PERFORMANCE TECHNOLOGIES INC \DE\
Form 10-K
March 06, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2011

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

Incorporated pursuant to the Laws of the State of Delaware

Internal Revenue Service – Employer Identification No. 16-1158413

205 Indigo Creek Drive, Rochester, New York 14626

(585) 256-0200

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

Title of each class	**Name of each exchange on which registered**
Common Stock, par value $0.01 per share	**NASDAQ Global Market**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

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 has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [ ] No [X]

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a small reporting company. Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [X]

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of the close of business on June 30, 2011 was approximately $17,272,625, based on the closing price of the registrant's common stock on the NASDAQ Global Market on that date.

The number of shares outstanding of the registrant's Common Stock, $.01 par value, was 11,116,397 as of February 29, 2012.

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Registrant's definitive proxy statement relating to the May 24, 2012 Annual Meeting of Stockholders are specifically incorporated by reference in Part III, Items 10, 11, 12, 13 and 14 of this Annual Report on Form 10-K, except for the equity plan information required by Item 12 as set forth therein.

Performance Technologies, Incorporated
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PART I

SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The Private Securities Litigation Reform Act of 1995 (the “Reform Act”) provides a “safe harbor” for forward-looking statements. Certain written and oral statements made by management of Performance Technologies, Incorporated and its subsidiaries (collectively “PT”) include forward-looking statements intended to qualify for the safe harbor from liability established by the Reform Act. These forward-looking statements generally can be identified by words such as “believes,” “expects,” “anticipates,” “projects,” “foresees,” “forecasts,” “estimates” or other words or phrases of similar imp Words such as the “Company,” “PT,” “management,” “we,” “us,” or “our,” mean Performance Technologies, Incorporated and subsidiaries. All statements herein that describe PT’s business strategy, outlook, objectives, plans, intentions, goals or similar projections are also forward-looking statements within the meaning of the Reform Act.

All such forward-looking statements are subject to certain risks and uncertainties and should be evaluated in light of important risk factors. These risk factors include, but are not limited to, the following as well as those that are described in “Risk Factors” under Item 1A and elsewhere in this Annual Report on Form 10-K: business and economic conditions, rapid technological changes accompanied by frequent new product introductions, competitive pressures, dependence on key customers, inability to gauge order flows from customers, fluctuations in quarterly and annual results, the reliance on a limited number of third party suppliers, limitations of our manufacturing capacity and arrangements, the protection of our proprietary technology, errors or defects in our products, the effects of pending or threatened litigation, the dependence on key personnel, changes in critical accounting estimates, potential impairments related to investments, foreign regulations, possible loss or significant curtailment of significant government contracts or subcontracts and potential material weaknesses in internal control over financial reporting. In addition, during weak or uncertain economic periods, customers’ visibility deteriorates causing delays in the placement of their orders. These factors often result in a substantial portion of the Company’s revenue being derived from orders placed within a quarter and shipped in the final month of the same quarter.

Any of these factors could cause PT’s actual results to differ materially from its anticipated results. For a more detailed discussion of these factors, see the "Risk Factors" discussion in Item 1A in this Annual Report on Form 10-K. The Company cautions readers to carefully consider such factors. Many of these factors are beyond the Company’s control.

Available Information

The Company's website address is www.pt.com. The Company makes available free of charge via a hypertext link on its website, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission ("SEC"). The Company will provide this information upon written request to the attention of the Chief Financial Officer, Performance Technologies, Incorporated, 205 Indigo Creek Drive, Rochester, New York 14626. Materials we provide to the SEC are also available for the public to read and copy through the SEC website at www.sec.gov or at the SEC Public Reference Room at 100 F Street, N.E. Washington, D.C. 20549 or by calling 1-800-SEC-0330.

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ITEM 1 – Business

Overview

Performance Technologies, Incorporated (“PT”), a Delaware corporation founded in 1981, is a global supplier of advanced network communications solutions to service providers, government and OEM markets.

PT’s product portfolio includes IP-centric network elements and applications designed for high availability, scalability, and long life cycle deployments. The industry-leading Monterey 8000™ MicroTCA and IPnexus® Platforms anchor a growing portfolio of PT solutions. OEMs and application developers, including PT itself, leverage the robust carrier grade Linux® development environment and rich suite of communications protocols (PT’s NexusWare®) of our Application-Ready Platforms as a cornerstone component of their end product value proposition. PT’s SEGway™ Signaling Solutions provide affordable, high density signaling, advanced routing for LTE and IMS applications, IP migration, gateway capabilities, SIP bridging, and core-to-edge distributed intelligence, as well as features such as Number Portability and SMS Spam Defense. The Company’s Xpress™ NGN applications enable evolving Mobile 2.0, Multi-media, and IMS-based revenue-generating services.

PT is headquartered in Rochester, New York and maintains direct sales and marketing offices in the U.S. in Raleigh, North Carolina and Chicago, Illinois and international offices in London, England and Shanghai, China, and has centers of engineering excellence in San Diego, California, and Kanata, Ontario, Canada, in addition to Rochester, New York.

Strategy

The Company’s strategy is to maximize the value proposition of its products by leveraging its field-proven systems, software and hardware technologies. Management believes the tightly integrated combination of these technologies provides considerable benefits to PT’s customers including a compelling return-on-investment proposition, significant development risk mitigation and a substantially accelerated time-to-market opportunity.

Management is focused on building on the momentum generated in 2011 and will continue to concentrate on the four network communications-focused initiatives established in 2010 to construct a solid foundation for long-term growth. These initiatives include further strengthening our SEGway Signaling Systems product line, continued evolution and enhancement of our open-standards based Application-Ready Platforms for mission critical communications applications, intensifying our market diversification efforts in government systems markets, and identifying forward-looking network communications growth opportunities, such as our Xpress portfolio of SIP-based applications and enabling infrastructure, that we can pursue with our own end product solutions.

Our signaling product portfolio, which is targeted at the service provider market, has reached a scale in terms of features, functionality and cost-effectiveness that generates strong interest on a global basis and especially in many emerging markets. As a result, beginning in 2011, our sales and marketing strategy for our signaling products became more focused on working with strong channel partners as our primary vehicle to further expand our reach in the global and emerging markets. To that end, we added GENBAND as a strong channel partner in January 2011, Kapsch CarrierCom AG in the third quarter 2011, and we continue to work closely under our established relationship with Alcatel-Lucent as another major channel partner.

From an expense perspective, in the fourth quarter 2009, management proactively undertook several new investments to further position PT for growth in anticipation that business conditions would improve. The timing of these investments was based upon forward-looking market data that we expected would drive opportunities for our technologies. It became apparent during the second half of 2010 that the economic and industry trends that occurred did not drive growth for PT's products to the degree expected. Therefore, in December 2010, PT announced an expense reduction program to substantially reduce its operating expenses by consolidating our San Luis Obispo, California engineering operation with our Rochester, New York engineering group and also reducing our sales and marketing staff. Management believes that while it was necessary to make these reductions for financial reasons, the significant strategic investments made during 2010 were important in underpinning a solid foundation for long-term future growth.

There are identifiable risks associated with PT's strategy in the current economic climate. While management believes that its network communications market focus offers opportunities for growth in the long term, network infrastructure investments by carriers are very sluggish; the total available market for traditional SS7-based signaling products is declining and the market for SIP-based next-generation network products is not yet growing as rapidly as anticipated. Despite the current economic climate, which may involve new risks not currently identified, management believes the outlook for the Company's profitability is improving because expenses have been aligned with projected revenues and our new channel partners are engaged in selling our products.

Market Overview

PT's business addresses one industry segment – Communications, and globally targets two primary vertical markets for its network communications products: telecommunications, and military, aerospace and government systems.

The telecommunications market, historically our largest vertical market, is fundamentally driven by investments in network infrastructure by carriers and service providers. Telecommunications market revenues derived from our Application-Ready Platforms, which are sold to OEMs, depend primarily on broad, multi-year deployments of next-generation telecommunications infrastructure. Telecommunications market revenues generated from service providers purchasing our SEGway and Xpress product lines result from investments necessary to support existing and evolving service demands such as text messaging and the transition to Internet-based communications networks.

Sales into the military, aerospace and government systems market are typically to prime contractors and system integrators and reflect investment levels by various government agencies and military branches in specific programs and projects requiring enhanced communications capabilities. Military, aerospace and government systems budgets are currently under pressure and shipments are subject to project deployment schedules, which are often unpredictable.

During 2011, the economy recovered unevenly around the world and business conditions continued to remain very challenging in the telecommunications equipment market. The norm in our OEM business is that OEM customers place orders for product only when they have orders in hand from their customers and then expect almost immediate delivery. Revenues from our telecommunications customers grew by $5.0 million, or 22%, in 2011, compared to 2010. The opportunity for government funded network infrastructure and military related expenditures remains positive but the timing of awarded business for the most part is highly unpredictable. Revenues from the military, aerospace and government systems market customers grew by $3.3 million, or 61% in 2011, compared to 2010. Our Xpress product line is generating interest from both telecommunications and government customers. PT successfully completed a pilot program with a government customer during the fourth quarter 2011 to demonstrate the Xpress products' capabilities in a communications cost reduction program. The first contract award for this program is expected during 2012. Forward-looking visibility on customer orders remains very challenging.

Products

PT's product portfolio includes SEGway Signaling Solutions, Monterey and IPnexus Application-Ready Platforms and Xpress SIP Applications. In January 2011, PT expanded its signaling product portfolio with the acquisition of GENBAND's Universal Signaling Platform ("USP") and SP2000 signaling technology.

SEGway Signaling Solutions: SEGway Signaling Solutions provide low cost, high density signaling, advanced routing, IP migration, gateway capabilities, SIP bridging, and core-to-edge distributed intelligence. PT's product suite of IP-centric STPs, gateways, edges, and network applications permits service providers to cost effectively deliver revenue generating features in current and next-generation networks. SEGway solutions have been deployed in numerous world-class carrier networks around the globe because of their high density and unparalleled price-to-performance ratio. This, together with SEGway's flexibility in edge-to-core deployments, small footprint, and ease of use, has earned the portfolio its reputation as "Simply Smarter Signaling®."

Deployed for over ten years, PT's SEGway Signaling solutions, which are built on our Application-Ready Platforms, provide a full suite of signaling capabilities that seamlessly operate in both circuit-switched and IP-based networks to address the signaling needs of wireless and wireline carriers and service providers.

In January 2011, PT acquired the Universal Signaling Point and SP2000 signaling products from GENBAND. In addition, PT has a long-term agreement to provide GENBAND with development, support and maintenance of signaling solutions as integral elements of GENBAND's premier switching portfolio.

Monterey and IPnexus Application-Ready Platforms: PT's Monterey and IPnexus Application-Ready Platforms anchor a growing portfolio of PT solutions. These platforms are built on PT's own U.S. manufactured hardware combined with PT's NexusWare Carrier Grade Linux operating system and software development environment. PT's Application-Ready Platforms are IP-native, designed for high availability, scalability, and long life cycle deployments. OEMs and application developers, including PT itself, leverage PT's carrier grade Linux development environment and suite of communications protocols (NexusWare) as a cornerstone component of their end product value proposition.

In November 2011, PT's Monterey 8000 platform, the newest member of the Monterey MicroTCA family of products, received the Best of Show-Hardware Award by the Advanced MicroTCA Summit.

Management believes that the tightly integrated combination of systems, hardware and software technologies found in the Company's Application-Ready Platforms provides measurable benefits to its customers through development risk mitigation and substantially accelerated time-to-market metrics. Furthermore, the Monterey and IPnexus product lines are built upon a fundamental premise of long life cycle deployment that is fully supported by PT, as opposed to offerings from some of our competitors.

Xpress SIP Applications: PT introduced its Xpress product line in 2010. Xpress is a portfolio of SIP-based applications and enabling infrastructure for next-generation network (NGN) architectures. Today, in addition to the Xpress scalable Application Server and its associated Service Creation Environment, PT offers four Xpress applications including Prepaid/Postpaid services, Voice Messaging, Private Network Cost Optimizer and Telemarketer Guard™. Adoption of voice-over-packet architectures by wireless and wireline carriers, and the emergence of SIP (Session Initiation Protocol) as the predominant next-generation network protocol have presented new opportunities for service providers to market media-rich and web-friendly applications to their subscribers. PT's Xpress product portfolio represents a new approach for delivering these capabilities in a cost effective manner. Based on a pure IP implementation, new service offerings can be quickly developed and readily deployed, network wide, on IMS-enabled, converged TDM/IP and VoIP networks.

Sales, Marketing and Distribution

PT markets its products worldwide to a variety of customers through its direct sales force and various channel partners including OEMs, Value Added Resellers (VARs), distributors and systems integrators. While more emphasis is being placed on channel sales for our service provider customers, currently the majority of PT's business is conducted through PT's direct sales organization.

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

At year end 2011, PT had a total of 35 sales, marketing and sales support personnel located in various U.S. offices including: Rochester, New York; Raleigh, North Carolina; Chicago, Illinois; San Jose, California and internationally in London, England and Shanghai, China. Beginning in 2011, our sales and marketing strategy for our signaling products became more focused on working with strong channel partners as our primary vehicle to further expand our reach in global and emerging markets. To that end, we added GENBAND as a strong channel partner in January 2011, Kapsch CarrierCom AG in the third quarter 2011, and we continue to work closely under our established relationship with Alcatel-Lucent as another major channel partner. In addition, PT had a total of fourteen individual and corporate independent sales representatives and agents at December 31, 2011.

PT executes various ongoing marketing strategies designed to attract new customers and to stimulate additional business with existing customers. These strategies include web-based activities, technology seminars, direct mail and email campaigns, active participation in technical standards groups, participation in regional, national and international trade shows, placement of selected trade press advertisements and the authoring of technical articles.

Management believes that the tightly integrated combination of systems, hardware and software technologies found

Sales to customers outside of the United States represented 46%, 58% and 53% of PT's revenue in 2011, 2010 and 2009, respectively. In 2011 and 2010, export shipments to the United Kingdom represented 20% and 26% of sales, respectively. International sales are subject to risks of import and export controls, transportation delays and foreign governmental regulations. Payments for shipments from the United States to outside the United States are generally made in U.S. dollars.

Management believes that the tightly integrated combination of systems, hardware and software technologies found

Customers

PT has approximately 110 customers worldwide in the telecommunications and military, aerospace and government systems markets. Many of PT's major customers are Fortune 1000 companies in the United States or companies of similar stature in Europe, Africa and Asia. In 2011, PT's two largest customers represented 19% and 7% of sales, respectively, and PT's four largest together represented 38% of sales. In 2010, PT's two largest customers represented 24% and 5% of sales, respectively, and PT's four largest customers together represented 39% of sales. In 2009, PT's two largest customers represented 15% and 10% of sales, respectively, and PT's four largest customers together represented 36% of sales.

In 2011, approximately 76% of PT's revenue came from the telecommunications industry and 24% from the military, aerospace and government systems market.

SEGway Signaling Solutions Customers: **Announced customers for our SEGway *Signaling* Solutions include Alcatel-Lucent, Alltel Communications (now Verizon), Bakcell Ltd., Cable and Wireless Guernsey, Comfone, Elephant Talk, Ericsson, GENBAND, GeoLink, Globacom, Hawaiian Telcom, Kapsch CarrierCom AG, Leap Wireless/Cricket, Pocket Communications, Primus Telecommunications, Siemens, Starcomms, Syniverse, Telefonica Moviles E*spana,* Tata Communications (formerly Teleglobe) and VeriSign.**

Monterey and IPnexus Application-Ready Platform Customers: **Announced customers for our Application-Ready Systems include: Aeroflex, Alcatel-Lucent, Aviat Networks, AudioCodes, FAA, General Dynamics, Honeywell, Lockheed Martin, Metaswitch Networks, Motorola, Nokia Siemens, Northrup Grumman, Raytheon, Rockwell Collins, Stratus Technologies, Sun Microsystems (now Oracle Corporation) and Unisys.**

The loss of one or more of our larger customers, the reduction, delay or cancellation of orders, or a delay in shipment of our products to such customers, would have a material adverse effect on our revenue and operating results. During 2012, Metaswitch Networks is expected to begin a transition away from using PT's IPnexus platforms in some of its product offerings. As a result, a significant reduction of shipments to Metaswitch is expected during 2012.

Backlog

The scheduled backlog of orders amounted to $7.7 million and $6.0 million at February 1, 2012 and 2011, respectively. The year-over-year increase is primarily due to the effect of revenue remaining to be recognized on the Company's signaling systems sale to a customer in Africa, which totals $1.2 million. Substantially all of the backlog amounts for 2012 are expected to be shipped and recognized in revenue prior to the end of the year. Orders are received unevenly, which makes comparison of backlog not particularly relevant. Orders are subject to postponement of delivery or cancellation in the normal course of business. A substantial portion of PT's revenue in each quarter results from orders placed within the quarter and shipped in the final month of the same quarter. Due to the global economic climate, forward-looking visibility on customer orders continues to be very challenging. (See Management's Discussion & Analysis included elsewhere in this report).

Seasonality

PT's business is not generally subject to large seasonal swings but business is frequently slower during the summer months due to the European and United States vacation seasons. Some of PT's customers have seasonal swings in their business which are reflected in their orders with PT. Much of PT's OEM business is project-related, which can cause quarterly fluctuations in revenue.

Environmental Matters

PT complies with U.S. federal, state and local laws relating to the protection of the environment and believes that environmental matters do not have any material effect on its capital expenditures, earnings or competitive position. Further, PT complies with national laws relating to the protection of the environment in all end country markets served by export sales.

If the products that we produce in the future do not comply with a country's laws relating to the protection of the environment, we would be unable to sell our products into those markets and our operating results would be harmed.

Competition

PT's SEGway Signaling solutions satisfy a wide range and scale of signaling requirements, most of which typically involve some component of utilizing Internet Protocol (IP) to carry signaling traffic. PT's SEGway Signaling solutions currently compete with products from Tekelec, Huawei, Ericsson, Nokia-Siemens Networks and Cisco Systems.

Embedded purpose-built computer platforms are either based on proprietary technology or are based on open standards. PT's Monterey and IPnexus Application-Ready Platforms are open standards based, which is the smaller portion of this market. A key differentiating factor of PT's Application-Ready Platforms is PT's internally developed NexusWare Carrier Grade Linux operating system and software development environment. We believe this is a key competitive advantage in our marketplace because many of PT's competitors provide third party operating systems with their products.

The OEM communications equipment market is characterized by rapid technological change and frequent introduction of products based on new technologies. Competitive factors in this market include price, product performance, functionality, product quality and reliability, customer service and support, marketing capability, corporate reputation and brand recognition, and changes in relative price/performance ratios. PT's Monterey and IPnexus Application-Ready Platforms compete in certain open standards-based markets, specifically AdvancedTCA, MicroTCA and CompactPCI 2.16.

Competitors providing some level of systems offerings include Emerson, Radisys, GE Fanuc and Kontron. Currently these companies sell into the AdvancedTCA, MicroTCA and CompactPCI 2.16 parts of the market. PT offers MicroTCA and CompactPCI 2.16 products and does not sell AdvancedTCA platforms. Management believes that PT's capability to deliver fully integrated, system-level platforms with a substantial software component including its NexusWare is a key differentiating factor for PT's products.

Monterey and IPnexus Application-Ready Platform Customers: Announced customers for our Application-Ready S

We cannot guarantee that we will be able to compete successfully with our existing or new competitors or that the competitive pressures faced by us will not have a material adverse effect on our revenue and operating results.

Research and Development

PT's research and development expenses were approximately $7.1 million, $7.8 million and $7.8 million in 2011, 2010, and 2009, respectively, and were net of capitalized software development costs of $2.0 million, $2.3 million and $2.3 million, respectively. These expenses consist primarily of personnel costs, material consumed in developing and designing new products, and amounts expended for software licenses/tools. PT expects to continue to invest heavily in research and development in order to create innovative next-generation products and maintain competitive advantages in the communications markets we serve. Research and development expenses declined in 2011 over 2010 primarily due to a reduction in force announced in December 2010.

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In addition, in January 2011, the Company acquired GENBAND's Universal Signaling Platform and SP2000 signaling technology at a cost of $4.3 million. PT is further developing the SP2000 product and is selling both products to GENBAND. This technology was recorded in purchased intangible assets.

During the fourth quarter 2010, PT licensed signaling technology from Alcatel-Lucent for $.2 million. During 2011, PT successfully integrated this technology into its signaling product portfolio and delivered it to its first customer. This technology was recorded in property, equipment and improvements. Similarly, in 2009, PT paid a one-time license fee of $.8 million to acquire certain software technologies, which PT combined with its captive technologies and released as its Xpress product line in 2010. This technology was recorded in purchased intangible assets.

PT has significant core competencies associated with advanced network communications and control solutions. PT provides remotely manageable, IP-centric network solutions, elements and applications specifically engineered for high availability, scalability, and long life cycle deployments. Its products are built upon our own U.S. manufactured hardware combined with PT's NexusWare Carrier Grade Linux operating system and software development environment plus a broad suite of communications protocols and high availability middleware.

Proprietary Technology

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

Manufacturing and Suppliers

In a fast-paced technology environment, product life cycles generally extend for two to four years. The obsolescence by manufacturers of individual electronic components used by PT is occurring more rapidly than ever before. During 2010, PT completed the transition of its printed circuit board assembly for the hardware elements of PT's products to a contract manufacturer, Mack Technologies, Inc. ("Mack"), based near Boston, Massachusetts. The purpose of this transition was to bring tangible benefits to PT, which includes more predictable product costs, a significant reduction in capital expenditure requirements, and an enhanced ability to continue to offer cutting-edge technologies in PT's product lines without sacrificing PT's high standards of quality. PT performs all integration and final testing steps of its products at its Rochester facility. The outsourcing of all printed circuit board assembly to one contract manufacturer presents additional risks, including reliance on Mack's on-time delivery, the quality of Mack's products, and Mack's financial wherewithal.

Mack is responsible for the acquisition of most of the electronic components that go into the Company's printed circuit board products. Mack has considerably larger buying power based on its procurement budget than PT had on a stand-alone basis. Still, lack of availability of components can cause delays in shipments. In addition, the costs and time delays caused by redesigning specific products when components are not available has become a challenging factor in several cases.

Monterey and IPnexus Application-Ready Platform Customers: Announced customers for our Application-Ready S

There can be no assurance that future component supplies will be adequate for the Company's needs or will be available on prices and terms acceptable to PT. Mack's or PT's inability in the future to obtain sufficient limited-source components, or to develop alternative sources, could result in delays in product introduction or shipments; and increased component prices could negatively affect PT's gross margins, either of which would have a material adverse effect on PT's revenue and operating results.

In addition to utilizing Mack for printed circuit board assembly, PT also outsources the fabrication of other elements of its product lines, such as system chassis, metalwork and plastic components, to various third party suppliers. In the event of an interruption of production at PT's outsourcing vendors or its Rochester manufacturing facility, PT's ability to deliver products in a timely fashion would be compromised, which would have a material adverse effect on PT's results of operations.

Employees

As of December 31, 2011, PT had 143 full-time and three part-time employees, and one engineering cooperative education student. Management believes its relations with its employees are generally good. PT's employees are not subject to collective bargaining agreements.

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

Research and Development	60
Sales and Marketing	35
Manufacturing	32
General and Administrative	16
Total	143

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

ITEM 1A – Risk Factors

Our global growth is subject to a number of economic risks.

Our revenue and profitability depend on the overall demand for our products and related services and the successful implementation of our strategy. While the economy in the United States is slowly recovering from the great recession of 2008, the government debt crisis in Europe continues to severely diminish liquidity and credit availability for

European economies. There can be no assurance that there will not be a further deterioration in financial markets and confidence in major economies. These economic developments affect businesses such as ours in a number of ways. Tightening of credit in financial markets adversely affects the ability of our customers to obtain financing for significant purchases and operations and could result in a decrease in or cancellation of orders for our products and services as well as impact the ability of our customers to make payments. Similarly, tight credit may adversely affect our supplier base and increase the potential for one or more of our suppliers to experience financial distress or bankruptcy.

Our global business is also adversely affected by decreases in the general level of economic activity, such as decreased capital expenditures by telecommunications service providers, decreases in general business and consumer spending, and government procurement. Many carriers/service providers have been cautious of making investments in infrastructure during difficult economic times, which customarily results in reduced budgets and spending. This can impact us through reduced revenues, elongated selling cycles, delays in product implementation and increased competitive margin pressure. Fluctuations in the rate of exchange for the U.S. Dollar against certain major currencies such as the Euro, the Pound Sterling, the Canadian Dollar and other currencies also tend to make our products more or less costly for foreign customers which can adversely affect our results. We are unable to predict the likely duration and severity of the current adverse economic conditions in the U.S. and other countries, and are unable to fully anticipate the effect that the current economic conditions will have on our business.

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

The market for our products is generally characterized by rapid technological change and frequent introduction of products based on new technologies. Although we have continued to enhance or introduce new elements within our IPnexus Application-Ready Platform offerings, this product family has been in the marketplace for eight years. Application of our IPnexus Application-Ready platforms, especially as targeted at the telecommunications industry, is volatile as the effects of new technologies, new standards, and new products contribute to changes in the market and the performance of industry participants. Although we have continued to enhance and introduce new features within our SEGway Signaling Solutions, this product family has been in the marketplace for more than ten years. The replacement for signaling protocols in IP-based networks has been defined and next-generation products with this new protocol are currently available. Our future revenue will depend upon our ability to anticipate technological changes and to develop and introduce enhanced products on a timely basis that meet customer requirements and comply with industry standards. New product introductions, or the delays thereof, could contribute to quarterly fluctuations in operating results as orders for new products commence and orders for existing products decline. Moreover, significant delays can occur between product introduction and commencement of volume production, typically twelve to eighteen months. The inability to develop and manufacture new products in a timely manner, the existence of reliability, quality or availability problems in our products or their component parts, or the failure to achieve market acceptance for our products would have a material adverse effect on our revenue and operating results. Further, current technologies may become obsolete before being replaced by new technologies, which would have a material adverse effect on our revenue and operating results.

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

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

We depend on a number of key customers, the loss of any of which, or the substantially decreased demand from which, would harm our revenues and operating results.

We cannot assure that our principal customers will continue to purchase products from us at current levels. Customers typically do not enter into long-term volume purchase contracts with us and customers have certain rights to extend or delay the shipment of their orders. During 2012, Metaswitch Networks is expected to begin a transition away from using PT's IPnexus platforms in some of its product offerings. As a result, a significant reduction of shipments to Metaswitch is expected during 2012. The loss of one or more of our major customers, the reduction, delay or cancellation of orders, or a delay in shipment of our products to such customers, would have a material adverse effect on our revenue and operating results.

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

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

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

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

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

In a fast-paced technology environment, product life cycles extend for approximately two to four years and the obsolescence by manufacturers of individual electronic components used by the Company is occurring more rapidly than ever before. Certain components used in our products are currently available to us from only one or a limited number of sources. There can be no assurance that future supplies will be adequate for our needs or will be available on prices and terms acceptable to us. Our inability in the future to obtain sufficient limited-source components, or to develop alternative sources, could result in delays in product introduction or shipments, and increased component prices could negatively affect our gross margins, either of which would have a material adverse effect on our revenue and operating results.

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

In order to fulfill orders for customers in the most optimal manner for a volume and mix of business, we have historically manufactured the majority of our products at our Rochester, New York facility. However, in 2010, we outsourced the manufacturing of all our printed circuit board assemblies for our products to an outside contract manufacturer. In addition, certain elements of these products, such as platform chassis, are manufactured by other contract manufacturers. We do not have alternative manufacturing capabilities to manufacture our products. Even if we were able to identify alternative third-party contract manufacturers, we cannot assume that we would be able to retain their services on terms and conditions acceptable to us. In the event of an interruption in production or damage to our manufacturing facility from a natural disaster or other catastrophic event, either of which would cause interruptions or delays in our manufacturing process, we would not be able to deliver products on a timely basis, which would have a material adverse effect on our revenue and operating results. Although we currently have business interruption insurance, we cannot be assured that such insurance would adequately cover our lost business as a result of such an interruption.

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

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

Because of the existence of an extremely large number of patents in the communications industry and the rapid rate of new patents granted or new standards or new technology developed, we may have to obtain technology licenses from others. We do not know whether these third party technology licenses will be available to us on commercially reasonable terms. The loss of, or inability to obtain, any of these technology licenses could result in delays or reductions in our product shipments. Any such delays or reductions in product shipments would have a material adverse effect on our revenue and operating results. Furthermore, although we believe that our products do not intentionally infringe on the proprietary rights of third parties, we cannot assure that infringement claims will not be asserted, resulting in costly litigation in which we may not ultimately prevail. Adverse determinations in such litigation could result in the loss of our proprietary rights, subject us to significant liabilities, and require us to seek licenses from third parties or prevent us from manufacturing or selling our products, any of which would have a material adverse effect on our revenue and operating results.

We depend on a number of key personnel. The loss of these people, or delays in replacing them, would harm our operating results.

Our success depends on the continued contributions of our personnel, many of whom would be difficult to replace, if they left us. Changes in personnel could adversely affect our operating results. In addition, although our employees are subject to our employment policy regarding confidentiality and ownership of inventions, employees are generally not subject to employment agreements or non-competition covenants and thus they could compete with us if they left our employment.

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

We hold investments in privately held companies from time to time. We may make additional investments in the future in these or other companies. Depending upon the future fortunes of these companies in meeting their operating objectives, an impairment charge or reserves could be recorded on these investments in the future. The occurrence of a future impairment or additional reserve would adversely affect our results of operations.

We are subject to certain foreign regulations that restrict the distribution of products containing certain substances. Failure to comply with these foreign regulations would harm our operating results.

Foreign and domestic governmental agencies periodically issue directives pertaining to the distribution of products which contain certain substances. While we believe we are in full compliance with all such existing directives, if in the future the products that we produce do not comply with existing or similar directives, we would be unable to sell our products into those markets and our operating results would be harmed.

Errors or defects in our products could result in disputes, litigation and product liability claims by our customers and could diminish demand for our products, injure our reputation and adversely affect our operating results.

Our products are very complex and may contain errors or defects that could be detected at any point in the life of the product. While we have rigorous quality control and testing procedures for our products, we can provide no absolute assurances that errors or defects will not be found in our products until deployment or long after a product has been deployed. Our products, even if error free, must interoperate with other vendors' equipment in our customers' networks and such operation could result in technical problems with our products. A warranty or product liability claim brought against us could result in costly, highly disruptive and time-consuming litigation, which could harm our business. Although our agreements with our customers contain provisions designed to limit our exposure to potential warranty and product liability claims, it is possible that these limitations may not be effective to cover all claims. Although we maintain product liability insurance, it may not be sufficient to cover all claims to which we may be subject. Errors and defects or failures to properly interoperate, could cause diminished demand for our products, delays in market acceptance and sales, diversion of development resources, injury to our reputation, increased service and warranty costs or could result in disputes, litigation and product liability losses with our customers. If any of these were to occur, there would be a material adverse effect to our revenue and operating results.

In future periods, we may experience material weaknesses in our internal control over financial reporting, which could adversely affect our ability to report our financial condition and results of operations accurately and on a timely basis.

Material weaknesses in our internal control over financial reporting could adversely impact our ability to provide timely and accurate financial information. If we identify material weaknesses, we may not be able to timely or accurately report our financial condition, results of operations or cash flows or maintain effective disclosure controls and procedures. If we are unable to report financial information timely and accurately or to maintain effective disclosure controls and procedures, we could be subject to, among other things, regulatory or enforcement actions, securities litigation, and a general loss of investor confidence, any one of which could adversely affect our business prospects and the valuation of our common stock.

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Our revenue includes sales to federal and foreign government entities, generally under subcontracts with prime contractors. A loss of such contracts or an interruption in government funding for such contracts, could have a material adverse effect on our business.

We derived approximately 24% and 19% of our revenue for 2011 and 2010 from contracts with agencies of the United States Federal Government or subcontracts with prime contractors or subcontractors of the Federal Government, or contracts with foreign governments. The loss or significant curtailment of any of these government contracts or subcontracts, whether due to PT's performance or due to interruptions of or changes in governmental funding for such contracts or subcontracts, could have a material adverse effect on our business, results of operations and financial condition. Among the factors that could impact federal government spending and which would reduce our federal government contracting and subcontracting business are: a significant decline in, or reapportioning of, spending by the Federal Government; changes, delays or cancellations of Federal Government programs or requirements; the adoption of new laws or regulations that affect companies that provide services to the Federal Government; Federal Government shutdowns or other delays in the government appropriations process; changes in the political climate, including with regard to the funding of the products we provide; and general economic conditions.

ITEM 1B – Unresolved Staff Comments

None.

ITEM 2 - Properties

PT's corporate headquarters is located in 57,000 square feet of leased office and manufacturing space in Rochester, New York. This lease expires in April 2012. Corporate headquarters includes executive offices, along with sales, marketing, engineering and manufacturing operations. The current space exceeds our expected requirements. PT has executed a lease for its new corporate headquarters (also in Rochester, New York) and expects to relocate to this 32,000 square foot facility during the second quarter of 2012. PT owns land adjacent to the current facility.

PT also leases sales and engineering office space in San Diego, California under a lease which expires in November 2013. PT's Signaling Systems Group is located in 16,000 square feet of office space located in Kanata Ontario (Canada), a suburb of Ottawa. This lease expires in October 2013. PT's European, Middle East and Africa marketing group occupies leased office space near London, England. The lease for this space expires in March 2012. In addition, PT leases a sales/marketing office in Connecticut.

ITEM 3 - Legal Proceedings

From time to time, PT is involved in litigation relating to claims arising out of its operations in the normal course of business.

In December 2009, the Company became aware that Tekelec, a California corporation headquartered in Morrisville, North Carolina, had filed but not served a complaint against the Company in the U.S. District Court for the Eastern District of North Carolina. The complaint alleged that certain of the Company's signaling systems products infringe three of Tekelec's issued patents and sought a determination of infringement, a preliminary and permanent injunction from further infringement and an unspecified amount of damages. On March 4, 2010, an amended complaint was served on the Company through its designated agent in North Carolina. The amended complaint contained the same allegations as the original complaint but added two patents to the number of patents which Tekelec alleged the Company's signaling systems products infringe. Subsequently, the complaint was further amended to add a sixth patent which Tekelec alleged the Company's signaling systems product infringe.

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In May 2011, PT and Tekelec agreed to voluntarily dismiss all of the claims and defenses against each other, without prejudice. By Stipulation dated May 4, 2011, the litigation has now been dismissed without prejudice.

PT is not presently a party to any other legal proceedings, the adverse outcome of which, individually or in the aggregate, would have a material adverse effect on PT’s results of operations, financial condition or cash flows.

PART II

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

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

2011	High	Low
First Quarter	$ 2.11	$ 1.68
Second Quarter	2.33	1.91
Third Quarter	2.17	1.74
Fourth Quarter	$ 2.00	$ 1.57

2010	High	Low
First Quarter	$ 2.98	$ 2.59
Second Quarter	2.81	2.33
Third Quarter	2.49	2.06
Fourth Quarter	$ 2.22	$ 1.62

Stock Performance Graph

The following graph compares the cumulative total return of our common stock at the end of each calendar year since December 31, 2006 to the NASDAQ Stock Market (U.S.) Index, and the NASDAQ Computer Manufacturer Index. The stock performance shown in the graph below is not intended to forecast or be indicative of future performance.

As of February 27, 2012, there were 160 stockholders of record of the Company's common stock.

To date, PT has not paid cash dividends on its common stock and has no expectation to do so for the foreseeable future. PT has not sold any securities during the past three years, other than shares of common stock issued pursuant to stock option exercises. Reference is made to Item 12 for PT's equity plan information.

ITEM 6 - Selected Financial Data

(in thousands, except per share amounts)

The following selected financial data are derived from our consolidated financial statements:

For the Year Ended December 31:	2011	2010	2009	2008	2007
Sales	$ 36,176	$ 27,946	$ 29,491	$ 40,517	$ 40,319
Net (loss) income	(1,163)	(11,177)	(10,112)	1,663	1,814

Basic (loss) earnings per share:					
Net (loss) income	$ (.10)	$ (1.01)	$ (0.91)	$ 0.14	$ 0.14
Weighted average common shares	11,116	11,116	11,130	11,601	12,581
Diluted earnings per share:					
Net income				$ 0.14	$ 0.14
Weighted average common and common equivalent shares				11,611	12,626

At December 31:	2011	2010	2009	2008	2007
Working capital (1)	$ 18,289	$ 23,181	$ 32,326	$ 41,220	$ 40,307
Total assets	$ 38,279	$ 40,440	$ 48,889	$ 59,318	$ 59,520
Total stockholders' equity	$ 31,781	$ 32,768	$ 43,616	$ 53,447	$ 52,896

(1) - defined as current assets less current liabilities

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See “Financial Overview” of Management's Discussion and Analysis of Financial Condition and Results of Operations for additional information.

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

PT's annual operating performance is subject to various risks and uncertainties. The following discussion should be read in conjunction with the Consolidated Financial Statements and related notes, included elsewhere herein, as well as the risk factors described in Item 1A of this Form 10-K. PT's future operating results may be affected by various trends and factors, which are beyond PT's control. These risks and uncertainties include, among other factors, business and economic conditions, rapid technological changes accompanied by frequent new product introductions, competitive pressures, dependence on key customers, inability to gauge order flows from customers, fluctuations in quarterly and annual results, the reliance on a limited number of third party suppliers, limitations of the Company’s manufacturing capacity and arrangements, the protection of the Company’s proprietary technology, errors or defects in our products, the effects of pending or threatened litigation, the dependence on key personnel, changes in critical accounting estimates, potential impairments related to investments, foreign regulations, possible loss or significant curtailment of significant government contracts or subcontracts and potential material weaknesses in internal control over financial reporting. In addition, during weak or uncertain economic periods, customers’ visibility deteriorates causing delays in the placement of their orders. These factors often result in a substantial portion of the Company’s revenue being derived from orders placed within a quarter and shipped in the final month of the same quarter.

Matters discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations, and elsewhere in this Form 10-K, include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. PT'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 the accounting principles generally accepted in the United States (GAAP), estimates and assumptions are required to be made that have an impact on the assets, liabilities, revenue and expense amounts reported. These estimates can also affect supplemental information disclosures, including information about contingencies, risk and financial condition. The Company believes that given the current facts and circumstances, these 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. Management’s judgment in making these estimates and relying on these assumptions may materially impact amounts reported for any period.

The critical accounting policies, judgments and estimates that we believe have the most significant effect on our financial statements are set forth below:

- Revenue Recognition
- Software Development Costs
- Valuation of Inventories
- Income Taxes
- Product Warranty
- Stock-Based Compensation
- Restructuring Costs
- Carrying Value of Long-Lived Assets

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

In September 2009, the FASB amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of industry-specific software revenue recognition guidance. As a result, these arrangements are accounted for in accordance with new, "non-software" guidance for arrangements with multiple deliverables. The FASB also amended the accounting standards for revenue recognition for arrangements with multiple deliverables. The new authoritative guidance for arrangements with multiple deliverables requires that arrangement consideration be allocated at the inception of an arrangement to all deliverables using the relative selling price method. It also establishes a selling price hierarchy for determining the selling price of a deliverable, which includes: (1) vendor-specific objective evidence ("VSOE") if available; (2) third-party evidence ("TPE") if vendor-specific objective evidence is not available; and (3) best estimated selling price ("BESP") if neither vendor-specific nor third-party evidence is available. The new guidance eliminates the residual method of allocation for multiple-deliverable revenue arrangements which we used historically when we applied the software revenue recognition guidance to our multiple element arrangements.

We have adopted this guidance as of January 1, 2011. As most of our signaling products include both tangible products and software elements that function together to deliver the tangible product's essential functionality, the existing software revenue recognition guidance no longer applies to these transactions. The adoption of the new, non-software revenue recognition guidance did not have a material impact on the timing, pattern, or amount of revenue recognized in 2011. Based on currently available information, we anticipate that the impact of adopting this guidance on revenue recognition in future periods will not be material. However, this assessment may change because such impacts depend on terms and conditions of arrangements in effect in those future periods.

The new guidance does not generally change the units of accounting for our revenue transactions. For our multiple deliverable arrangements, our products and services qualify as separate units of accounting. Our multiple deliverable arrangements generally include a combination of our telecommunications hardware and software products, services including installation and training, and support services. These arrangements typically have both software and non-software components that function together to deliver the product's essential functionality. Our arrangements generally do not include any provisions for cancellation, termination, or refunds that would significantly impact recognized revenue.

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For substantially all of our multiple deliverable arrangements, whereby equipment and software are combined with other elements, such as software and maintenance, we defer support and services revenue, and recognize revenue for delivered products in an arrangement when persuasive evidence of an arrangement exists and delivery of the last product has occurred, provided the fee is fixed or determinable, and collection is deemed probable. In instances where final acceptance of the product is based on customer specific criteria, revenue is deferred until the earlier of the receipt of customer acceptance or the expiration of acceptance period. Support revenue is recognized ratably over the term of the support period. Services revenue is typically recognized upon completion of the services for fixed-fee service arrangements, as these services are relatively short term in nature (typically several weeks, or in limited cases, several months). For service arrangements that are billed on a time and material basis, we recognize revenue as the services are performed.

For multiple deliverable arrangements entered into prior to January 1, 2011 and not materially modified after that date, we recognize revenue based on the existing software revenue recognition guidance, which require the entire fee from the arrangement to be allocated to each respective element based on its relative selling price using VSOE. For such arrangements, when we are unable to establish VSOE for the delivered telecommunications products, we utilize the residual method to allocate revenue to each of the elements of an arrangement. Under this method, we allocate the total fee in an arrangement first to the undelivered elements (typically support and services) based on VSOE of those elements, and the remaining, or “residual” portion of the fee to the delivered elements (typically the product or products).

For multiple deliverable arrangements entered into after January 1, 2011, we recognize revenue based on the new non-software revenue recognition guidance. We allocate consideration to each deliverable in an arrangement based on its relative selling price. We follow a hierarchy to allocate the selling price of VSOE, then TPE and finally BESP. Because we rarely sell products with multiple deliverable arrangements on a stand-alone basis or without support, we are not able to establish VSOE for these products. Additionally, we generally expect that we will not be able to establish TPE due to the nature of our products and the markets in which we compete. Accordingly, we expect the selling price of our proprietary hardware and software products to be based on our BESP. We have established VSOE for our support and services and, therefore, we utilize VSOE for these elements.

Since the adoption of the new guidance, we have primarily used the same information used to set pricing strategy to determine BESP. The Company has corroborated the BESP with our historical sales prices, the anticipated margin on the deliverable, the selling price and profit margin for similar deliverables and the characteristics of the geographical markets in which the deliverables are sold. We plan to analyze the selling prices used in our allocation of arrangement consideration at least semi-annually. Selling prices will be analyzed more frequently if a significant change in our business necessitates a more timely analysis.

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

The accounting estimate related to revenue recognition is considered a “critical accounting estimate” because terms of sale can vary, and judgment is exercised in determining whether to defer revenue recognition. Such judgments may materially affect net sales for any period. Judgment is exercised 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 collectibility is reasonably assured.

Software Development Costs: All software development costs incurred in establishing the technological feasibility of computer software products to be sold are charged to expense as 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, using the straight-line method or using the ratio of current revenues to current and anticipated revenues from such product, whichever provides greater amortization. If the technological feasibility for a particular project is judged not to have been met or recoverability of amounts capitalized is in doubt, project costs are expensed as research and development or charged to cost of goods sold, as applicable. The accounting estimate related to software development costs is considered a "critical accounting estimate" because judgment is exercised 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. Judgment is exercised 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. Inventory includes purchased parts and components, work in process and finished goods. Provisions for excess, obsolete or slow moving inventory are recorded after periodic evaluation of historical sales, current economic trends, forecasted sales, estimated product life cycles and estimated inventory levels. Purchasing practices, electronic component obsolescence, accuracy of sales and production forecasts, introduction of new products, product life cycles, product support and foreign regulations governing hazardous materials are the factors that contribute to inventory valuation risks. Exposure to inventory valuation risks is managed 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 accounting estimate related to valuation of inventories is considered 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, including purchasing, sales, production, and after-sale support. If actual demand, market conditions or product life cycles differ from estimates, 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: PT provides deferred income tax assets and liabilities based on the estimated future tax effects of differences between the financial and tax bases of assets and liabilities based on currently enacted tax laws. A valuation allowance is established for deferred tax assets in amounts for which realization is not considered more likely than not to occur. The accounting estimate related to income taxes is considered a "critical accounting estimate" because judgment is exercised in estimating future taxable income, including prudent and feasible tax planning strategies, and in assessing the need for any valuation allowance. If it should be determined that all or part of a net deferred tax asset is not able to be realized in the future, an adjustment to the valuation allowance would be charged to income in the period such determination was made. Likewise, in the event that it should be determined that all or part of a deferred tax asset in the future is in excess of the net recorded amount, an adjustment to the valuation allowance would increase income to be recognized in the period such determination was made.

PT operates within multiple taxing jurisdictions worldwide and is subject to audit in these jurisdictions. These audits can involve complex issues, which may require an extended period of time for resolution. Although management believes that adequate provision has been made for such issues, there is the possibility that the ultimate resolution of such issues could have an adverse effect on the earnings of PT. Conversely, if these issues are resolved favorably in the future, the related provisions would be reduced, thus having a positive impact on earnings.

In addition, the calculation of PT's tax liabilities involves dealing with uncertainties in the application of complex tax regulations. PT recognizes liabilities for uncertain tax positions based on a two-step process. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires PT to estimate and measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. It is inherently difficult and subjective to estimate such amounts, as this requires PT to determine the probability of various possible outcomes. PT re-evaluates these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit, and new audit activity. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision in the period. At December 31, 2011, there are no tax uncertainties that PT has determined are required to be recognized.

Finally, the value of PT's deferred tax assets is dependent upon PT's ability to generate future taxable income in the jurisdictions in which PT operates. These assets consist of research credit carry-forwards, capital and net operating loss carry-forwards, and the future tax effect of temporary differences between balances recorded for financial statement purposes and for tax return purposes. It will require future pre-tax earnings in excess of $21 million in order to fully realize the value of the Company's deferred tax assets. Due to the uncertainty of PT's ability to realize its deferred tax assets, a valuation allowance has been recorded against substantially the full value of its deferred tax assets.

Product Warranty: Warranty obligations are generally incurred in connection with the sale of PT's 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. Future warranty costs are estimated based on historical performance rates and related costs to repair given products. The accounting estimate related to product warranty is considered a "critical accounting estimate" because judgment is exercised 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.

Stock-Based Compensation: PT's board of directors approves grants of stock options to employees to purchase our common stock. Stock compensation expense is recorded based upon the estimated fair value of the stock option at the date of grant. The accounting estimate related to stock-based compensation is considered a "critical accounting estimate" because estimates are made in calculating compensation expense including expected option lives, forfeiture rates and expected volatility. Expected option lives are estimated using vesting terms and contractual lives. Expected forfeiture rates and volatility are calculated using historical information. Actual option lives and forfeiture rates may be different from estimates and may result in potential future adjustments which would impact the amount of stock-based compensation expense recorded in a particular period.

Restructuring Costs: Restructuring costs generally consist of employee-related severance costs, lease termination costs and other facility-related closing expenses. Employee-related severance benefits are recorded either at the time an employee is notified, or if there are extended service periods, is estimated and recorded pro-rata over the period of each planned restructuring activity. Lease termination costs are calculated based upon fair value considering the remaining lease obligation amounts and estimates for sublease receipts. The accounting estimate related to restructuring costs is considered a "critical accounting estimate" because estimates are made in calculating the amount of employee-related severance benefits that will ultimately be paid and the amount of sublease receipts that will ultimately be received in future periods. Actual amounts paid for employee-related severance benefits can vary from these estimates depending upon the number of employees actually receiving severance payments. Actual sublease receipts received may also vary from estimates.

Carrying Value of Long-Lived Assets: PT periodically reviews the carrying values of its long-lived assets, other than capitalized software development costs and purchased intangible assets with indefinite useful lives, for impairment whenever events or changes in circumstances indicate that the carrying values may not be recoverable. PT assesses the recoverability of the carrying values of long-lived assets by first grouping its long-lived assets with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities (the asset group) and, secondly, by estimating the undiscounted future cash flows that are directly associated with and that are expected to arise from the use of and eventual disposition of such asset group. PT estimates the undiscounted cash flows over the remaining useful life of the primary asset within the asset group. If the carrying value of the asset group exceeds the estimated undiscounted cash flows, PT records an impairment charge to the extent the carrying value of the long-lived asset exceeds its fair value. PT determines fair value through quoted market prices in active markets or, if quoted market prices are unavailable, through the performance of internal analyses of discounted cash flows. The accounting estimate related to impairment of long-lived assets is considered a "critical accounting estimate" because PT's impairment tests include estimates of future cash flows that are dependent upon subjective assumptions regarding future operating results including revenue growth rates, expense levels, discount rates, capital requirements and other factors that impact estimated future cash flows and the estimated fair value of long-lived assets.

Overview

Performance Technologies, Incorporated ("PT"), a Delaware corporation founded in 1981, is a global supplier of advanced network communications solutions to service providers, government and OEM markets.

PT's product portfolio includes IP-centric network elements and applications designed for high availability, scalability, and long life cycle deployments. The industry-leading Monterey MicroTCA and IPnexus Platforms anchor a growing portfolio of PT solutions. OEMs and application developers, including PT itself, leverage the robust carrier grade Linux development environment and rich suite of communications protocols (PT's NexusWare) of our Application-Ready Platforms as a cornerstone component of their end product value proposition. PT's SEGway Signaling Solutions provide affordable, high density signaling, advanced routing for LTE and IMS applications, IP migration, gateway capabilities, SIP bridging, and core-to-edge distributed intelligence, as well as features such as Number Portability and SMS Spam Defense. The Company's Xpress NGN applications enable evolving Mobile 2.0, Multi-media, and IMS based revenue-generating services.

PT's business addresses one industry segment – Communications, and globally targets two primary vertical markets for its network communications products: telecommunications, and military, aerospace and government systems.

The telecommunications market, historically our largest vertical market, is fundamentally driven by investments in network infrastructure by carriers and service providers. Telecommunications market revenues derived from our Application-Ready Platforms, which are sold to OEMs, depend primarily on broad, multi-year deployments of next-generation telecommunications infrastructure. Telecommunications market revenues generated from service providers purchasing our SEGway and Xpress product lines result from investments necessary to support existing and evolving service demands such as text messaging and the transition to Internet-based communications networks.

Sales into the military, aerospace and government systems market are typically to prime contractors and system integrators that reflect investment levels by various government agencies and military branches in specific programs and projects requiring enhanced communications capabilities. Military, aerospace and government systems budgets are currently under pressure and shipments are subject to project deployment schedules, which are often unpredictable.

During 2011, the economy recovered unevenly around the world and business conditions continued to remain very challenging in the telecommunications equipment market. The new norm in our OEM business appears to be that OEM customers place orders for product only when they have orders in hand from their customers and then expect almost immediate delivery. Revenues from our telecommunications customers grew by $5.0 million, or 22% in 2011, compared to 2010. The opportunity for government funded network infrastructure and military related expenditures remains positive but the timing of awarded business for the most part is highly unpredictable. Revenues from the military, aerospace and government systems market customers grew by $3.3 million, or 61% in 2011, compared to 2010. Our Xpress product line is generating interest from both telecommunications and government customers. PT began a pilot program with a government customer during the third quarter 2010 to demonstrate the Xpress products' capabilities in a communications cost reduction program. The first contract award for this program is expected during 2012. Forward-looking visibility on customer orders is very challenging.

Please refer to Part 1, Item 1, under the caption "Business," for further discussion of the industry, markets and economic environment.

Strategy

The Company's strategy is to maximize the value proposition of its products by leveraging its field-proven systems, software and hardware technologies. Management believes the tightly integrated combination of these technologies results in considerable benefits to its customers including a compelling return-on-investment proposition, significant development risk mitigation and a substantially accelerated time-to-market opportunity.

Management is focused on building on the momentum generated in 2011 and will continue to concentrate on the four network communications-focused initiatives established in 2010 to construct a solid foundation for long-term growth. These initiatives include further strengthening our SEGway Signaling Systems product line, continued evolution and enhancement of our open-standards based Application-Ready Platforms for mission critical communications applications, intensifying our market diversification efforts in government systems markets, and identifying forward-looking network communications growth opportunities, such as our Xpress portfolio of SIP-based applications and enabling infrastructure, that we can pursue with our own end product solutions.

In addition, our signaling product portfolio, which is targeted at the service provider market, has reached a scale in terms of features, functionality and cost-effectiveness that generates strong interest on a global basis and especially in many emerging markets. As a result, beginning in 2011, the sales and marketing strategy for our signaling products became more focused on working with strong channel partners as our primary vehicle to further expand our reach in the global and emerging markets. To that end, we added GENBAND as a strong channel partner in January 2011, Kapsch CarrierCom AG in the third quarter 2011, and we continue to work closely under our established relationship with Alcatel-Lucent as another major channel partner.

From an expense perspective, in the fourth quarter 2009, management proactively undertook several new investments to further position PT for growth as business conditions improve. The timing of these investments was based upon forward-looking market data that we expected would drive opportunities for our technologies. It became apparent during the second half of 2010 that the economic and industry trends that occurred did not drive growth for PT's products to the degree expected. Therefore, in December 2010, PT announced an expense reduction program to substantially reduce its operating expenses by consolidating our San Luis Obispo, California engineering operation with our Rochester, New York engineering group and also reducing of our sales and marketing staff. Management believes that while it was necessary to make these reductions for financial reasons, the significant strategic investments made during 2010 were important in underpinning a solid foundation for long-term future growth.

There are identifiable risks associated with PT's strategy in the current economic climate. While management believes that its network communications market focus offers opportunities for growth in the long term, network infrastructure investments by carriers are very sluggish; the market for signaling products is declining and the market for SIP-based products is not growing rapidly enough to offset these declines. Despite the current economic conditions, which may involve new risks not currently identified, management believes the outlook for the Company's profitability is improving.

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

Key Performance Indicator

PT believes that a key indicator for its business is the trend for the volume of orders received from customers. The telecommunications market, historically our largest vertical market, is fundamentally driven by investments in network infrastructure by carriers and service providers. Telecommunications market revenues derived from our Monterey and IPnexus Application-Ready Platforms depend primarily on broad, multi-year deployments of next-generation telecommunications infrastructure. Telecommunications market revenues generated from service providers result from investments necessary to support existing and evolving service demands such as text messaging and the transition to Internet-based communications networks. Revenues from our telecommunications customers grew by $5.0 million, or 22% in 2011, compared to 2010. The economy appears to be recovering unevenly around the world and current business conditions continue to remain quite challenging in the telecommunications equipment market.

Sales into the military, aerospace and government systems market are typically to prime contractors and system integrators that reflect investment levels by various government agencies and military branches in specific programs and projects requiring enhanced communications capabilities. Revenues from the military, aerospace and government systems market customers grew by $3.3 million, or 61% in 2011, compared to 2010.

During 2011, the challenging economic climate continued to cause customers to limit and/or delay investments in their network infrastructure. However, PT is gaining market traction despite this climate. Sales to customers amounted to $36.2 million in 2011, compared to $27.9 million in 2010. During weak economic periods, customers' ability to forecast their requirements deteriorates causing delays in the placement of orders. Forward-looking visibility on customer orders continues to be very challenging.

Financial Overview

Revenue:

Revenue for 2011 amounted to $36.2 million, compared to $27.9 million in 2010. Despite continued weakness in the global economy, PT experienced a 22% increase in demand for its products from its telecommunications customers as service providers appear to be moderately increasing capital expenditure budgets. For the year, PT experienced revenue growth from its new distribution relationships which totaled $3.5 million. Also contributing to telecommunications revenue were increases in shipments to three customers amounting to $.7 million, $.9 million and $1.6 million, respectively. Shipments to PT’s largest customer increased $0.2 million in 2011 over 2010, to $6.9 million.

Shipments to customers outside of the United States represented 46% and 58% of sales in 2011 and 2010, respectively. Shipments to customers in the United States increased by $7.8 million in 2011 as compared to 2010, representing substantially all of the revenue increase for the year. Shipments to the United Kingdom represented 20% and 26% of PT’s total sales in 2011 and 2010, respectively. The increase in shipments to various military, aerospace and government customers amounted to $3.3 million, representing a 61% increase, compared to 2010.

Earnings:

PT incurred a net loss in 2011 amounting to ($1.2 million), or ($.10) per basic share, based on 11.1 million shares outstanding. This loss included:

- Restructuring charges of $.02 per share;
- Stock-based compensation expense of $.03 per share;
- An impairment charge against fixed assets of $.04 per share;
- Write-offs of software development costs of $.02 per share;
- Amortization of purchased intangible assets of $.10 per share; and
- Litigation expenses of $.04 per share.

PT incurred a net loss in 2010 amounting to ($11.2 million), or ($1.01) per basic share, based on 11.1 million shares outstanding. This loss included:

- Restructuring charges of $.11 per share;
- Write-offs of software development costs of $.05 per share;
- Stock-based compensation expense of $.04 per share
- Litigation expenses of $.11 per share; and
- Discrete income tax provision items totaling $.02 per share.

Cash:

Cash, cash equivalents and investments amounted to $15.8 million and $19.2 million at December 31, 2011 and 2010, respectively, and the Company had no long-term debt at either date. The decrease in cash in 2011 was due primarily to $4.4 million of cash used for the purchase of equipment, inventory and intellectual property, including signaling software products from GENBAND in January 2011, and the payment of accrued restructuring costs, partially offset by positive cash flows from operations.

Cash provided by operating activities amounted to $3.4 million in 2011, as compared with cash used by operating activities of $6.5 million in 2010. The change in operating cash flows totaled $10.0 million year over year. The 2011 amount included net loss of ($1.2 million), offset by non-cash charges including depreciation, amortization, asset write-offs and impairments totaling $4.4 million and stock-based compensation expense of $.3 million. In addition, inventories decreased by $2.4 million, offset substantially by a $1.7 million decrease in accounts payable and a $.2 million increase in accounts receivable. Accrued expenses declined by $1.4 million primarily due to the payment of accrued restructuring costs and a $.5 million decrease in accrued vacation. The increase in accounts receivable was principally due to higher fourth quarter sales in 2011, compared to 2010. The decrease in inventory is primarily attributable to the higher sales level in 2011 and the working down of the inventory that was needed to accommodate the transition to a contract manufacturer in 2010. Accounts payable decreased primarily due to lower levels of inventory purchases at the end of 2011, as compared with the prior year end.

Restructuring Activities:

PT completed two restructuring actions during 2011. In December 2009, PT announced its decision to outsource the manufacturing of the printed circuit board assembly for PT's hardware products. In connection with this decision, the Company reduced its Rochester workforce by fourteen employees during 2010 and 2011.

In December 2010, the Company announced its plan to implement a strategic reduction of its existing workforce in response to the continuing challenges of the global economic environment. This program, which was completed in the fourth quarter 2011, was projected to reduce operating expenses by approximately $4.0 million to $4.5 million on an annualized run rate basis. It included closing the San Luis Obispo, California engineering facility and the elimination of 22 sales, marketing and engineering positions which represented approximately 12% of the Company's workforce. The Company recorded a pre-tax charge of $0.9 million in the fourth quarter of 2010 and a pre-tax charge of $.2 million in 2011 for severance and other costs related to this program. This program required an outlay of cash totaling $1.1 in 2011.

PT implemented two restructuring actions during 2009. In January 2009, the Company implemented a strategic reduction of its existing workforce in response to the challenging global economic environment. As a result of this action, the Company eliminated twenty positions in the first quarter 2009, approximately 8% of its global workforce. In the first quarter, PT recorded restructuring charges for cash expenditures associated with employee-related costs of approximately $.4 million. In July 2009, the Company implemented a voluntary separation program in which substantially all U.S. employees were offered the opportunity to elect termination of employment, subject to the Company's approval. Eight employees voluntarily terminated under this program. In the third quarter, PT recorded restructuring charges for cash expenditures associated with employee-related costs of approximately $.2 million.

Results of Operations

The following table sets forth, for the years indicated, certain consolidated financial data expressed as a percentage of sales, which has been included as an aid to understanding PT's results and should be read in conjunction with the Selected Financial Data and Consolidated Financial Statements (including the notes thereto) appearing elsewhere in this report.

	Year Ended December 31,		
	2011	2010	2009
Sales	100.0 %	100.0 %	100.0 %
Cost of goods sold	51.4 %	55.7 %	46.8 %
Software capitalization write-off	0.5 %	2.1 %	
Gross profit	48.1 %	42.2 %	53.2 %
Operating expenses:			
Selling and marketing	17.7 %	29.7 %	24.3 %
Research and development	19.7 %	28.0 %	26.4 %
General and administrative	12.6 %	20.9 %	15.7 %
Restructuring charges	.7 %	4.2 %	2.1 %
Impairment charges - vendor software	1.1 %		
Impairment charges of goodwill and long-lived assets			14.5 %
Total operating expenses	51.8 %	82.8 %	83.0 %
Loss from operations	(3.7 %)	(40.6 %)	(29.8 %)
Other income, net	0.4 %	1.2 %	1.5 %
Loss before income taxes	(3.3 %)	(39.4 %)	(28.3 %)
Income tax (benefit) provision	(0.1 %)	0.6 %	6.0 %
Net loss	(3.2 %)	(40.0 %)	(34.3 %)

Year Ended December 31, 2011 compared with the Year Ended December 31, 2010

Sales. Total revenue for 2011 amounted to $36.2 million, compared to $27.9 million for 2010. PT's products have been grouped into two primary vertical markets within one segment, communications. Revenue from each product category is expressed as a percentage of sales for the periods indicated:

	2011	**2010**
Telecommunications	76 %	81 %
Military, aerospace and government systems	24 %	19 %
Total	100 %	100 %

Telecommunications products:

Telecommunications products are comprised of Monterey and IPnexus Application-Ready Platforms, SEGway signaling systems and Xpress products. PT's Application-Ready Platforms are designed for high availability, scalability, and long life cycle deployments and are sold to telecommunication equipment manufacturers. The Company's SEGway signaling products, which are built on our Application-Ready Platforms, provide a full suite of signaling solutions that seamlessly bridge between circuit-switched networks and growing "IP-based" networks. PT's Xpress products are a portfolio of SIP-based applications and enabling infrastructure for next-generation network (NGN) architectures.

Revenue from telecommunications products amounted to $27.6 million and $22.6 million in 2011 and 2010, respectively. This increase in revenue of $5.0 million, or 22%, primarily reflects the impact of PT's significant new channel partner relationships which totaled $3.4 million in 2011, plus a $1.6 million increase in sales to a customer in Africa. Sales to the Company's largest customer increased $.2 million, from $6.7 million to $6.9 million.

Military, aerospace and government products:

Our Government Systems group continues to work with numerous prime contractors to incorporate PT's COTS-based, application-ready systems into specific programs and projects requiring enhanced communications capabilities. Revenue from military, aerospace and government system products was $8.6 million and $5.3 million in 2011 and 2010, respectively. This increase of $3.3 million, or 61%, included increased shipments to two customers amounting to $1.5 million and $.7 million, respectively.

Gross profit. Gross profit consists of sales, less cost of goods sold including material costs, manufacturing expenses, depreciation, amortization of software development costs, and expenses associated with engineering contracts and the technical support function. Gross profit totaled $17.4 million and $11.8 million in 2011 and 2010, respectively, an increase of $5.6 million, or 47%. Gross margin was 48.1% and 42.2% of sales for 2011 and 2010, respectively. Of the increase in margin, $.4 million resulted from a decrease in charges to write off or write down to estimated net realizable value software development costs. Such charges totaled $.2 million and $.6 million in 2011 and 2010, respectively. The most significant factors impacting the improved gross margin were the increase in revenue; an improvement in product mix toward higher-margin, more software-content products, especially our signaling products; and better utilization of the Company's fixed manufacturing labor and overhead due to the increase in sales. Included in cost of goods sold is the amortization of software development costs and purchased intangible assets, which totaled $3.0 million and $2.1 million in 2011 and 2010, respectively, excluding the charges for the write down of capitalized software development projects discussed above. The amount of amortization recorded in 2011 increased by $.9 million, as compared to 2010, due to the amortization associated with the purchase of signaling technology from GENBAND in January 2011. This technology is being amortized over a five-year estimated life.

Total Operating Expenses. Total operating expenses in 2011 amounted to $18.8 million including restructuring expenses of $.3 million, and stock compensation expense of $.3 million. Total operating expenses in 2010 amounted to $23.1 million including restructuring charges of $1.2 million and stock compensation expense of $.4 million. Total operating expenses decreased $4.3 million from 2010 to 2011, as discussed below.

Selling and marketing expenses amounted to $6.4 million and $8.3 million in 2011 and 2010, respectively. This decrease of $1.9 million, or 23%, was principally the result of reduced numbers of sales and marketing personnel primarily due to the Company's December 2010 restructuring program, lower trade show spending, and lower expenses due to an improved foreign currency exchange rate between the U.S. dollar and the British pound, offset partially by higher commissions.

Research and development expenses amounted to $7.1 million and $7.8 million in 2011 and 2010. The Company capitalizes certain software development costs, which reduces the amount charged to research and development expenses. Amounts capitalized were $2.0 million and $2.3 million in 2011 and 2010, respectively. Gross research and development expenditures were $9.1 million and 10.1 million in 2011 and 2010, respectively. The decrease in gross research and development expenditures totaled $1.0 million, or 10%, and was primarily due to the Company's decision to close its engineering center in San Luis Obispo, California, reducing engineering by seventeen positions.

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General and administrative expenses totaled $4.6 million and $5.8 million for 2011 and 2010, respectively. General and administrative expenses in 2010 and early in 2011 were unusually high due to the costs associated with the Company's defense of intellectual property litigation instituted by one of the Company's competitors. This litigation was dismissed in May 2011. Litigation-related expenses declined by $.8 million from 2010 to 2011.

During 2011, PT recorded a $.4 million charge to impair certain assets in conjunction with the Company's termination of a value-added resellers agreement. $.4 million of the decrease in total operating expenses from 2010 to 2011 was due to a change in the Company's paid-time-off policy. In addition, a $.1 million out-of-period charge was recorded in 2011 to reduce the recorded balance of software development costs.

Restructuring charges amounted to $.3 million and $1.2 million in 2011 and 2010, respectively. In 2010, the Company recorded restructuring charges related to two programs. In December 2009, the Company announced its decision to outsource its printed circuit board assembly operation to a contract manufacturer. This action resulted in the elimination of fourteen positions during 2010, for which a restructuring charge of $.3 million was recorded. In December 2010, the Company announced a reduction in force, which was completed during the fourth quarter of 2011. A restructuring charge of $.2 million and $.9 million was recorded in 2011 and 2010, respectively, in connection with this action.

Restructuring charges amounted to $.6 million in 2009 and relate to two reductions in force that management initiated during the year. In January 2009, twenty positions were eliminated in an involuntary reduction in force, while in August 2009, eight positions were eliminated in a voluntary reduction in force. Both of these actions were completed in 2009.

A summary of the activity with respect to the 2011 and 2010 restructuring activity is as follows (amounts in millions):

	Number of employees	Severance Reserve	Lease commitments and other	Total
Balance at January 1, 2010	-	$ -	$ -	$ -
2010 restructuring charges	36	1.1	.1	1.2
2010 utilization	(13)	(.2)	(.1)	(.3)
Balance at December 31, 2010	23	.9	-	.9
2011 restructuring charges	2	.1	.1	.2
2011 utilization	(25)	(1.0)	(.1)	(1.1)
Balance at December 31, 2011	-	$ -	$ -	$ -

All utilization amounts except $.1 million in each of 2011 and 2010 represent cash payments.

Other Income, net. Other income consists primarily of interest income and totaled $.2 million in 2011, compared to $.3 million in 2010. This decrease was due to continued depressed yields the Company is earning on its investments and lower average cash and investment balances in 2011 than in 2010. As of December 31, 2011, the Company's funds are primarily invested in high-quality corporate bonds of short duration, government-backed money market funds, municipal bonds and bank guaranteed interest contracts.

Income taxes. The 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 tax credits related to research and development activities in the United States and Canada, and tax-exempt interest income.

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For 2011, the income tax benefit amounted to $.02 million and includes the effect of expected foreign investment and research credits. For 2010, the income tax provision amounted to $.2 million and includes the effect of a discrete foreign deferred tax provision of $.1 million resulting from the Company revising its assertion that the earnings in its Canadian subsidiary will be indefinitely reinvested. The 2010 provision also includes a discrete income tax provision of $.1 million which was recorded due to the income tax benefit which resulted from the decrease in unrealized gain on foreign currency hedge contracts during 2010, and state and foreign taxes, offset by refundable U.S. federal and Province of Ontario credits.

Stock compensation expense. Cost of goods sold and operating expenses include stock compensation expense which totaled $.3 million, $.4 million and $.5 million in 2011, 2010, and 2009, respectively.

Year Ended December 31, 2010 compared with the Year Ended December 31, 2009

Sales. Total revenue for 2010 amounted to $27.9 million, compared to $29.5 million for 2009. Revenue from each product category is expressed as a percentage of sales for the periods indicated:

	2010	**2009**
Telecommunications	81 %	82 %
Military, aerospace and government systems	19 %	18 %
Total	100 %	100 %

Telecommunications products:

Telecommunications products are comprised of IPnexus Application-Ready Systems, SEGway signaling systems and Xpress products. PT’s IPnexus Application-Ready Systems are designed for high availability, scalability, and long life cycle deployments and are sold to telecommunication equipment manufacturers. The Company’s SEGway signaling products, which are built on our IPnexus systems, provide a full suite of signaling solutions that seamlessly bridge between circuit-switched networks and growing “IP-based” networks. PT’s Xpress products are a portfolio of SIP-based applications and enabling infrastructure for next-generation network (NGN) architectures.

Revenue from telecommunications products amounted to $22.6 million and $24.2 million in 2010 and 2009, respectively. This decrease in revenue of $1.6 million, or 7%, reflects the impact of the economy on the telecommunications industry, partially offset by a rebound in sales to the Company’s largest customer increased $2.4 million year-over-year.

Military, aerospace and government products:

Our recently realigned Government Systems group continues to work with numerous prime contractors to incorporate PT's COTS-based, application-ready systems into specific programs and projects requiring enhanced communications capabilities. Revenue from military, aerospace and government system products was essentially unchanged in 2010 over 2009. PT had significant sales to the Company’s second largest customer in 2010, as well as to the FAA and the U.S. military in 2010.

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Gross profit. Gross profit consists of sales, less cost of goods sold including material costs, manufacturing expenses, depreciation, amortization of software development costs, and expenses associated with engineering contracts and the technical support function, and totaled $11.8 million and $15.7 million in 2010 and 2009, respectively. Gross margin was 42.2% and 53.2% of sales for 2010 and 2009, respectively. Of this 11% decrease, 2.2% resulted from charges totaling $.6 million to write off or write down to the estimated net realizable value software development costs which were capitalized for new products which either had not reached commercial general release and were discontinued, or which have been released but for which the revenue is not expected to be sufficient to absorb the project's unamortized cost. In addition, the significant decline in gross margin as a percentage of sales in 2010 resulted from a less favorable product sales mix, the non-absorption of fixed manufacturing costs, which resulted from significantly lower sales and production volumes, and redundant costs resulting from the transition of the Company's printed circuit board assembly operation to a contract manufacturer. Also included in cost of goods sold is the amortization of software development costs which totaled $2.1 million and $1.7 million in 2010 and 2009, respectively, excluding the $.6 million of 2010 charges for the write down of capitalized software development projects discussed above.

Total Operating Expenses. Total operating expenses in 2010 amounted to $23.1 million including restructuring expenses of $1.2 million, and stock compensation expense of $.4 million. Total operating expenses in 2009 amounted to $24.5 million including impairment charges recorded against goodwill and long-lived assets which totaled $4.3 million, restructuring expenses of $.6 million, and stock compensation expense of $.5 million.

Selling and marketing expenses were $8.3 million and $7.2 million in 2010 and 2009, respectively. This increase of $1.1 million, or 15%, was primarily the result of hiring additional sales and marketing personnel, engaging independent sales representatives, increased trade show spending, higher expenses associated with the foreign currency exchange rate between the U.S. dollar and the British pound and Canadian dollar, offset partially by lower commissions.

Research and development expenses amounted to $7.8 million in both 2010 and 2009. The Company capitalizes certain software development costs, which reduces the amount charged to research and development expenses. Amounts capitalized were $2.3 million in both 2010 and 2009. Gross research and development expenditures were $10.1 million in both 2010 and 2009. 2010 benefited as a result of the full effect of 2009 workforce reductions, offset by higher expenses associated with the foreign currency exchange rate between the United States dollar and Canadian dollar in 2010 compared to 2009, and a $.1 million reduction in the savings realized from the Company's Canadian dollar hedging strategy.

General and administrative expenses totaled $5.8 million and $4.6 million for 2010 and 2009, respectively. The increase in expenses was primarily related to significantly higher legal expenses associated with the Company's defense of intellectual property litigation instituted by one of the Company's competitors.

Restructuring charges amounted to $1.2 million and $.6 million in 2010 and 2009, respectively. In 2010, the Company recorded restructuring charges related to two programs. In December 2009, the Company announced its decision to outsource its printed circuit board assembly operation to a contract manufacturer. This action resulted in the elimination of fourteen positions during 2010, for which a restructuring charge of $.3 million was recorded. In December 2010, the Company announced a reduction in force, which will be substantially completed during the first quarter of 2011. A restructuring charge of $.9 million was recorded in 2010 in connection with this action.

Restructuring charges amounted to $.6 million in 2009 and relate to two reductions in force that management initiated during the year. In January 2009, twenty positions were eliminated in an involuntary reduction in force, while in August 2009, eight positions were eliminated in a voluntary reduction in force. Both of these actions were completed in 2009.

A summary of the 2010 and 2009 restructuring activity is as follows (amounts in millions):

	Number of employees	Severance Reserve	Lease commitments and other	Total
Balance at January 1, 2009	-	$ -	$ -	$ -
2009 restructuring charges	28	.6	-	.6
2009 utilization	(28)	(.6)	-	(.6)
Balance at December 31, 2009	-	-	-	-
2010 restructuring charges	36	1.1	.1	1.2
2010 utilization	(13)	(.2)	(.1)	(.3)
Balance at December 31, 2010	23	$ .9	$ -	$ .9

All utilization amounts except $.1 million in 2010 represent cash payments.

Carrying Value of Goodwill and Long-lived Assets. Due to the Company's decreased stock price during the second half of 2009 and resulting lower market capitalization, particularly in comparison with the 2009 recovery in United States equity markets, management recorded an impairment charge amounting to $4.14 million against the full recorded value of goodwill based on the Company's assessment at December 31, 2009. In conjunction with the review for impairment of goodwill at December 31, 2009, PT also performed a review of the recoverability of its other long-lived assets. As a result, PT recorded a non-cash impairment charge against the carrying value of property, equipment and improvements amounting to $.14 million.

Other Income, net. Other income consists primarily of interest income and totaled $.3 million in 2010, compared to $.4 million in 2009. This decrease was due to depressed yields the Company is earning on its investments and lower average cash and investment balances in 2010 than in 2009. As of December 31, 2010, the Company's funds were primarily invested in government-backed money market funds, certificates of deposit, government or government-backed bonds of short duration and high-quality corporate bonds of short duration.

Income taxes. The 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 tax credits related to research and development activities in the United States and Canada, and tax-exempt interest income.

For 2010, the income tax provision amounted to $.2 million and includes the effect of a discrete foreign deferred tax provision of $.1 million resulting from the Company reverting to a partial assertion that the earnings in its Canadian subsidiary will be indefinitely reinvested. The 2010 provision also includes a discrete income tax provision of $.1 million which was recorded due to the income tax benefit which resulted from the decrease in unrealized gain on foreign currency hedge contracts during 2010, and state and foreign taxes, offset by refundable U.S. federal and Province of Ontario credits. For 2009, the income tax provision amounted to $1.8 million, which included state and foreign taxes of $.1 million and a valuation allowance recorded against the balance of the Company's United States deferred tax assets in the amount of $2.9 million, offset by discrete income tax benefits of $.3 million; the recognition of a deferred tax asset relating to a United States tax law change in November 2009 of $.4 million; and the reversal of the deferred tax liability relating to the Company's full impairment of goodwill which amounted to $.5 million.

Stock compensation expense. Cost of goods sold and operating expenses include stock compensation expense which totaled $.4 million, $.5 million and $.6 million in 2010, 2009, and 2008, respectively.

Liquidity and Capital Resources

At December 31, 2011, our primary sources of liquidity are cash, cash equivalents and investments. Together, cash, cash equivalents and investments totaled $15.8 million and $19.2 million at December 31, 2011 and 2010, respectively. The decrease in cash, cash equivalents and investments amounted to $3.4 million and is primarily the result of the Company's purchase of GENBAND assets, offset partially by positive cash flows from operations after taking into consideration non-cash depreciation, amortization, asset write-offs and impairments. The Company had working capital of $18.3 million and $23.2 million at December 31, 2011 and 2010, respectively. While the decrease in working capital amounted to $4.9 million, working capital was essentially equal year-over-year except for the use of cash to fund the Company's $4.4 million purchase of equipment, inventory, and intellectual property from GENBAND early in 2011, as well as an increase in non-current investments of $.7 million. In 2011, the Company also used cash to fund capitalized software development costs of $2.0 million and property, equipment and improvements of $.3 million.

Cash flows from operating activities totaled $3.4 million in 2011, a $9.9 million improvement over 2010, when cash flows used in operations totaled $6.5 million. The 2011 amount included the net loss of ($1.2 million), offset by non-cash charges including depreciation, amortization, asset write-offs and impairments totaling $4.3 million and stock-based compensation expense of $.3 million. In addition, inventories decreased by $2.4 million and deferred revenue increased by $.9 million. This was more than offset by a $3.1 million decrease in accounts payable and accrued expenses and a $.2 increase in accounts receivable. The increase in accounts receivable was principally due to higher fourth quarter sales in 2011, compared to 2010. The decrease in inventory is primarily attributable to the higher sales level in 2011 and the working down of the inventory that was needed to accommodate the transition to a contract manufacturer. Accounts payable decreased primarily due to lower levels of inventory purchasing at the end of 2011, as compared with the prior year end, and accrued expenses decreased primarily due to the payout of severance and other restructuring costs. Deferred revenue increased primarily due to funds received in advance of revenue recognition on telecommunications transactions.

While cash flow from operations was positive for 2011, the Company is prepared to take measures and consider options should significant negative cash flow from operations occur.

Cash used by investing activities during 2011 amounted to $6.5 million, compared to cash provided by investing activities during 2010, which amounted to $1.8 million. Cash used by investing activities resulted primarily from the Company's purchase of software, equipment, inventory and intellectual property from GENBAND in early 2011, which totaled $4.4 million. In addition, the Company capitalized $2.0 million of software development costs and spent $.3 million to acquire property, equipment and improvements. Cash provided by investing activities during 2010 amounted to $1.8 million, compared to cash used by investing activities during 2009, which amounted to $11.2 million. Cash provided by investing activities resulted primarily from net sales of investments, which amounted to

$5.3 million, offset partially by capitalized software development costs of $2.3 million and capital and technology asset purchases totaling $1.3 million.

In 2011, management initiated certain actions to align expenses with projected revenue levels. Management believes that the Company's current cash, cash equivalents and investments will be sufficient to meet our anticipated cash requirements, including working capital and capital expenditure requirements, for at least the next twelve months. However, if revenue levels are not sustained, expenses may need to be reduced further. Furthermore, management is continuing to evaluate strategic acquisitions to accelerate the Company's growth and market penetration efforts. These strategic acquisition efforts could have an impact on our working capital, liquidity or capital resources.

Off-Balance Sheet Arrangements:

The Company had no off-balance sheet arrangements during 2011.

Contractual Obligations:

The Company leases facilities under operating leases. Under the terms of the facility lease in Rochester, New York, which expires in April 2012, the Company pays annual rent which amounts to $783,000.

On February 3, 2012, the Company executed a lease agreement for its new corporate headquarters facility. The new facility, which has approximately 32,000 square feet of office and warehouse space, is located in Rochester, New York. This facility will replace PT's existing corporate headquarters facility and will house executive offices, along with sales, marketing, engineering and manufacturing operations. PT expects to occupy the new premises during the second quarter 2012.

The new lease has a sixty-six month term for approximately two-thirds of the space and a thirty-eight month term for the remaining space. The initial rent payments for the new facility will total approximately $352,000 annually and will escalate by approximately 1.3% each year. In addition, PT will be responsible for payment of the utilities, real estate taxes, insurance and maintenance on this property.

In addition, PT entered into a termination of lease agreement with the Landlord for its existing corporate headquarters facility, which waives PT's remaining obligations for the payment of rent and real estate taxes through the expiration date of its current lease. As part of these agreements, PT will commence paying rent and real estate taxes on the new facility as of January 1, 2012.

During 2011, the Company exercised its option to early terminate its lease for its former facility in San Luis Obispo, California, effective April 30, 2011.

The Company leases office space in Kanata, Ontario, Canada under a lease which was extended in 2011. This lease terminates in October 2013. Rent payments under this lease, including payments of minimum operating costs, amount to $435,000CDN annually (approximately $426,000USD at December 31, 2011), with annual inflationary adjustments.

The Company leases office space near London, England. The term of this lease extends through March 2012 and will not be renewed. This lease requires quarterly lease payments of £7,000 (approximately $11,000 at December 31, 2011). The Company is evaluating alternatives for its UK office space requirements.

For the lease agreements described above, the Company is also required to pay the pro rata share of the real property taxes and assessments, expenses and other charges associated with these facilities.

The Company enters into purchase commitments during the normal course of its operations. Certain of these purchase commitments are non-cancelable. As of December 31, 2011, the Company's non-cancelable purchase commitments expire through December 31, 2012. Included in the table below is the total of non-cancelable purchase commitments outstanding as of December 31, 2011.

Future minimum payments for non-cancelable operating leases having a remaining term in excess of one year and outstanding non-cancelable purchase commitments at December 31, 2011 are as follows:

	Payments Due by Period (in thousands)		
Contractual Obligations	Total	2012	2013 through 2015
Operating leases	$ 1,233	$ 786	$ 447
Purchase commitments	109	109	-
Total	$ 1,342	$ 895	$ 447

Taking into consideration the new Rochester facility lease, future minimum payments for non-cancelable operating leases having a remaining term in excess of one year and outstanding non-cancelable purchase commitments for 2012 through 2015 are as follows:

	Payments Due by Period (in thousands)		
Contractual Obligations	Total	2012	2013 through 2015
Operating leases	$ 2,308	$ 877	$ 1,431
Purchase commitments	109	109	-
Total	$ 2,417	$ 986	$ 1,431

The Company is not a party to any other significant contractual obligations.

Due to uncertainties regarding whether, and when, the Company's tax returns may be examined by the applicable taxing authorities, and the uncertain possible outcomes of such examinations, if any, an estimate of the timing of payments related to uncertain tax positions and related interest cannot be made. See Note M, "Income Taxes," in the Notes to Consolidated Financial Statements for additional information regarding the Company's uncertain tax positions.

RECENT ACCOUNTING PRONOUNCEMENTS

Comprehensive Income:

In June 2011, the FASB issued authoritative guidance on the presentation of comprehensive income that eliminates the option to present the components of other comprehensive income as part of the statement of equity and requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This guidance is effective retrospectively for fiscal years (and interim periods within those years) beginning after December 15, 2011 (an effective date of January 1, 2012 for the Company). The guidance requires changes in financial statement presentation only and will have no impact on the Company's financial position or results of operations.

Fair Value Measurement and Disclosures:

In May 2011, the FASB issued authoritative guidance that amends current fair value measurement and disclosure guidance to include increased transparency around valuation inputs and investment categorization. This guidance is effective prospectively for interim and annual periods beginning after December 15, 2011 (an effective date of January 1, 2012 for the Company). The Company does not expect that the adoption of this guidance will have a significant impact on its consolidated financial statements.

ITEM 7A – 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. The Company believes its exposure to such risk is minimal. The Company’s investments are made in accordance with the Company’s investment policy and consist primarily of money market funds, highly-rated corporate and government bonds, and certificates of deposit at December 31, 2011. The Company is also subject to foreign exchange risk related to its operations in Ottawa, Canada and London, England. The Company believes that its exposure to foreign currency risk is minimal, as generally all revenues and accounts receivable are denominated in U.S. dollars. However, the Company’s expenses at these locations are denominated in the local currency and the Company’s results of operations are influenced by changes in the exchange rates between the United States and Canada and the United Kingdom.

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ITEM 8 – Financial Statements and Supplementary Data

Index to Financial Statements:

Index to Financial Statement Schedule:

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Performance Technologies, Incorporated:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Performance Technologies, Incorporated and their subsidiaries at December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note A to the consolidated financial statements, the Company changed the manner in which it accounts for arrangements with multiple deliverables in 2011.

/s/ PricewaterhouseCoopers LLP

Rochester, New York

March 6, 2012

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PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 2011	December 31, 2010
Current assets:		
Cash and cash equivalents	$ 9,641,000	$ 12,796,000
Investments (Note C)	2,798,000	3,753,000
Accounts receivable, net (Note D)	5,622,000	5,478,000
Inventories (Note E)	5,421,000	7,787,000
Prepaid expenses and other assets	1,155,000	940,000
Prepaid income taxes (Note M)	67,000	31,000
Fair value of foreign currency hedge contracts (Note P)		17,000
Total current assets	24,704,000	30,802,000
Investments (Note C)	3,362,000	2,677,000
Property, equipment and improvements, net (Note F)	1,891,000	2,162,000
Software development costs, net (Note N)	3,932,000	3,995,000
Purchased intangible assets (Note B)	4,390,000	804,000
Total assets	$ 38,279,000	$ 40,440,000

LIABILITIES AND STOCKHOLDERS' EQUITY

	2011	2010
Current liabilities:		
Accounts payable	$ 1,015,000	$ 2,756,000
Other payable (Note B)	999,000	
Accrued expenses (Note H)	1,547,000	2,919,000
Deferred revenue	2,808,000	1,946,000
Fair value of foreign currency hedge contracts (Note P)	46,000	
Total current liabilities	6,415,000	7,621,000
Deferred income taxes (Note M)	83,000	51,000
Total liabilities	6,498,000	7,672,000
Commitments and contingencies (Notes I and Q)		
Stockholders' equity:		
Preferred stock - $.01 par value:		

1,000,000 shares authorized; none issued		
Common stock - $.01 par value: 50,000,000 authorized; 13,304,596		
shares issued; 11,116,397 shares outstanding	133,000	133,000
Additional paid-in capital	17,347,000	17,042,000
Retained earnings	24,237,000	25,400,000
Accumulated other comprehensive (loss) income (Note T)	(118,000)	11,000
Treasury stock – at cost; 2,188,199 shares held	(9,818,000)	(9,818,000)
Total stockholders' equity	31,781,000	32,768,000
Total liabilities and stockholders' equity	$ 38,279,000	$ 40,440,000

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

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PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2011	2010	2009
Sales	$ 36,176,000	$ 27,946,000	$ 29,491,000
Cost of goods sold	18,585,000	15,558,000	13,793,000
Software capitalization write-off (Note N)	175,000	604,000	
Gross profit	17,416,000	11,784,000	15,698,000
Operating expenses:			
Selling and marketing	6,410,000	8,301,000	7,152,000
Research and development	7,124,000	7,823,000	7,796,000
General and administrative	4,568,000	5,824,000	4,642,000
Restructuring charges (Note R)	253,000	1,176,000	626,000
Impairment charge - vendor software (Note F)	400,000		
Impairment of goodwill and long-lived assets (Note G)			4,278,000
Total operating expenses	18,755,000	23,124,000	24,494,000
Loss from operations	(1,339,000)	(11,340,000)	(8,796,000)
Other income, net	154,000	329,000	444,000
Loss before income taxes	(1,185,000)	(11,011,000)	(8,352,000)
Income tax (benefit) provision	(22,000)	166,000	1,760,000
Net loss	$ (1,163,000)	$ (11,177,000)	$ (10,112,000)
Basic loss per share	$ (.10)	$ (1.01)	$ (0.91)
Weighted average number of common shares used in basic loss per share	11,116,397	11,116,397	11,129,548

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

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PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2011, 2010 AND 2009

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income	Tota
Balance - January 1, 2009	13,304,596	$ 133,000	$ 16,052,000	$ 46,689,000	$ (9,500,000)	$ 73,000	$ 53,447
Comprehensive income:							
2009 net loss				(10,112,000)			(10,112
Unrealized gain on foreign currency hedge contracts, net of tax of $39,000						55,000	55
Total comprehensive loss							(10,057
Purchase of 100,000 treasury shares					(318,000)		(318
Stock compensation expense			544,000				544
Balance - December 31, 2009	13,304,596	133,000	16,596,000	36,577,000	(9,818,000)	128,000	43,616
Comprehensive income:							
2010 net loss				(11,177,000)			(11,177
Decrease in unrealized gain on foreign currency hedge contracts, net							

of tax of $67,000						(117,000)	(117
Total comprehensive loss							(11,294
Stock compensation expense			446,000				446
Balance - December 31, 2010	13,304,596	133,000	17,042,000	25,400,000	(9,818,000)	11,000	32,768
Comprehensive income:							
2011 net loss				(1,163,000)			(1,163
Net unrealized loss on investments						(72,000)	(72
Net unrealized loss on foreign currency hedge contracts						(57,000)	(57
Total comprehensive loss							(1,292
Stock compensation expense			305,000				305
Balance - December 31, 2011	13,304,596	$ 133,000	$ 17,347,000	$ 24,237,000	$ (9,818,000)	$ (118,000)	$ 31,781

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

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PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2011	2010	2009
Cash flows from operating activities:			
Net (loss) income	$ (1,163,000)	$ (11,177,000)	$ (10,112,000)
Non-cash adjustments:			
Depreciation and amortization	3,767,000	2,959,000	2,546,000
Stock-based compensation expense	305,000	446,000	544,000
Impairment of goodwill and long-lived assets	400,000	62,000	4,278,000
Non-cash intangible asset write-off	175,000	604,000	
Provision for bad debts	75,000	91,000	(226,000)
Loss (gain) on disposal of assets	32,000	(75,000)	(58,000)
Non-cash interest and other	26,000		
Realized loss on maturity of investments	17,000		
Deferred income taxes	38,000	191,000	2,012,000
Changes in operating assets and liabilities:			
Accounts receivable	(219,000)	973,000	361,000
Inventories	2,433,000	(3,328,000)	844,000
Prepaid expenses and other assets	(215,000)	(120,000)	(24,000)
Accounts payable and accrued expenses	(3,122,000)	2,787,000	(219,000)
Deferred revenue	862,000	(374,000)	(44,000)
Income taxes payable and prepaid income taxes	(36,000)	423,000	(60,000)
Net cash provided (used) by operating activities	3,375,000	(6,538,000)	(158,000)
Cash flows from investing activities:			
Purchase of equipment, inventory and intangible assets	(4,378,000)		(835,000)
Purchases of property, equipment and improvements	(300,000)	(1,341,000)	(572,000)
Capitalized software development costs	(2,037,000)	(2,261,000)	(2,273,000)
Purchases of investments	(4,782,000)	(5,344,000)	(15,479,000)
Proceeds from sales of investments	4,963,000	10,605,000	7,920,000
Proceeds from sale of equipment	4,000	112,000	60,000

Net cash (used) provided by investing activities	(6,530,000)	1,771,000	(11,179,000)
Cash flows from financing activities:			
Purchase of treasury stock			(318,000)
Net cash used by financing activities			(318,000)
Net decrease in cash and cash equivalents	(3,155,000)	(4,767,000)	(11,655,000)
Cash and cash equivalents at beginning of year	12,796,000	17,563,000	29,218,000
Cash and cash equivalents at end of year	$ 9,641,000	$ 12,796,000	$ 17,563,000
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Net income taxes refunded	$ 26,000	$ 475,000	$ 224,000
Non-cash investing activity:			
Other payable incurred for the purchase of assets	$ 973,000	$ -	$ -

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

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note A – Nature of Business and Summary of Significant Accounting Policies

The Company: Performance Technologies, Incorporated ("the Company", "PT") was formed in 1981 under the laws of the State of Delaware and maintains its corporate offices in Rochester, New York. The Company is a global supplier of advanced network communications solutions to service providers, government and OEM markets.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant inter-company transactions have been eliminated.

Foreign Currency Translation: The U.S. dollar is the functional currency of the Company's foreign subsidiaries. Monetary assets and liabilities are re-measured at year-end exchange rates. Non-monetary assets and liabilities are re-measured at historical rates. Revenues, expenses, gains and losses are re-measured using the rates on which those elements were recognized during the period.

Use of Estimates: The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at year-end and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications and Adjustments: Certain 2010 balances have been reclassified to conform with the 2011 presentation. Reclassifications have been made to present purchased intangible assets and deferred revenue separately in the balance sheets. In addition, a $94,000 out-of-period charge was recorded in 2011 to reduce the recorded balance of software development costs. This adjustment did not have a material impact on our consolidated financial statements.

Concentration of Credit Risk: Financial instruments that potentially expose the Company to significant concentrations of credit risk consist principally of bank deposits, investments, and accounts receivable. Investments consist of high quality, interest bearing financial instruments. Included in cash and cash equivalents at December 31, 2011 are $3.2 million of AAA-rated money market funds and $2.7 million of deposits with one AA- -rated Canadian bank.

The Company performs ongoing credit evaluations of its customers' financial condition and maintains an allowance for uncollectible accounts receivable based upon the expected collectibility of all accounts receivable. As of December 31, 2011, three customers represented 25%, 14% and 11% of net accounts receivable, respectively. As of December 31, 2010, two customers represented 18% and 14% of net accounts receivable, respectively.

Fair Value of Financial Instruments: The carrying amounts of the Company's accounts receivable and accounts payable approximate fair values at December 31, 2011 and 2010, as the maturity of these instruments are short term. The fair value of investments is discussed in Note C – Investments.

Cash Equivalents: The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Investments: The Company may classify its investments as available-for-sale, held-to-maturity, or trading. Available-for-sale investments are carried at fair value, with unrealized gains and losses, if any, reported in accumulated other comprehensive income, a component of stockholders' equity. Losses that are judged to be other-than-temporary, if any, are recorded in net income (loss). Held-to-maturity investments are carried at amortized cost. Amortization of purchase premiums or discounts is included in other income, net.

Inventories: Inventories are valued at the lower of cost or market. Cost is determined using the first-in, first-out method. The Company records provisions for excess, obsolete or slow moving inventory based on changes in customer demand, technology developments or other economic factors.

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

Revenue Recognition for Arrangements with Multiple Deliverables –

In September 2009, the Financial Accounting Standards Board ("FASB") amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of industry-specific software revenue recognition guidance. As a result, these arrangements are accounted for in accordance with new, "non-software" guidance for arrangements with multiple deliverables. The FASB also amended the accounting standards for revenue recognition for arrangements with multiple deliverables. The new authoritative guidance for arrangements with multiple deliverables requires that arrangement consideration be allocated at the inception of an arrangement to all deliverables using the relative selling price method. It also establishes a selling price hierarchy for determining the selling price of a deliverable, which includes: (1) vendor-specific objective evidence ("VSOE") if available; (2) third-party evidence ("TPE") if vendor-specific objective evidence is not available; and (3) best estimated selling price ("BESP") if neither vendor-specific nor third-party evidence is available. The new guidance eliminates the residual method of allocation for multiple-deliverable revenue arrangements which the Company used historically when the Company applied the software revenue recognition guidance to our multiple element arrangements.

PT adopted this guidance as of January 1, 2011. As most of the Company's signaling products include both tangible products and software elements that function together to deliver the tangible product's essential functionality, the existing software revenue recognition guidance no longer applies to these transactions. Due to the adoption of the new revenue recognition guidance, the Company recognized $830,000 of revenue in 2011 that otherwise would have been deferred under the prior revenue recognition rules due to the lack of VSOE and TPE of undelivered elements on one transaction. Based on currently available information, it is possible that the impact of adopting this guidance on revenue recognition in future periods, as compared with prior revenue recognition guidance, may be material. This assessment may change because such impacts depend on terms and conditions of arrangements in effect in those future periods.

The new guidance does not generally change the units of accounting for our revenue transactions. For PT's multiple deliverable arrangements, our products and services qualify as separate units of accounting. The Company's multiple deliverable arrangements generally include a combination of telecommunications hardware and software products, services including installation and training, and support services. These arrangements typically have both software and non-software components that function together to deliver the product's essential functionality. These arrangements generally do not include any provisions for cancellation, termination, or refunds that would significantly impact recognized revenue.

For substantially all multiple deliverable arrangements, PT defers support and services revenue, and recognizes revenue for delivered products in an arrangement when persuasive evidence of an arrangement exists and delivery of the last product has occurred, provided the fee is fixed or determinable, and collection is deemed probable. In instances where final acceptance of the product is based on customer specific criteria, revenue is deferred until the earlier of the receipt of customer acceptance or the expiration of acceptance period. Support revenue is recognized ratably over the term of the support period. Services revenue is typically recognized upon completion of the services for fixed-fee service arrangements, as these services are relatively short-term in nature (typically several weeks, or in limited cases, several months). For service arrangements that are billed on a time and material basis, we recognize revenue as the services are performed.

For multiple deliverable arrangements entered into prior to January 1, 2011 and not materially modified after that date, PT recognized revenue based on the then-existing software revenue recognition guidance, which required the entire fee from the arrangement to be allocated to each respective element based on its relative selling price using VSOE. For such arrangements, when the Company was unable to establish VSOE for the delivered telecommunications products, PT utilized the residual method to allocate revenue to each of the elements of an arrangement. Under this method, PT allocated the total fee in an arrangement first to the undelivered elements (typically support and services) based on VSOE of those elements, and the remaining, or "residual" portion of the fee to the delivered elements (typically the product or products).

For multiple deliverable arrangements entered into or materially modified after January 1, 2011, PT recognizes revenue based on the new non-software revenue recognition guidance. Consideration is allocated to each deliverable in an arrangement based on its relative selling price. PT follows a hierarchy to allocate the selling price of VSOE, then TPE and finally BESP. Because the Company rarely sells such products on a stand-alone basis or without support, PT isn't able to establish VSOE for these products. Additionally, PT generally expects that it will not be able to establish TPE due to the proprietary nature of PT's products and the markets in which we compete. Accordingly, PT expects the selling price of its proprietary hardware and software products to be based on its BESP. PT has established VSOE for its support and services and, therefore, it utilizes VSOE for these elements.

Since the adoption of the new guidance, we have primarily used the same information used to set pricing strategy to determine BESP. The Company has corroborated the BESP with our historical sales prices, the anticipated margin on the deliverable, the selling price and profit margin for similar deliverables and the characteristics of the geographical markets in which the deliverables are sold. PT plans to analyze the selling prices used in our allocation of arrangement consideration at least semi-annually. Selling prices will be analyzed more frequently if a significant change in our business necessitates a more timely analysis.

Revenue from software requiring significant production, modification, or customization is recognized using the percentage of completion method of accounting. Anticipated losses on contracts, if any, are charged to operations as soon as such losses are determined. If all conditions of revenue recognition are not met, the Company defers revenue recognition and will recognize revenue when the Company has fulfilled its obligations under the arrangement. Revenue from software maintenance contracts is recognized ratably over the contractual period.

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

Property, Equipment and Improvements: Property, equipment and improvements are stated at cost. Depreciation of equipment and improvements is provided for using the straight-line method over the following estimated useful lives:

Engineering equipment and software	3 - 5 years
Manufacturing equipment and tooling	3 - 5 years
Furniture and equipment	3 - 5 years
Leasehold improvements	the lesser of 10 years or the lease term

Repairs and maintenance costs are expensed as incurred. Asset betterments are capitalized.

Goodwill: Goodwill represents the excess of cost over the fair value of net assets acquired in business combinations. Goodwill is reviewed for impairment at least annually as of December 31 of each fiscal year or when events or changes in circumstances indicate the carrying value of the goodwill might exceed the fair value. Management has determined that the Company has one reporting unit for purposes of applying the impairment testing rules based on its reporting structure. The fair value of the Company's single reporting unit at each measurement date is determined based on a weighted average of the fair market value of the Company's outstanding common stock on a control basis and a discounted cash flow valuation model applied to a projection of future cash flows. Each of these methods was weighted 50%.

The Company recorded an impairment charge against the full recorded value of goodwill based on the Company’s assessment at December 31, 2009 (See Note G).

Long-Lived Assets: The Company reviews the carrying values of its long-lived assets (other than goodwill, capitalized software development costs and purchased intangible assets with indefinite useful lives) for impairment whenever events or changes in circumstances indicate that the carrying values may not be recoverable. The Company assesses the recoverability of the carrying values of long-lived assets by first grouping its long-lived assets with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities (the asset group) and, secondly, by estimating the undiscounted future cash flows that are directly associated with, and that are expected to arise from, the use of and eventual disposition of such asset group. The Company estimates the undiscounted cash flows over the remaining useful life of the primary asset within the asset group. If the carrying value of the asset group exceeds the estimated undiscounted cash flows, the Company records an impairment charge to the extent the carrying value of the long-lived asset exceeds its fair value. The Company determines fair value through quoted market prices in active markets or, if quoted market prices are unavailable, through the performance of internal analyses of discounted cash flows. If this review indicates that the remaining useful life of the long-lived asset has changed significantly, the Company adjusts the depreciation on that asset to facilitate full cost recovery over its revised estimated remaining useful life.

In conjunction with the review for impairment of goodwill at December 31, 2009, the Company also performed a review of the recoverability of its other long-lived assets. As a result, the Company recorded a non-cash impairment charge against the carrying value of property, equipment and improvements (See Note G).

Derivative Financial Instruments: The Company uses derivative financial instruments as foreign currency hedges of a portion of the costs of its Canadian and United Kingdom operations. The fair value of these derivative instruments is estimated in accordance with the framework for measuring fair value contained in GAAP and is recorded as either an asset or liability in the balance sheet based on changes in the current spot rate, as compared to the exchange rates specified in the contracts. For these instruments, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income and is reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. The fair value measurement of the Company's derivative instruments is estimated using Level 2 inputs, which are inputs other than quoted prices that are directly or indirectly observable for the asset or liability (See Note P).

Research and Development: Research and development costs, excluding amounts capitalized as software development costs, are expensed as incurred and include employee related costs, occupancy expenses and new product prototyping costs.

Shipping and Handling Costs and Sales Taxes: Amounts charged to customers and costs incurred by the Company related to shipping and handling are included in net sales and cost of goods sold, respectively. Revenue is presented net of any sales taxes collected and remitted by the Company.

Advertising: Advertising costs are expensed as incurred and recorded in "Selling and marketing" in the Consolidated Statements of Operations. Advertising expense amounted to $11,000, $48,000, and $65,000 for 2011, 2010, and 2009, respectively.

Software Development Costs: On a product-by-product basis, software development costs incurred subsequent to the establishment of technological feasibility and prior to general release of the product are capitalized and amortized commencing after general release over its estimated remaining economic life, generally three years, using the straight-line method or using the ratio of current revenues to current and anticipated revenues from such software, whichever provides greater amortization.

Income Taxes: The Company provides deferred income tax assets and liabilities based on the estimated future tax effects of differences between the financial and tax basis of assets and liabilities based on currently enacted tax laws.

A valuation allowance is established for deferred tax assets in amounts for which realization is not considered more likely than not to occur.

Prior to the fourth quarter 2010, the Company had not provided for federal and state income taxes on the accumulated earnings of its Canadian subsidiary as it was the Company's intent to indefinitely reinvest such earnings in the operations of the subsidiary. As of December 2010, the Company now believed that it is reasonably possible that a portion of such accumulated earnings may be repatriated in the foreseeable future. As such, during 2011 and 2010, the Company recorded a deferred tax provision amounting to $48,000 and $138,000, respectively, calculated based on the amount of earnings of the Canadian subsidiary that the Company may repatriate, recorded at the federal and state marginal tax rates, less the amount of net operating losses and tax credit carry-forwards that can be used to offset the federal and state tax.

The Company recognizes and measures uncertain tax positions using a two-step approach. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained upon examination, including resolution of related appeals or litigation processes, if any. In making this assessment, the Company must assume that the taxing authority will examine the income tax position and have full knowledge of all relevant information. The second step is to measure the tax benefit as the largest amount which is more than 50% likely to be realized upon ultimate settlement. The Company considers many factors when evaluating and estimating tax positions and tax benefits, which may require periodic adjustments and which may or may not accurately forecast actual outcomes.

The Company reports interest and penalties accrued relating to uncertain income tax positions as a component of income tax provision.

Earnings Per Share: Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Due to the net losses in 2011, 2010 and 2009, diluted earnings per share are equal to basic earnings per share. Diluted earnings per share calculations reflect the assumed exercise and conversion of dilutive employee stock options and unvested restricted stock, applying the treasury stock method. Diluted earnings per share calculations exclude the effect of approximately 1,688,000, 1,663,000 and 1,445,000 options in 2011, 2010 and 2009, respectively, since such options have an exercise price in excess of the average market price of the Company’s common stock.

Stock Options and Stock-Based Employee Compensation: In 2001, the stockholders approved the 2001 Stock Option Plan pursuant to which 1,500,000 shares of common stock were reserved for grant. In 2003, the stockholders approved the 2003 Omnibus Incentive Plan pursuant to which 1,500,000 shares of common stock were reserved for future grants. Awards under the 2003 Omnibus Incentive Plan may include stock options, stock appreciation rights, restricted stock and other stock performance awards as determined by the Board of Directors. The 2001 Plan expired during 2011. At December 31, 2011, 622,000 shares were available for future grant under the 2003 Plan.

Stock options may be granted to any officer or employee at not less than the fair market value at the date of grant (not less than 110% of the fair market value in the case of holders of more than 10% of the Company's common stock). Options granted under the plans generally expire between five and ten years from the date of grant and vest in periods ranging from one to five years.

The Company recognizes compensation expense in the financial statements for share-based awards based on the grant date fair value of those awards. Stock-based compensation expense includes an estimate for pre-vesting forfeitures and is recognized over the requisite service periods of the awards on a straight-line or graded vesting basis, which is generally commensurate with the vesting term. Stock-based compensation expense amounted to $305,000, $446,000 and $544,000 in 2011, 2010 and 2009, respectively.

The Company may either issue shares or utilize treasury stock shares upon employees' stock option exercises. In 2011, 2010 and 2009 there were no exercises of stock options.

Please refer to Note K, *Stock-based Compensation Expense*, for further information.

Segment Data, Geographic Information and Significant Customers and Vendors: The Company is not organized by market and is managed and operated as one business. A single management team that reports to the chief operating decision maker comprehensively manages the entire business. The Company does not operate any material separate lines of business or separate business entities. Accordingly, the Company does not accumulate discrete financial information, other than product revenue and material costs, with respect to separate product lines and does not have separately reportable segments.

Shipments to customers outside of the United States represented 46%, 58% and 53% of sales in 2011, 2010 and 2009, respectively. In 2011, 2010 and 2009, export shipments to the United Kingdom represented 20%, 26% and 15% of sales, respectively. The Company maintains significant amounts of long-lived assets in the United States and Canada.

For 2011, 2010, and 2009, four customers accounted for approximately 38%, 39% and 36% of sales respectively. In 2011, two customers accounted for 19% and 7% of sales, respectively. In 2010, two customers accounted for 24% and 5% of sales, respectively. In 2009, two customers accounted for 15% and 10% of sales, respectively.

As of December 31, 2011, all of the Company's printed circuit board assembly operations are conducted by one vendor and platform chassis are manufactured by two contract manufacturers.

Fair Value Measurements: GAAP establishes a fair value hierarchy which prioritizes the inputs to valuation techniques used to measure fair value. Level 1 inputs are quoted prices in active markets for identical assets or liabilities. Level 2 inputs are inputs other than quoted prices included in Level 1 that are directly or indirectly observable for the asset or liability. Such inputs include quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability, or inputs derived principally from or corroborated by observable market data by correlation or other means. Level 3 inputs are unobservable inputs for the asset or liability. Such inputs are used to measure fair value when observable inputs are not available.

The Company's assets and liabilities measured at fair value on a recurring basis at December 31, 2011, were as follows:

	Level 1	Level 2	Level 3
Assets:			
Investments	$ 4,260,000	$ 1,900,000	$ -
Total assets measured at fair value	$ 4,260,000	$ 1,900,000	$ -

Liabilities:			-
Foreign currency hedge contract	$ -	46,000	$ -
Total liabilities measured at fair value	$ -	$ 46,000	$ -

Foreign currency hedge contracts are valued based on observable market spot and forward rates as of our reporting date and are included in Level 2 inputs. We use these derivative instruments to mitigate the effect of changing foreign currency exchange rates on our expense levels in our Canadian and United Kingdom operations. All contracts are recorded at fair value and marked to market at the end of each reporting period and realized and unrealized gains and losses are included in net income for that period.

Contingencies and Related Legal Costs: An accrual of losses related to contingencies is made when, in the opinion of management and legal counsel, if applicable, the likelihood of loss is deemed probable and the amount of loss is reasonably estimable. Related legal costs are expensed as incurred (See Note Q).

Recent Accounting Pronouncements:

Comprehensive Income:

In June 2011, the FASB issued authoritative guidance on the presentation of comprehensive income that eliminates the option to present the components of other comprehensive income as part of the statement of equity and requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This guidance is effective retrospectively for fiscal years (and interim periods within those years) beginning after December 15, 2011 (an effective date of January 1, 2012 for the Company). The guidance requires changes in financial statement presentation only and will have no impact on the Company's financial position or results of operations.

Fair Value Measurement and Disclosures:

In May 2011, the FASB issued authoritative guidance that amends current fair value measurement and disclosure guidance to include increased transparency around valuation inputs and investment categorization. This guidance is effective prospectively for interim and annual periods beginning after December 15, 2011 (an effective date of January 1, 2012 for the Company). The Company does not expect that the adoption of this guidance will have a significant impact on its consolidated financial statements.

Note B – Asset Purchase

In January 2011, the Company entered into an asset purchase agreement with GENBAND to acquire GENBAND's Universal Signaling Platform (“USP”) and SP2000 signaling technology which GENBAND acquired in its May 2010 acquisition of Nortel's Carrier VoIP and Application Solutions business. In connection with this transaction, the Company acquired software, equipment, inventories, and intellectual property including a signaling-related patent, a license under GENBAND's signaling patent portfolio and an assignment of certain signaling technology conveyed to GENBAND under license from Nortel. Certain of these licensed property rights are not transferable without GENBAND’s consent. Furthermore, under certain circumstances, GENBAND has the right to terminate this licensing agreement. In addition to the acquisition of assets, the Company agreed to provide GENBAND with ongoing development, support and maintenance of signaling solutions, and solutions for stand-alone signaling applications as well as integrated signaling capabilities.

The total consideration for these assets amounted to $5,378,000, of which $4,000,000 was paid at closing in January 2011, $378,000 was paid for transaction-related expenses, and $1,000,000 is due in January 2012. This payable, discounted at 3%, had a present value of $973,000 at the date of closing. Including amortization of the discount, this payable amounts to $999,000 at December 31, 2011.

Approximately $613,000 of the total consideration for the GENBAND assets was allocated to property, plant and equipment, $67,000 to inventory, and the remainder was allocated to purchased intangible assets, including the estimated value of the support contract, which amounted to $420,000, and purchased developed technologies, which amounted to $4,260,000.

In addition to the software technologies acquired from GENBAND, the Company reclassified the technologies acquired in 2009 from Pactolus (with a cost of $835,000 and accumulated amortization of $31,000 at December 31, 2010) from software development costs, net, into purchased intangible assets. Purchased intangible assets are being amortized over estimated useful lives of three to five years.

Purchased intangible assets consist of the following:

	At December 31, 2011	2010
Purchased developed technologies	$ 5,095,000	$ 835,000
Support contracts	420,000	-
Total	5,515,000	835,000
Less: accumulated amortization	(1,125,000)	(31,000)
Purchased intangible assets, net	$ 4,390,000	$ 804,000

Amortization of purchased intangible assets totaled $1,094,000 and $31,000 in 2011 and 2010, respectively. Amortization of purchased intangible assets will total approximately $1,168,000, $1,183,000, $1,029,000, $982,000 and $28,000 in 2012, 2013, 2014, 2015 and 2016, respectively.

Note C – <u>Investments</u>

Investments consisted of the following:

	At December 31, 2011 Amortized cost	2011 Fair value	2010 Fair value
Corporate bonds	$ 4,328,000	$ 4,260,000	$ 3,190,000
Municipal bond	504,000	500,000	-
Guaranteed investment certificates	1,400,000	1,400,000	-
U.S. Government bond	-	-	2,000,000
Certificates of deposit	-	-	1,240,000
Total investments	6,232,000	6,160,000	6,430,000
Less-current investments	(2,849,000)	(2,798,000)	(3,753,000)
Non-current investments	$ 3,383,000	$ 3,362,000	$ 2,677,000

All income generated from the Company’s investments is recorded in other income, net, and totaled $169,000, $198,000 and $277,000 in 2011, 2010 and 2009, respectively.

The Company's bond investments have a cumulative par value of $4,601,000 at December 31, 2011. Two of these bonds with a cumulative par value of $1,353,000 mature in 2012 and are classified as current assets, while the remaining bonds with a cumulative par value of $3,248,000 mature in 2013 and 2014 and are classified as non-current assets.

Prior to December 31, 2010, the Company classified its investments as held-to-maturity and the investments were stated at amortized cost. At December 31, 2010, the Company determined that it is probable that at least some of its investments may need to be sold prior to maturity in order to fund operations. As such, the Company now classifies its investments as available-for-sale, and any unrealized gains or losses will be included in accumulated other comprehensive income. At December 31, 2011, the amortized cost of the Company's investments exceeded the fair value of those investments by $72,000. At December 31, 2010, there was an immaterial difference between amortized cost and fair value of the Company's investments.

Note D – Accounts Receivable, net

Accounts receivable consisted of the following:

	At December 31, 2011	At December 31, 2010
Accounts receivable	$ 5,942,000	$ 5,728,000
Less: allowance for doubtful accounts	(320,000)	(250,000)
Net	$ 5,622,000	$ 5,478,000

Note E – Inventories

Inventories consisted of the following:

	At December 31, 2011	At December 31, 2010
Purchased parts and components	$ 2,036,000	$ 2,040,000
Work in process and purchased assemblies	2,015,000	4,639,000
Finished goods	1,370,000	1,108,000
Net	$ 5,421,000	$ 7,787,000

Note F – Property, Equipment and Improvements, net

Property, equipment and improvements consisted of the following:

	At December 31, 2011	At December 31, 2010
Land	$ 407,000	$ 407,000
Engineering equipment and software	6,698,000	6,422,000
Manufacturing equipment	1,141,000	1,600,000
Furniture and equipment	1,608,000	1,871,000
Leasehold improvements	412,000	404,000
	10,266,000	10,704,000
Less: accumulated depreciation and amortization	(8,375,000)	(8,542,000)
Net	$ 1,891,000	$ 2,162,000

Total depreciation and amortization expense for equipment and improvements for 2011, 2010 and 2009 was $748,000, $766,000 and $820,000, respectively.

The net book value of property, equipment and improvements located in the United States was $951,000 and $1,851,000 at December 31, 2011 and 2010, respectively. Substantially all of the Company's property, equipment and improvements outside the United States are located in Canada.

During 2010, the Company paid one-time license fees totaling $580,000 to acquire certain software technologies, which the Company plans to use in synergistic combination with its captive technologies to develop new end-market products. These amounts were recorded in property, equipment and improvements. During 2011, the Company terminated a value-added reseller agreement with the licensor of certain of these software technologies and recorded an impairment totaling $400,000 against this asset.

During 2011, the Company disposed of assets with a cost basis of $1,352,000 (including the $400,000 impairment of vendor software technologies) and accumulated depreciation of $916,000. The loss on disposal totaled $32,000.

During 2010, the Company disposed of assets with a cost basis of $994,000 and accumulated depreciation of $957,000 and recorded a gain on disposal of $75,000. During 2009, the Company disposed of assets with a cost basis of $120,000 and accumulated depreciation of $119,000, and recorded a gain on disposal amounting to $58,000.

Note G – Impairments

The Company made the decision to outsource manufacturing of the printed circuit board assembly for the hardware elements of the Company's products in 2009. This action was completed during 2010 and certain long-lived manufacturing assets were identified for sale, which was completed during 2010. As of December 31, 2010, the carrying values of the remaining assets relating to the printed circuit board assembly operation were reviewed for recoverability and the Company recorded a non-cash impairment against the recorded value of property, equipment and improvements in the amount of $61,000.

Due to the Company's decreased stock price during the second half of 2009 and resulting lower market capitalization, particularly in comparison with the 2009 recovery in United States equity markets, management determined that the fair value of the Company was no longer in excess of its book value including goodwill, and recorded a non-cash impairment charge of $4,143,000 (less income taxes of $586,000) against the full recorded value of goodwill as of December 31, 2009.

In conjunction with its assessment of the carrying value of goodwill as of December 31, 2009, management also reviewed the carrying values of the Company's other long-lived assets for recoverability (excluding capitalized software development costs which are amortized and separately reviewed for impairment). As a result of this review, the Company recorded a non-cash impairment charge against the recorded value of property, equipment and improvements in the amount of $135,000.

Note H – Accrued Expenses

Accrued expenses consisted of the following:

At December 31,

	2011	2010
Accrued compensation and related costs	$ 776,000	$ 815,000
Accrued vacation	33,000	487,000
Accrued professional services	221,000	219,000
Accrued warranty obligations	92,000	156,000
Accrued restructuring	3,000	924,000
Other accrued expenses	422,000	318,000
Total	$ 1,547,000	$ 2,919,000

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 2011, 2010 and 2009 were as follows:

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Accrued warranty obligations at January 1, 2009	$ 167,000
Actual warranty experience	(89,000)
Net warranty provisions	-
Accrued warranty obligations at December 31, 2009	78,000
Actual warranty experience	(106,000)
Net warranty provisions	184,000
Accrued warranty obligations at December 31, 2010	156,000
Actual warranty experience	(101,000)
Net warranty provisions	37,000
Accrued warranty obligations at December 31, 2011	$ 92,000

Note I – Commitments

The Company leases facilities under operating leases. Subsequent to December 31, 2011, the Company entered into a lease for new, more appropriately-sized office and manufacturing space in Rochester, New York, a facility that will replace the Company's existing Rochester facility in the second quarter 2012. The lease for the Company's existing facility expires in April 2012. Under the terms of the new lease, the Company will remain in its current facility until the build-out of the new space is complete but will pay rent for the new facility, which is approximately $30,000 per month beginning January 1, 2012. The new lease term is 66 months for approximately 2/3 of the space and 38 months for the remainder of the space. Rentals under the new lease will escalate by approximately 1.3% annually.

The lease for office space in San Diego, California requires a monthly payment of approximately $7,000, and expires in November 2013.

The Company also leases office space in Kanata, Ontario, Canada. This lease, which requires a monthly rental and operating expense totaling approximately $36,000CDN (approximately $35,000USD based on the December 31, 2011 exchange rate) has been extended through October 2013.

Finally, the Company leases office space near London, England. This lease requires a quarterly rental of approximately £7,000 (approximately $11,000 based on the December 31, 2011 exchange rate), expires in 2012, and has not been renewed.

As of December 31, 2010, the Company exercised its option to terminate its San Luis Obispo, California lease as of April 30, 2011, and the hardware research and development activities that were conducted at that facility were transitioned to the Company's Rochester, New York facility.

For the lease agreements described above, the Company is required to pay the pro rata share of the real property taxes and assessments, expenses and other charges associated with these facilities.

Future minimum payments for all operating leases at December 31, 2011 are as follows (based on current foreign currency exchange rates):

2012	$ 786,000
2013	447,000
Total	$ 1,233,000

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After giving effect to the new Rochester facility lease, future minimum payments for all operating leases are as follows:

2012	$ 877,000
2013	804,000
2014	362,000
2014	266,000
2015	249,000
thereafter	126,000
Total	$ 2,684,000

Rent expense amounted to $1,344,000, $1,386,000 and $1,340,000 for 2011, 2010 and 2009, respectively.

During 2010, the Company completed the transition of its printed circuit board assembly operations to a contract manufacturer. In connection with this transition, the Company committed to purchasing from the contract manufacturer any inventory which is purchased to fulfill the Company's requirements, in the event that the Company revises downward those requirements. The Company is committed to repurchase excess inventory totaling $109,000 under this contract provision for 2011.

Note J – Stock Repurchase Program

In October 2008, the Board of Directors authorized a stock repurchase program, for an aggregate amount not to exceed $10,000,000. Under this program, which expired in October 2009, repurchased shares were to be used for the Company's stock option plan, potential acquisition initiatives and general corporate purposes. Under this program, 100,000 shares were repurchased during 2009 for an aggregate purchase price of $318,000.

Note K – Stock-based Compensation Expense

The table below summarizes the impact of outstanding stock options on the results of operations for the years ended December 31, 2011, 2010 and 2009:

	2011	2010	2009
Stock-based compensation expense:			
Stock options	$ 305,000	$ 446,000	