and 2003, the Company's effective tax rate was 34% and 29%, respectively. The increase in the effective rate from the first quarter 2003 to the first quarter 2004 was a result of changes in certain permanent items.

Equity in Income (Loss) of Unconsolidated Company. The Company maintains an ownership interest in Momentum Computer, Inc., a developer of specialized single board computer products. During the fourth quarter 2003, the Company reduced its ownership in Momentum from 47% to 30%. The amounts presented reflect the Company's allocation of Momentum's income or loss for the periods presented based on the Company's ownership percentage.

Liquidity and Capital Resources

The Company's primary source of liquidity included cash and cash equivalents which totaled \$24.1 million at March 31, 2004. The Company had working capital of \$35.1 million and \$38.2 million at March 31, 2004 and December 31, 2003, respectively.

Cash provided by operating activities was \$.9 million for the first quarter 2004. This amount included net income of \$1.6 million, non-cash charges related to depreciation and amortization of \$.8 million, and in-process research and development expense of \$.2 million. Cash used in operations due to changes in operating assets and liabilities included an increase in accounts receivable of \$2.1 million which was a result of the increased sales activity experienced in the first quarter 2004.

Cash used by investing activities during the first quarter 2004 totaled \$9.0 million. This use of cash is primarily attributable to the acquisition of Mapletree Networks of \$7.0 million, a loan of \$1.3 million to InSciTek Microsystems, Inc., in the form of a convertible note, and the capitalization of software development costs amounting to \$.5 million.

Cash provided by financing activities amounted to \$2.6 million in the first quarter 2004 resulting from the exercise of stock options.

Off-Balance Sheet Arrangements:

The Company did not enter into any off-balance sheet arrangements during the

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first quarter 2004.

Contractual Obligations:

As described in the Company's recent Annual Report on Form 10-K, during the first quarter 2004, the Company renewed the lease for its operations in Ottawa, Canada through May 2006. The Company did not enter into any other significant contractual obligations during the first quarter 2004.

Current Position:

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

Recently Issued Accounting Pronouncements

FIN 46 - In January 2003, the FASB issued Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities," an Interpretation of Accounting Research Bulletin (ARB) No. 51, "Consolidated Financial Statements." FIN 46 addresses the consolidation by business enterprises of variable interest entities (VIEs) either: (1) that do not have sufficient equity investment at risk to permit the entity to finance its activities without additional subordinated financial support, or (2) in which the equity investors lack an essential characteristic of a controlling financial interest. In December 2003, the FASB completed deliberations of proposed modifications to FIN 46 (Revised Interpretations) resulting in multiple effective dates based on the nature and creation date of the VIE. The Revised Interpretations must be applied to all VIEs no later than the end of the first interim or annual reporting period ending after March 15, 2004. However, prior to the required application of the Revised Interpretations, its provisions must be adopted by the end of the first interim or annual reporting period that ends after December 15, 2003 (for the year ended December 31, 2003 for the Company) for VIEs considered to be special purpose entities (SPEs). SPEs for this provision include any entity whose activities are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements. The adoption of FIN 46 did not have an impact on the Company's financial position.

FORWARD-LOOKING STATEMENTS AND RISK FACTORS

This Quarterly Report on Form 10-Q contains forward-looking statements, which reflect the Company's current views with respect to future events and financial performance, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and is subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

These forward-looking statements are subject to certain risks and uncertainties, including those identified below, which could cause actual results to differ materially from historical results or those anticipated. The words "believes," "anticipates," "plans," "may," "intend," "estimate," "will," "should," "could," "feels," "is optimistic," "expects," and other expressions which indicate future events and trends also identify forward-looking statements. However, the absence of such words does not mean that a statement is not forward-looking.

The Company's future operating results are subject to various risks and uncertainties and could differ materially from those discussed in the

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forward-looking statements and may be affected by various trends and factors which are beyond the Company's control. These risks and uncertainties include, among other factors, general business and economic conditions, rapid technological changes accompanied by frequent new product introductions, competitive pressures, dependence on key customers, the attainment of design wins, fluctuations in quarterly and annual results, the reliance on a limited number of third party suppliers, limitations of the Company's manufacturing arrangements, the protection of the Company's proprietary technology, the dependence on key personnel, potential delays associated with the purchase and implementation of an enterprise-wide software system, and potential impairments of investments. These statements should be read in conjunction with the audited Consolidated Financial Statements, the Notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company as of December 31, 2003, as reported in its Annual Report on Form 10-K, and other documents as filed with the Securities and Exchange Commission.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

A. Evaluation of Disclosure Controls and Procedures

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

B. Changes in Internal Controls

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

PART II. OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

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A. Exhibits

31.1	Certification of Chief Executive Officer
31.2	Certification of Chief Financial Officer
32.1	Section 1350 Certification

B. Reports on Form 8-K

(1) On January 14, 2004, the Company filed a Current Report on Form 8-K, Item 2, announcing it entered into an agreement to acquire Mapletree Networks, Inc., in a purchase of assets transaction.

(2) On January 26, 2004, the Company filed a Current Report on Form 8-K, Item 2, announcing it completed the purchase of Mapletree Networks, Inc., fulfilling the closing conditions of the definitive agreement announced on January 12, 2004.

(3) On February 3, 2004, the Company filed a Current Report on Form 8-K, Item 2, to amend the Company's Current Reports on Form 8-K, dated January 14, 2004, and January 26, 2004, related to the Company's agreement with Mapletree Networks, Inc.

(4) On February 6, 2004, the Company filed a Current Report on Form 8-K, Item 12, to inform stockholders that on February 5, 2004, the Company announced its results of operations for the quarter and year ended December 31, 2003.

(5) On February 20, 2004, the Company filed a Current Report on Form 8-K, Item 5, announcing it entered into an agreement to invest up to \$3.0 million in InSciTek Microsystems, Inc. in the form of an interest bearing convertible note.

SIGNATURES

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

PERFORMANCE TECHNOLOGIES, INCORPORATED

May 14, 2004

By: /s/ Donald L. Turrell

Donald L. Turrell
President and
Chief Executive Officer

May 14, 2004

By: /s/ Dorrance W. Lamb

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

Exhibit 31.1

Certification of Chief Executive Officer

I, Donald L. Turrell certify that:

1. I have reviewed this quarterly report on Form 10-Q of Performance Technologies, Incorporated;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's first fiscal quarter) that has materially affected, or is

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reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 14, 2004

By: /s/ Donald L. Turrell

Donald L. Turrell
Chief Executive Officer

Exhibit 31.2

Certification of Chief Financial Officer

I, Dorrance W. Lamb certify that:

1. I have reviewed this quarterly report on Form 10-Q of Performance Technologies, Incorporated;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this

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report based on such evaluation; and

- c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's first fiscal quarter) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 14, 2004

By: /s/ Dorrance W. Lamb

Dorrance W. Lamb
Chief Financial Officer

Exhibit 32.1

Section 1350 Certification

Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 ("Section 906"), Donald L. Turrell and Dorrance W. Lamb, the Chief Executive Officer and Chief Financial Officer, respectively, of Performance Technologies, Incorporated, certify that (i) the quarterly report on Form 10-Q for the quarter ended March 31, 2004 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of Performance Technologies, Incorporated.

A signed original of this written statement required by Section 906 has been provided to Performance Technologies, Incorporated and will be retained by Performance Technologies, Incorporated and furnished to the Securities and

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Exchange Commission or its staff upon request.

Date: May 14, 2004

By: /s/ Donald L. Turrell

Donald L. Turrell
President and
Chief Executive Officer

Date: May 14, 2004

By: /s/ Dorrance W. Lamb

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