

1977 ANNUAL REPORT



COMTECH
LABORATORIES INC.

® TEN YEARS OF PROGRESS IN COMMUNICATION SYSTEMS

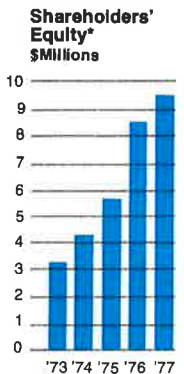
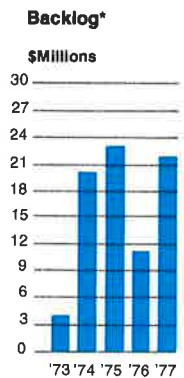
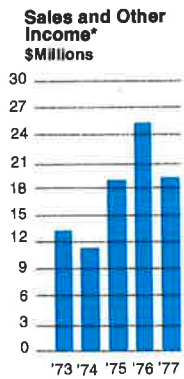
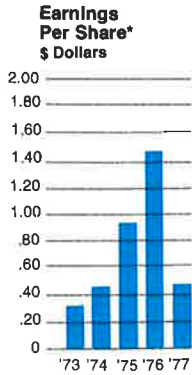


Western Union's Westar I and Westar II satellites were launched into a geostationary orbit from the John F. Kennedy Space Center in Florida—providing a domestic satellite system to serve the communication needs of the Government, business and the public. Each satellite contains 12 transponders, with each transponder capable of relaying one color television signal including audio, or 1,200 separate one-way voice signals, or 50 million bits of data per second. Comtech participated in this historic event when contracted by Western Union to design, manufacture and install comprehensive communication subsystems for their earth stations in Lake Geneva, Wisconsin; Glenwood, New Jersey; and Steele Valley, California. Plans for the next generation of Westar satellites have been formulated and will offer not only C-band (4/6 GHz) coverage to assure continuity of service with present Westar satellites, but also K-band (12/14 GHz) coverage to facilitate a spectrum of digital communication services.

Photo courtesy of NASA and Western Union



COMTECH LABORATORIES INC.



*Restated to reflect the acquisition of RF Systems, Inc. for the years 1973-76.

Board of Directors

F. Kornberg—*Chairman*
 B. Adler—*Business and Engineering Consultant*
 G. Bugliarello—*President, Polytechnic Institute of New York*
 D. R. Campbell
 G. R. Nocita—*Consultant to the Company*
 J. E. Rosenblum
 J. A. Tokar—*Vice President, Combustion Equipment Associates, Inc.*

Officers

F. Kornberg—*President and Chief Executive Officer*
 D. R. Campbell—*Vice President*
 M. L. Deever—*Vice President*
 A. K. Fowler—*Vice President*
 E. Ladin—*Vice President*
 J. E. Rosenblum—*Vice President*
 R. F. Welte—*Vice President*
 J. P. Windus, Jr.—*Secretary/Treasurer*

Bank

Chemical Bank
 1455 Veterans Memorial Highway
 Hauppauge, New York 11787

Legal Counsel

Botein, Hays, Sklar & Herzberg
 200 Park Avenue
 New York, New York 10017

Registrar and Transfer Agent

Chemical Bank
 55 Water Street
 New York, New York 10041

Independent Accountants

Arthur Andersen & Co.
 1 Huntington Quadrangle
 Huntington, Long Island, New York 11746

Stock Traded—OTC

NASDAQ Symbol—CMTL

135 Engineers Road • Smithtown, N.Y. 11787 • (516) 231-5454 • TWX 510-227-6235

To Our Shareholders:

This year after nearly a decade of sustained growth, Comtech, for the first time, had annual earnings below its prior year.

Sales for the fiscal year ended 31 July 1977 were \$19,042,747, with net income of \$780,037 or \$0.45 per share. The Company's all-time record results for fiscal 1976 were sales of \$25,492,915, with a net income of \$2,492,548 or \$1.45 per share. Backlog at 1977 year-end was \$22,125,000 compared with \$11,223,000 for 1976.

Comtech's sales in fiscal 1977 were, in fact, the second highest in the Company's history despite the significantly lower backlog level with which the Company began the year. This would not have been possible without the total commitment of a dedicated, highly motivated, and capable staff.

Fiscal 1977's lower level of sales can be attributed to several factors. One factor was a sharp decline, industry-wide, in U.S. domestic satellite system sales as the market shifted from the requirement stage to the implementation stage, and customer usage lagged behind available capacity. We believe that this is not a cyclical condition but rather one of temporary market saturation. Several common carriers instituted their satellite domestic communications systems at approximately the same time, and as a result, capacity exceeded customer usage. It is anticipated that the four major U.S. carriers—ATT, Western Union, RCA and AMSAT—will soon close this capacity gap.

Comtech, nevertheless, has maintained a competitive position in the U.S. satellite domestic market area having obtained a good portion of the satellite ground station business available from Western Union and RCA. In addition, Comtech received a \$1-million contract from Satellite Business Systems Inc. (SBS) in mid-1976 for two satellite earth stations (4/6 GHz) located at IBM facilities in Poughkeepsie, New York, and Los Gatos, California. These stations were shipped in fiscal 1977. More recently, we received a contract for a third SBS station to be located near Raleigh, North Carolina.

The entry of SBS as a business-oriented carrier should help provide the impetus for continued industry growth. SBS has plans for an innovative domestic satellite communications network to serve private and government customers. The planned network will be digital, will operate at higher frequency ranges than those used in today's satellite and terrestrial microwave networks, and will have the ability to bypass the existing terrestrial network.

Another factor affecting our sales was that the overseas satellite systems market did not materialize in the time

frame expected. Conducting business in the international arena requires longer preparation and negotiation than that which we have experienced with domestic contracts. Although extended lead time has a noticeable impact upon doing business abroad, we view our comparatively recent entry into the foreign market as a strong beginning, with a significant gain in experience and the cultivation of reliable international contacts. In November 1976, we were awarded a \$19-million contract to design and supply a troposcatter communications network in Libya. Initial deliveries began at the end of fiscal 1977 and major shipments are scheduled for delivery in fiscal 1978. This contract comprised about 70 percent of the Company's backlog as of 31 July 1977, and represents the first phase of a planned three-phase communications network complex which will include domestic and international satellite as well as terrestrial microwave and troposcatter systems. The remaining phases will be awarded to successful bidders in the future.

The final significant factor was a decline in our defense satellite communication sales. This was a result of a combination of elements including economic austerity measures and a government fiscal year-end stretch-out from June 30 to September 30. This came at a time when our defense satellite communication systems backlog was in a downtrend. Defense communication requirements, we believe, will be less repressed by government austerity measures in the ensuing year and we will concentrate efforts to maintain if not improve, our past performance in this area.

Despite these factors, we have moved aggressively and decisively to improve Comtech's future and enhance its potential, albeit at a current cost. We have confidence in Comtech's future and have committed funds in support of that belief. We have increased expenditures for Company-sponsored research and development and have expanded our marketing activities, particularly in the foreign sector. Start-up costs, and as yet unabsorbed overhead, were incurred for our new west coast venture, Comtech Advanced Systems, Inc. In Smithtown, N.Y., we moved certain of our manufacturing activities to a leased 123,000-square foot facility which greatly increased our potential to handle large production runs.

In all our markets, we are striving to strengthen the quick-reaction capability for which Comtech is generally known and credited. Major emphasis continues to be given to building a firm foundation for long-term business success and broadening our scope of activity in the overall communications field.

In February 1977, we acquired R. F. Systems, Inc., an

established manufacturer of antennas for terrestrial microwave, satellite, troposcatter and radar systems. This step enhanced our ability to provide low-cost, turn-key communication systems, and allowed us to broaden our product base to include small earth stations, such as those used in cable TV applications. In addition to a complete line of antenna systems, this Subsidiary is a manufacturer of antenna components, feeds and related equipment. Plans to increase R.F. Systems' manufacturing capabilities include the construction of a new 32,000-square foot facility in St. Cloud, Florida. This facility, near completion, will be put into operation in the fall of 1977.

In May 1977, we formed Comtech Advanced Systems, Inc., located in Sunnyvale, California, to address the digital communications market for information processing



systems, multiplexers, demultiplexers, data compaction and signal detection equipment. This Subsidiary's capability to employ advanced techniques and equipment designs should complement and reinforce Comtech's government and commercial product lines. The Federal Government has used, and is currently employing, sophisticated digital communication systems and networks. Today, similar systems and networks are receiving major consideration by the common carriers.

Consistent with these steps to broaden our activities, a decision was reached to propose a change in the parent Corporate name at the Annual Stockholders' Meeting in December.

We were pleased to announce, in October 1977, the election of Benjamin Adler to the Board of Directors. Mr. Adler brings to Comtech over 45 years of experience in the electronic and communications industry. He founded Adler Electronics Inc., which later became the Litcom Division of Litton Industries, Inc. and also served as President of Polytechnic Institute of Brooklyn. His current activities include independent business and engineering consulting.

We are also pleased to report that Eugene Ladin joined Comtech as Vice President of Finance. Mr. Ladin had previously been Vice President, Treasurer, and Comptroller of the Puerto Rico Telephone Company; Director of Financial Planning of COMSAT; and Chief Financial Officer of the North American Operations of Landis and Gyr.

This month, Comtech's line of bank credit, which is subject to annual renewal, was increased to \$19-million. With the exception of two short-duration (not exceeding 8 weeks) loans of \$600,000, Comtech has not found it necessary to draw on this line of credit for the past 28 months.

We view the opportunities and challenges of the year ahead with confidence and believe that our ongoing efforts are appropriately directed toward Comtech's future. Our ability to meet the needs of our customers is to a great extent dependent upon the caliber of our personnel. Their performance this year has been more than gratifying and has reinforced our belief in Comtech's ultimate growth.

President and
Chairman of the Board

October 26, 1977

THE ORGANIZATION

The cumulative resources offered by Comtech have been expanded with the acquisition of R. F. Systems, Inc. and the formation of Comtech Advanced Systems, Inc. These new Subsidiaries permit the Company to address a wider range of communication technological demands, as well as enhance its position as a manufacturer of total satellite communications, tropospheric scatter, terrestrial microwave systems, analog/digital equipment, related communication subsystems, and test equipment. The Company, with corporate headquarters located in Smithtown, New York, is currently organized into three primary operating groups, Comtech Laboratories, R. F. Systems, Inc., and Comtech Advanced Systems, Inc.

COMTECH LABORATORIES Smithtown, New York

This Division of Comtech Laboratories, Inc. concentrates its activities in the design, production, and installation of completely unified communication systems and networks for domestic, military, and international applications. The Division provides a full-range capability from design concept through system implementation for satellite communication earth stations, tropospheric scatter systems, and terrestrial microwave links. Services range from initial planning through design, manufacture, installation, test, operation, and logistic support.



John E. Rosenblum

The Division occupies approximately 190,000 square feet of space in two buildings located in Smithtown, New York. Resources are allocated to provide a balance between a complete systems design and integration capability, and the engineering and support skills required for the design and manufacture of subsystems and state-of-the-art equipment. Engineering experience is heavily concentrated in communications, extending from early microwave, troposcatter, and satellite systems to the current-day state of communications technology. The facilities and personnel available have enabled the Division to develop a technically-advanced and highly-reliable product line of system building blocks including low-noise amplifiers, single- and dual-frequency conversion systems, modulators, threshold extension demodulators, wide-band predetection and baseband combiners, klystron and TWT power amplifiers, and associated control, monitoring, and test equipment. This equipment is integrated into fixed-site, transportable, and highly-transportable communication systems to meet specific customer requirements. Inventoried equipment and standardized designs ensure the user of rapid turn-around from the date of order to the time at which operations are initiated.



R. F. SYSTEMS, INC.
St. Cloud, Florida

R. F. Systems, Inc. was acquired by Comtech Laboratories Inc., as a subsidiary in February of 1977. This Subsidiary designs, manufactures, and installs antenna systems, components, radomes and related equipment to meet a broad spectrum of applications including terrestrial microwave, troposcatter, and satellite communications. The acquisition of this Subsidiary has reinforced Comtech's dedication to provide quick-response, turn-key installations comprised of equipment and subsystems manufactured by, and under the full control of the Comtech organization. In particular, this Subsidiary provides Comtech with the ability to meet the demand for low-cost, TV, receive-only, earth stations and similar special-purpose satellite communication systems.

R. F. Systems will conduct operations from facilities located in Cohasset, Massachusetts, and St. Cloud, Florida. Manufacturing space is being leased in nearby Orlando until construction of the St. Cloud facility is completed in the fall of 1977. The St. Cloud location will serve as administrative, marketing, engineering and management headquarters as well as the prime manufacturing facility for large-quantity production runs. The Cohasset location will be used primarily for prototype development, fabrication, and long-range antenna testing.



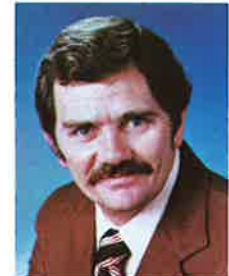
Alfred K. Fowler



COMTECH ADVANCED SYSTEMS, INC.
Sunnyvale, California

Comtech Advanced Systems, Inc. was formed as a subsidiary in April 1977 to specifically address the high-technology demands of digital communication techniques and information processing systems. This Subsidiary is comprised of key personnel having demonstrated experience in the design, manufacture, and installation of large-scale digital communication systems and equipment. Their backgrounds include the development of extremely compact portable communication terminals, large-scale signal processing systems, and communication networks using multiple interactive computer systems, high-speed array processors, and micro-processor control of data bases via microwave and satellite links. These talents support and complement the overall existing systems capabilities of Comtech while providing for a greater degree of concentration in the development and marketing of special digital systems for defense and commercial communication applications.

A systems research and development laboratory has been established in Sunnyvale, California. This facility is in the process of being equipped with high-speed scientific computers, on-line and off-line storage, and soft- and hard-copy displays to provide a variety of operations and research simulation activities in conjunction with system and software development. Specific areas are allocated to handle classified and special access programs.



Robert F. Welte



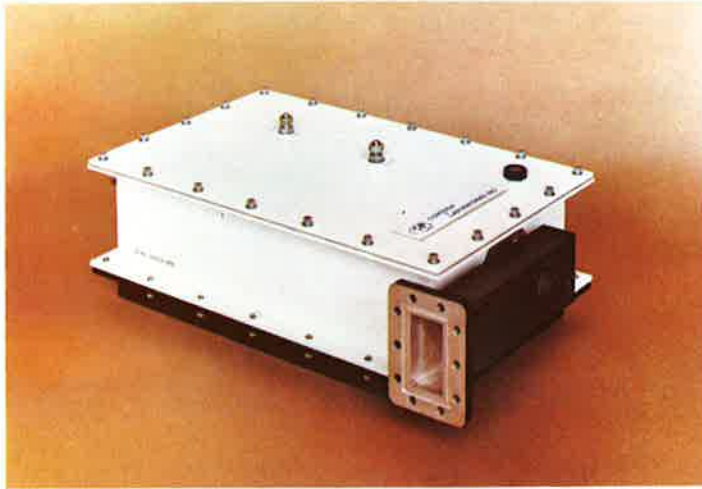
1977 Accomplishments

**Data Transmission and Reception Satellite Communication Earth Stations,
Manufactured and Installed by Comtech on a Turn-Key Basis.**



1977 Developments

Highly-compact low-noise parametric amplifiers—4.2 and 12.2 GHz frequency range



Highly-compact video microwave troposcatter subsystems



Microwave Semiconductor Facility

Comtech's dedication to meet the technological demands in Communications have been enhanced with the establishment of our microwave semiconductor facility. This modern, environmentally-controlled facility contains the latest state-of-the-art equipment to economically produce highly-reliable, solid-state devices for use in low noise parametric amplifiers, frequency multipliers, frequency sources, microwave mixers and other critical components used in Comtech's compact communications equipment.





Consolidated Balance Sheets

	<u>ASSETS</u>	
	1977	July 31, 1976*
Current assets:		
Cash	\$ 384,204	\$ 807,373
U.S. treasury bills	395,167	—
Certificates of deposit (Note 12)	1,000,000	—
Accounts receivable (Notes 1 and 3)	5,285,291	2,695,136
Inventories, less progress payments (Notes 1 and 4)	3,524,549	6,211,425
Other current assets	83,688	56,535
	<u>10,672,899</u>	<u>9,770,469</u>
Property, plant and equipment less accumulated depreciation and amortization (Notes 1, 5 and 6)	3,704,669	3,448,988
Other assets	68,925	104,431
	<u>\$14,446,493</u>	<u>\$13,323,888</u>

*Restated to reflect the acquisition of R. F. Systems, Inc. which has been accounted for as a pooling of interests.

LIABILITIES AND SHAREHOLDERS' EQUITY

	1977	July 31, 1976*
Current liabilities:		
Accounts payable	\$ 2,475,580	\$ 1,328,976
Accrued expenses and taxes withheld	1,031,821	1,069,450
Income taxes currently payable (receivable) (Notes 1 and 7)	(125,103)	847,289
Advance contract payments received	591,023	—
Current maturities of mortgage notes	58,000	67,250
	<u>4,031,321</u>	<u>3,312,965</u>
Mortgage notes due after one year (Note 6)	601,599	864,877
Deferred income taxes (Notes 1 and 7)	308,300	481,300
Shareholders' equity (Notes 2, 8 and 9):—		
Common stock, \$.10 par value:		
Authorized—3,000,000 shares		
Outstanding—1977—1,728,703		
1976—1,716,303	172,870	171,630
Additional paid-in capital	2,802,997	2,743,747
Retained earnings	6,529,406	5,749,369
	<u>9,505,273</u>	<u>8,664,746</u>
Commitments and contingencies (Note 12)		
	<u>\$14,446,493</u>	<u>\$13,323,888</u>



Consolidated Statements of Income and Retained Earnings

	Year ended July 31,	
	1977	1976*
Net sales	\$19,042,747	\$25,492,915
Costs and expenses:		
Cost of sales	14,411,665	18,095,121
Selling, general and administrative	2,615,030	1,983,210
Depreciation and amortization	435,278	403,509
Interest	80,737	92,027
	<u>17,542,710</u>	<u>20,573,867</u>
Income before income taxes	1,500,037	4,919,048
Provision for income taxes (Note 7)	720,000	2,426,500
Net income	780,037	2,492,548
Retained earnings at beginning of year	5,749,369	3,256,821
Retained earnings at end of year	<u>\$ 6,529,406</u>	<u>\$ 5,749,369</u>
Earnings per share (Note 1)	<u>\$.45</u>	<u>\$1.45</u>

*Restated to reflect the acquisition of R. F. Systems, Inc. which has been accounted for as a pooling of interests.



Consolidated Statements of Changes in Financial Position

	Year ended July 31,	
	<u>1977</u>	<u>1976*</u>
Financial resources were provided by:		
Operations:		
Net income	\$ 780,037	\$2,492,548
Add (deduct) income charges not affecting working capital:		
Depreciation and amortization	435,278	403,509
Deferred income taxes	(173,000)	164,000
Total from operations	<u>1,042,315</u>	<u>3,060,057</u>
Net proceeds from exercise of stock options	6,214	267,285
Stock issued in connection with the organization of a subsidiary	31,276	—
Tax benefit from disqualifying disposition of option stock	23,000	132,000
	<u>1,102,805</u>	<u>3,459,342</u>
Financial resources were used for:		
Purchases of equipment—net	690,959	951,960
Reduction in long-term debt	263,278	57,400
Other	<u>(35,506)</u>	<u>82,939</u>
	<u>918,731</u>	<u>1,092,299</u>
Increase in working capital	<u>\$ 184,074</u>	<u>\$2,367,043</u>
<u>Analysis of changes in working capital</u>		
Increases (decreases) in current assets:		
Cash	(\$ 423,169)	(\$ 22,374)
U.S. treasury bills	395,167	—
Certificates of deposit (Note 12)	1,000,000	—
Accounts receivable	2,590,155	(711,781)
Inventories	(2,686,876)	1,690,842
Other current assets	27,153	(28,161)
	<u>902,430</u>	<u>928,526</u>
(Increases) decreases in current liabilities:		
Accounts payable	(1,146,604)	1,684,123
Accrued expenses and taxes withheld	37,629	(403,708)
Income taxes currently payable	972,392	(108,266)
Advance contract payments received	(591,023)	245,848
Current maturities of mortgage notes	9,250	20,520
	<u>(718,356)</u>	<u>1,438,517</u>
Increase in working capital	<u>\$ 184,074</u>	<u>\$2,367,043</u>

*Restated to reflect the acquisition of R. F. Systems, Inc. which has been accounted for as a pooling of interests.



Notes to Consolidated Financial Statements

July 31, 1977 and 1976

NOTE 1—ACCOUNTING POLICIES:

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany transactions have been eliminated.

Contract Accounting

Sales are recorded under the unit of delivery method of accounting. Cost of sales, which is applied to units delivered, is based upon the actual contract costs incurred and, in the case of partial shipments, estimated final contract costs. Contract costs include material, direct labor, manufacturing overhead and certain selling and finance costs associated with contracts. All other selling, general and administrative expenses are charged to operations as incurred. Under all contracts, when estimates indicate a probable future loss, an immediate provision for the full amount thereof is charged to cost of sales.

Inventories

Raw materials and components are stated at first-in, first-out cost, which is not in excess of market. Work in process has been valued at the total material, direct labor, manufacturing overhead and other costs incurred under each contract.

Property, Plant and Equipment

Property, plant and equipment (including major renewals and betterments) are recorded at cost; expenditures for maintenance and repairs are charged to operations as incurred. At the time property is retired or otherwise disposed of, the cost

and accumulated depreciation or amortization of such property is eliminated and the gains or losses on disposition are reflected in operations. Annual depreciation is provided utilizing the straight-line method over the estimated useful lives.

Research and Development Costs

The Company charges research and product development costs to operations as incurred except where such costs are reimbursable under customer-funded contracts. Research and development costs not relating to customer-funded contracts amounted to \$474,173 in 1977 and \$254,225 in 1976.

Income Taxes

The Company provides deferred income tax expense (credits) for transactions reported in different periods for financial and income tax reporting purposes. Investment tax credits are accounted for as a reduction of income taxes in the year the related asset is placed in service.

Income taxes have not been provided on the undistributed earnings (cumulatively \$879,000) of the Company's Domestic International Sales Corporation (DISC) subsidiary since the Company intends to permanently reinvest these earnings in export related activities.

Earnings Per Share

Earnings per share is based upon the weighted average common shares and common share equivalents outstanding during the year. Retroactive effect has been given to the shares issued in connection with the acquisition of R. F. Systems, Inc. as discussed in Note 2. The number of common shares and common share equivalents used in computing earnings per share were 1,740,635 and 1,714,712 in 1977 and 1976, respectively.

NOTE 2—ACQUISITION AND ORGANIZATION OF SUBSIDIARIES:

R. F. Systems, Inc.

In February 1977, the Company exchanged approximately 51,000 shares of unregistered and previously unissued common stock for all of the outstanding shares of R. F. Systems, Inc. and subsidiaries, an antenna manufacturer. This exchange resulted in a combination which has been accounted for as a pooling of interests and accordingly the accompanying financial statements have been restated. The net sales and net income for both companies included in the Consolidated Statements of Income and Retained Earnings for the years ended July 31, 1977 and 1976 are as follows:

	<u>Net Sales</u>	<u>Net Income</u>
<u>1977</u>		
Comtech Laboratories Inc.	\$16,677,535	\$ 725,346
R. F. Systems, Inc.	2,365,212	54,691
Combined	19,042,747	780,037
<u>1976</u>		
Comtech Laboratories Inc. (as previously reported)	23,128,055	2,396,024
R. F. Systems, Inc.	2,364,860	96,524
Combined (as restated)	25,492,915	2,492,548

For years prior to acquisition, R. F. Systems, Inc. has been included in the Consolidated Financial Statements utilizing the fiscal year end nearest that of the respective fiscal year of the Company; for the current year R. F. Systems, Inc. is included on a July 31 fiscal year basis.

Comtech Advanced Systems, Inc.

In April 1977, the Company entered into agreements with a group of individuals and established Comtech Advanced Systems, Inc., a digital communications systems subsidiary. Under the agreements, the Company sold to these individuals 10,000 shares of common stock at par value (\$.10 per share) and will sell to these individuals up to 90,000 shares of common stock at \$.10 per share upon the achievement of earnings levels as defined in the agreements.

The greater of the excess of market value over the proceeds received for such shares on the date of the agreement or upon the achievement of the earnings milestone will be charged to compensation expense over the estimated period of earnings achievement. This expense was approximately \$31,000 in 1977.

Expenses associated with the establishment and operation of subsidiary for the year ended July 31, 1977 have been included in the Consolidated Statements of Income and Retained Earnings.

NOTE 3—ACCOUNTS RECEIVABLE:

	<u>July 31,</u>	
	<u>1977</u>	<u>1976</u>
Amounts receivable from the United States Government	\$ 244,576	\$ 447,907
Amounts receivable from others ..	5,040,715	2,247,229
	<u>\$5,285,291</u>	<u>\$2,695,136</u>

During the fiscal years ended July 31, 1977 and 1976, approximately 27% and 40%, respectively, of the Company's revenues resulted from contracts with U.S. Government agencies and prime contractors and approximately 28% and 19%, respectively, resulted from export sales.

NOTE 4—INVENTORIES:

	<u>July 31,</u>	
	<u>1977</u>	<u>1976</u>
Raw materials and components ..	\$1,217,374	\$1,184,810
Work in process	5,902,604	5,333,519
	7,119,978	6,518,329
Less—progress payments	3,595,429	306,904
	<u>\$3,524,549</u>	<u>\$6,211,425</u>

Work in process relating to contracts is expected to be delivered over a period of less than twelve months. Approximately 84% in 1977 and 77% in 1976 of the Company's work in process represents work performed pursuant to contracts. The remainder represents parts and components being manufactured for stock.

Title to work in process is vested in the customer on contracts which provide for progress, partial, or advance payments to the extent of such payments received.

During 1977 the Company included in work in process inventory certain selling and finance expenses of \$1,078,000 which are associated with a particular contract (see Note 12 for further information). At July 31, 1977, approximately \$706,000 of these specific expenses remain in work in process inventory.



NOTE 5—PROPERTY, PLANT AND EQUIPMENT:

	Estimated Useful Lives	July 31,	
		1977	1976
Land	—	\$ 190,728	\$ 190,728
Building	40 Years	1,350,320	1,348,493
Construction in process	—	5,788	—
Leasehold improvements ...	Lease Term	275,099	124,830
Equipment	3-8 Years	3,571,318	3,093,847
		5,393,253	4,757,898
Less—accumulated depreciation and amortization		1,688,584	1,308,910
		<u>\$3,704,669</u>	<u>\$3,448,988</u>

NOTE 6—MORTGAGE NOTES:

	July 31,	
	1977	1976
9.4% First mortgage indebtedness to a bank payable monthly, maturing in 1980	\$471,594	\$482,890
6.5% Second mortgage indebtedness to the New York State Job Development Authority payable monthly, maturing in 1981	188,005	230,830
10.25% indebtedness to a bank guaranteed by the SBA, payable monthly, maturing in 1982	—	218,407
	659,599	932,127
Less—portion due within one year	58,000	67,250
	<u>\$601,599</u>	<u>\$864,877</u>

The 10.25% bank indebtedness was assumed in the acquisition of R. F. Systems, Inc. and was repaid in March 1977.

At July 31, 1977, the aggregate principal amount maturing annually during each of the four fiscal years ending July 1981 is as follows: 1978—\$58,000; 1979—\$62,000; 1980—\$498,000; 1981—\$42,000. These mortgages are secured by approximately \$1,530,000 of land and building referred to in Note 5.

NOTE 7—INCOME TAXES:

The provisions for income taxes for the years ended July 31, 1977 and 1976 were as follows:

	July 31,	
	1977	1976
Current:		
Federal	\$698,000	\$1,743,000
State	195,000	519,500
Deferred	(173,000)	164,000
Total	<u>\$720,000</u>	<u>\$2,426,500</u>

The following tabulation sets forth the difference between the statutory and effective income tax rates for the years ended July 31, 1977 and 1976.

	July 31,	
	1977	1976
Federal statutory income tax rate	48%	48%
State income taxes, net of federal tax benefit	4	6
Tax exempt DISC income	—	(3)
Investment credit	(4)	(2)
Effective income tax rate	<u>48%</u>	<u>49%</u>

NOTE 8—SHAREHOLDERS' EQUITY:

Changes in Shareholders' Equity during the years ended July 31, 1977 and 1976 are as follows:

	No. of Shares	Common Stock	Additional Paid-In Capital	Retained Earnings
Balance July 31, 1975, as previously reported	1,598,840	\$159,884	\$2,273,210	\$3,115,980
Shares issued in connection with the acquisition of R. F. Systems, Inc.	<u>51,353</u>	<u>5,135</u>	<u>77,863</u>	<u>140,841</u>
Balance July 31, 1975, as restated	1,650,193	165,019	2,351,073	3,256,821
Exercise of stock options	66,110	6,611	260,674	
Net income for the period				2,492,548
benefits resulting from disqualifying disposition by employees of stock purchased under stock option plans			<u>132,000</u>	
Balance July 31, 1976	1,716,303	171,630	2,743,747	5,749,369
Exercise of stock options	2,400	240	5,974	
Net income for the period				780,037
Shares issued in connection with the organization of a subsidiary	10,000	1,000	30,276	
Tax benefit resulting from disqualifying disposition by employees of stock purchased under stock option plans			<u>23,000</u>	
Balance July 31, 1977	<u>1,728,703</u>	<u>\$172,870</u>	<u>\$2,802,997</u>	<u>\$6,529,406</u>



NOTE 9—STOCK OPTION PLANS:

Options to purchase common stock of the Company have been granted under various plans to officers and other key employees. Options granted under the Company's 1968 and 1970 qualified option plans are at prices equal to the fair market value of such stock on the date of grant and are exercisable over a period of not more than five years. Options granted under the Company's 1976 Incentive Stock Option Plan are at prices which may not be less than 85% of the fair market value of such stock on the date of grant and are exercisable over a period determined by the Board of Directors at the time of grant.

The following tabulation sets forth the activity in stock options for the years ended July 31, 1977 and 1976:

	July 31,			
	1977		1976	
	Number of Shares	Option Price Per Share	Number of Shares	Option Price Per Share
Qualified Stock Options:				
Outstanding, beginning of the year	72,450	\$1.25-18.13	93,160	\$1.25-18.13
Granted	20,500	6.50	50,750	9.25-24.75
Exercised	(2,400)	1.25-9.88	(66,110)	1.25-18.13
Cancelled	(54,500)	1.25-24.75	(5,350)	4.25-18.13
Outstanding, end of year	36,050	4.25-18.13	72,450	1.25-18.13
Incentive Stock Options:				
Granted and Outstanding, end of year	108,600	5.53	—	
Total Options Outstanding, end of year	144,650	4.25-18.13	72,450	1.25-18.13
Exercisable, end of year	89,220	4.25-18.13	15,400	1.25-18.13

At July 31, 1977 and 1976, 83,000 and 7,600 shares, respectively, were available for grant under the plans.

In connection with options issued under the 1976 Incentive Stock Option Plan, the difference between the option price and the fair market value on the date of grant is compensation expense and is charged to operations over the period during which the options become exercisable. This compensation expense amounted to \$71,000 during 1977.

In May 1977, the Company established, subject to shareholder approval, an Incentive Warrant Plan for directors of the Company who are neither officers nor employees of the Com-

pany or its subsidiaries. Under the plan, a maximum of 25,000 shares of common stock were available for grant under provisions to be established at the discretion of a committee of the Board of Directors. Warrants which have been granted under the plan become exercisable over a period of ten years and are limited to a maximum of 3,750 shares for each qualified director.

NOTE 10—LINE OF CREDIT:

The Company has an agreement with the Chemical Bank of New York which provides a short-term \$19,000,000 line of credit. Under the terms of the agreement, the Company may borrow up to \$9,500,000 on a short-term unsecured basis, at an interest rate of $\frac{1}{2}\%$ above prime, with additional short-term borrowings up to \$9,500,000, to be secured by certain accounts receivable and inventory. No compensating balances are required by the agreement. During the year the Company borrowed a maximum of \$600,000 for a period of two months at a rate of $6\frac{3}{4}\%$. There were no borrowings under the line of credit in fiscal 1976. See Note 12 of the Notes to Consolidated Financial Statements for further information on outstanding guarantee letters of credit.

NOTE 11—PROFIT SHARING AND INCENTIVE COMPENSATION PLANS:

Effective August 1, 1974, the Company adopted a profit sharing plan covering all eligible employees. The plan, which is subject to the approval of the IRS, provides for the Company to contribute such amounts as the Board of Directors determines. During the years ended July 31, 1977 and 1976, the Board approved contributions of \$100,000 and \$250,000, respectively, which were charged to income.

Effective August 1, 1975, the Company adopted an incentive compensation plan for officers and other key employees. Under the plan, an amount equal to 5% of income before income taxes without taking into consideration extraordinary items and before amounts allocated hereunder shall be payable to selected key employees of the Company. A provision of \$83,000 and \$249,600 was charged against income in fiscal 1977 and 1976, respectively.

NOTE 12—COMMITMENTS AND CONTINGENCIES:

In June 1976, the Company entered into a 20 year lease agreement for a new manufacturing facility with annual rentals of approximately \$277,000 plus property taxes and other specific costs. The agreement also includes an option to purchase the facility after one year for approximately \$2,574,000.

Certain sales of the Company are subject to the Renegotiation Act of 1951, as amended. Clearance has been received through fiscal year 1974. In the opinion of management, no refunds are anticipated for sales subject to renegotiation.

In connection with a contract for \$19,000,000 which was awarded to the Company in November 1976, the Company was required to establish customary standby letters of credit for 20% of the contract value (which represents an amount equal to the down payment received under the contract) and a 10% performance guarantee. Under the terms of the contract, the letter of credit for the advance payment is reduced as shipments are made against the contract. As of July 31, 1977, such reductions amount to approximately \$700,000.

In connection with issuance of the standby letters of credit, the Company agreed in April 1977, to secure the performance guarantee by March 1978, and in the event of default thereunder, the Company will, upon request, grant the bank a security interest in its assets. The agreement contains covenants considered customary to such agreements, including maintenance of defined levels of consolidated working capital and tangible net worth which the Company has maintained through the date of this report. At July 31, 1977, the Company had secured the performance guarantee with \$1,000,000 of Certificates of Deposit.

NOTE 13—QUARTERLY DATA (UNAUDITED):

Quarter	Net Sales	Gross Profit	Net Income (Loss)	Earnings (Loss) Per Share
<u>Fiscal 1977</u>				
First	\$5,215,994	\$1,670,380	\$ 496,584	\$.29
Second	4,221,122	946,325	158,534	.09
Third	3,399,231	207,246	(276,073)	(.16)
Fourth	6,206,400	1,807,131	400,992	.23
<u>Fiscal 1976</u>				
First	6,000,448	1,499,323	558,030	.33
Second	7,059,562	2,128,406	661,388	.38
Third	5,513,773	1,754,009	699,661	.41
Fourth	6,919,132	2,016,056	573,469	.33



REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Shareholders of
Comtech Laboratories Inc.

We have examined the consolidated balance sheets of Comtech Laboratories Inc. (a New York corporation) and subsidiaries as of July 31, 1977 and July 31, 1976, and the related consolidated statements of income and retained earnings and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying consolidated financial statements present fairly the financial position of Comtech Laboratories Inc. and subsidiaries as of July 31, 1977 and July 31, 1976, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied during the years.

ARTHUR ANDERSEN & CO.

Huntington, N.Y.

October 4, 1977,

(except for Notes 10 and 12, as to which the date is
October 20, 1977)

Five-Year Summary of Operations

	Year Ended July 31,				
	1973(A)	1974(A)	1975(A)	1976(A)	1977
Net sales	\$13,872,174	\$11,284,377	\$18,399,784	\$25,492,915	\$19,042,747
Costs and expenses:					
Cost of sales	12,017,283	8,723,014	13,722,678	18,095,121	14,411,665
Selling, general and administrative	730,577	893,002	1,169,838	1,983,210	2,615,030
Depreciation and amortization	153,790	224,059	314,350	403,509	435,278
Interest	97,765	135,510	158,385	92,027	80,737
	<u>12,999,415</u>	<u>9,975,585</u>	<u>15,365,251</u>	<u>20,573,867</u>	<u>17,542,710</u>
Income before income taxes	872,759	1,308,792	3,034,533	4,919,048	1,500,037
Provision for income taxes	320,300	591,925	1,439,075	2,426,500	720,000
Net income	<u>\$ 552,459</u>	<u>\$ 716,867</u>	<u>\$ 1,595,458</u>	<u>\$ 2,492,548</u>	<u>\$ 780,037</u>
Earnings per share (B)	<u>\$.33</u>	<u>\$.43</u>	<u>\$.95</u>	<u>\$ 1.45</u>	<u>\$.45</u>

(A) Restated to reflect the acquisition of R. F. Systems, Inc. which has been accounted for as a pooling of interests.

(B) Based upon the weighted average common shares outstanding during the year after giving retroactive effect to the shares issued in the acquisition of R. F. Systems, Inc. as discussed in Note 2 of the financial statements.



Management Discussion and Analysis of Summary of Operations

Sales

During the fiscal year 1977 as compared to 1976, sales decreased by approximately 25%. This decrease is attributable to previous reductions in backlog and to the delivery schedules on major contracts. Sales for the fiscal year 1976 as compared to 1975 increased by approximately 40%. This increase is due principally to the rapid growth in the satellite communications market for which the Company supplies a comprehensive and technically sophisticated product line.

Costs and Expenses

Cost of sales as a percentage of sales for fiscal 1977 compared to 1976 increased by approximately 5%. This increase was due to increases in expenses associated with a new facility, research and development costs, and

changes in the mix of products. Cost of sales as a percentage of sales for fiscal 1976 compared to 1975 decreased by approximately 3%, reflecting a favorable product mix and efficiencies associated with higher production volume.

Selling, general and administrative expenses in fiscal year 1977 compared to 1976, and 1976 to 1975 increased approximately 32% and 69%, respectively. These increases are attributable to increased levels of employment, higher costs of compensation, employee benefits, selling and marketing expenses.

Depreciation and amortization in fiscal year 1977 compared to 1976, and 1976 compared to 1975 increased by 8% and 29%, respectively, due to the addition of new equipment.

Stock Prices

The common stock of Comtech Laboratories Inc. is traded in the Over-The-Counter market. The prices shown are representative quotations supplied by the National Association of Securities Dealers, Inc. through NASDAQ and do not include retail mark-up, mark-down or commissions and do not necessarily reflect actual transactions.

Quarter	Fiscal Year 1977		Fiscal Year 1976	
	Bid, Low-High	Asked, Low-High	Bid, Low-High	Asked, Low-High
1st	12 $\frac{1}{4}$ -20 $\frac{3}{4}$	13 $\frac{1}{4}$ -21 $\frac{3}{4}$	8 $\frac{1}{4}$ -13	9 $\frac{1}{4}$ -14
2nd	11-15	12-16	11 $\frac{1}{2}$ -17	12 $\frac{1}{2}$ -18
3rd	8 $\frac{1}{4}$ -13 $\frac{3}{4}$	9 $\frac{1}{4}$ -14 $\frac{3}{4}$	16 $\frac{1}{2}$ -24 $\frac{1}{2}$	17 $\frac{1}{2}$ -25 $\frac{1}{2}$
4th	5 $\frac{3}{4}$ -8 $\frac{3}{4}$	6 $\frac{3}{4}$ -9 $\frac{3}{4}$	14 $\frac{3}{4}$ -24 $\frac{1}{4}$	15 $\frac{3}{4}$ -25 $\frac{1}{4}$

Dividends

No dividends have been paid on the Company's common stock.

Form 10-K

A copy of the Company's Annual Report on Form 10-K for fiscal year 1977 as filed with the Securities and Exchange Commission (excluding exhibits) will be furnished, without charge, to any owner of common stock of the Company entitled to vote at its Annual Meeting, upon written request to J. P. Windus, Jr., Secretary-Treasurer, Comtech Laboratories Inc., 135 Engineers Rd, Smithtown, NY 11787.



Two data-only earth stations, manufactured and installed by Comtech for Satellite Business Systems Inc., provide a satellite communications data link between the east (Poughkeepsie, N.Y.) and west coasts (Los Gatos, California). Currently, this satellite link is undergoing development tests for direct high-speed digital, and time-division multiple-access (TDMA) transmissions via an existing geostationary domestic satellite. The earth stations contain Comtech's highly-reliable C-band communication equipment and antennas. An additional earth station, currently being manufactured by Comtech, will be located at the Research Triangle Park site in Raleigh, North Carolina.



10th Anniversary

Founded in 1967, Comtech Laboratories Inc. has advanced from a component manufacturer to a major supplier of complete vertically-integrated communication systems serving both the domestic and international markets. Since its incorporation, Comtech has gained widespread recognition as a major manufacturer of highly-reliable satellite communication earth stations, troposcatter and microwave systems.

