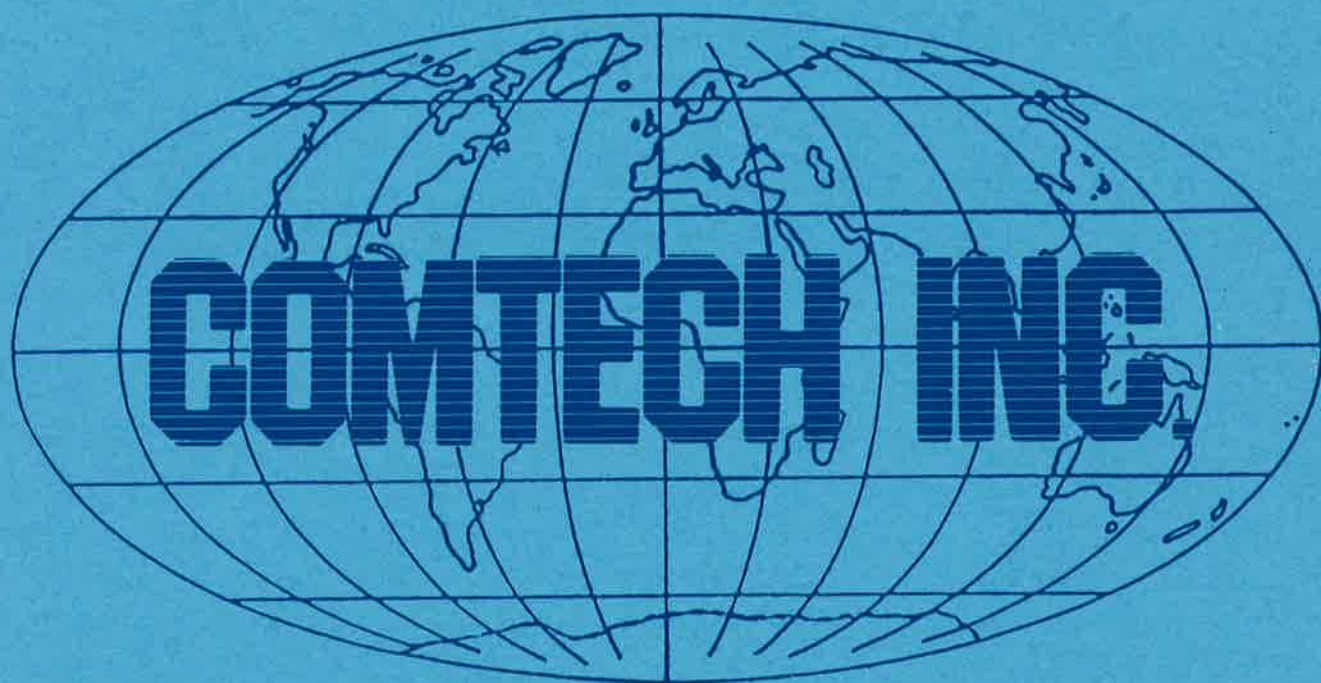


# **ANNUAL REPORT**



**1985**

**ABOUT THE COMPANY**

---

Comtech Inc. was incorporated in 1967 as Comtech Laboratories, Inc. The Company is principally engaged in the design, development, manufacture and installation, for commercial and government applications, of high technology, communications-related equipment. The Company's products are chiefly used in connection with satellite, tropospheric scatter and terrestrial line-of-sight communication systems. The Company designs, manufactures and sells microwave components for electronic systems utilizing microwaves for various military defense and commercial purposes. The Company sells its products directly to end users, as well as to subcontractors and prime contractors which incorporate such products in a full system installation, and also uses its products, along with products of others, to sell and install entire communication systems on a turnkey basis.

The Company's operating units are Premier Microwave Corporation, Comtech Microwave Corp. and Comtech Systems, Inc.

**CORPORATE HEADQUARTERS**

---

Comtech Inc.  
63 Oser Avenue  
Hauppauge, NY 11788  
(516) 435-4646

**OPERATING UNITS**

---

Premier Microwave Corporation  
33 New Broad Street  
Port Chester, NY 10573  
(914) 939-8900

Comtech Microwave Corp.  
63 Oser Avenue  
Hauppauge, NY 11788  
(516) 435-4646

Comtech Systems, Inc.  
3100 Communications Road  
St. Cloud, FL 32769  
(305) 892-6111

## TO OUR SHAREHOLDERS AND EMPLOYEES:

Through the restructuring and consolidation of Comtech's operations - a principal focus of management during this last year - we have been creating the foundation from which we can again generate desirable momentum. And so, even before I recite Comtech's previously reported results for 1985, I would like to describe to you Comtech's operations as we are structured today.

### Premier Microwave Corporation

Premier, our wholly owned Port Chester, New York subsidiary, manufactures components for radar, missile, and command, control and communications systems. Premier's business consists principally of the design and manufacture of waveguide, coaxial and stripline microwave components, and the supply of its products and services to the U.S. Government, prime contractors and subcontractors doing business with the U.S. Government, and original equipment manufacturers of systems employing microwave technology.

An important part of Premier's business continues to be components of on-going systems in which the Company has developed a recognized capability, such as antennas for "Sparrow" missiles, millimeter wave components for periscope radars, high power rotary joints for shipboard radar, microwave packages for airborne navigation radar, and filters for "Lamps" helicopter radar.

In May 1985, Premier formed a new active microwave supercomponent and subsystems division called "Supercomp", responsible for the design, development and manufacture of active microwave integrated assemblies and supercomponents. These components consist of combinations of active and passive signal processing devices such as diode switches, attenuators, oscillators, multipliers, phase shifters and modulators, ferrite circulators and custom assemblies in stripline, microstrip, and airstrip packages. We expect that this technological capability, as well as the addition of 5,000 square feet of adjoining space and the support team of key engineers we have recently added, should enable Premier to rapidly begin the introduction and sale of sophisticated quality microwave components to industry. Supercomponent products and designs, using soft substrate microwave technology, augment our present microwave capability. Our Supercomp division with its active component capability should allow us to better penetrate our present customer base as well as introduce new customers to our basic products. Although Premier's bookings during fiscal year 1985 did not reach expectations, customer orders for Premier's products have recently shown renewed strength, including approximately

\$500,000 of new orders of our new Supercomp product line. During the year we added a number of new customers along with new applications for Premier's products, which include, among others, the Nexrad sophisticated weather radar.

### Comtech Microwave Corp.

The principal product line of Comtech Microwave, low noise amplifiers, has been an important part of the Company's product line since its formation in 1967. These amplifiers are in use in more than 120 countries in satellite stations carrying millions of telephone, television, and data circuits. The markets for Microwave's products include satellite and troposcatter communication systems for commercial and defense applications, earth stations monitoring telemetry data from deep space probing vehicles, electronic intelligence systems, radio astronomy and similar demanding applications where uncompromised high performance is required.

Last year Comtech Microwave had its most successful year in securing customer orders. For the year, this operation obtained orders for approximately \$7,500,000, with awards for X-Band Solid State Intermediate Power Amplifiers, Low Noise Amplifiers, and Radio Frequency Synthesizers/Oscillators.

Newly developed products include a quick-reaction highly transportable suitcase X-Band satellite terminal for U.S. Government tactical and strategic satellite communications applications, and X-Band microprocessor-controlled Up and Down Frequency Converters with patented low phase noise frequency synthesizers.

### Comtech Systems, Inc.

Fiscal 1985 was a year in which the foundation for the future of Comtech Systems, Inc. was formed. Early in 1985, Comtech Systems International, Inc., a business segment devoted primarily to supplying troposcatter communications systems, was co-located at our St. Cloud, Florida facility and merged with Comtech Antenna Corp. The combining of these companies to form Comtech Systems, Inc. has resulted in the emergence of a highly competitive group which has the in-house capability to supply fixed as well as transportable systems for both the satellite and troposcatter communications markets. During the year, we installed a digital troposcatter communications system for the United States Air Force as part of its east coast over-the-horizon radar program. The system incorporated our patented predetection combiner and newly designed fade-resistant modem. We have expectations of follow on awards for additional phases of this project.

Of further note, the Comtech Systems "Offsat" antenna system, designed to accommodate the FCC's two degree satellite spacing regulation, was selected as the primary antenna system for a nationwide audio baseball network having transmit and receive antenna systems in practically all cities where a National and/or American League baseball team is located. Additionally, our transportable version of the "Offsat" antenna has been used by many of the major teleconferencing professionals for special events, such as Live Aid concerts, the 1984 Olympics, political conventions, and other sporting events and general corporate teleconferences.

The most significant disappointment has been the continued delays in the award of several major projects we are pursuing. We continue to have expectations that, in time, we will be able to convert some of these into orders. However, many of the programs being pursued by Comtech Systems are highly-competitive multi-year foreign procurements and, as such, are subject to significant uncertainty as to contract award date, award recipient, and ultimate program size.

**1985 Financial Results**

For the year ended July 31, 1985, Comtech reported net income of \$6,675,000 or \$1.39 per share, as compared to a net loss of \$27,886,000 or \$5.89 per share, the year earlier. Results for 1985 reflected a loss of \$933,000 from continuing operations, a loss of \$1,375,000 from discontinued operations, an after-tax gain of \$6,583,000 from the sale of subsidiaries, and a \$2,400,000 extraordinary credit from the utilization of tax loss carryforwards. Continuing operations for 1985 benefitted from a \$2,544,000 gain on the sale of a Hauppauge, New York manufacturing facility. Sales from continuing operations were \$18,955,000 for fiscal 1985 as compared to \$18,227,000 for 1984.

Backlog of continuing operations at July 31, 1985 was \$13,156,000 as compared to \$15,882,000 (exclusive of the U.S. Army Radio Contract) a year before.

**Debt Service and Restructuring Activities**

We have been taking a very hard look at Comtech's outstanding long-term debt, and have been considering or attempting to implement actions intended to deal further with that burden. In this connection, Storage Technology Corp. was, unfortunately, unable to obtain approval of the Court having jurisdiction over Storage Technology's reorganization proceedings to an agreement with Comtech that would have discharged Comtech's outstanding note to Storage Technology. Discussions, however, are continuing. We are also continuing to analyze and evaluate various ways of addressing Comtech's principal indebtedness, its outstanding Subordinated Debentures.

Earlier this year, the Company's capital deficiency resulted in Comtech's being removed from listing on the NASDAQ automatic market quotation system. While our shares continue to be traded on the OTC market, an objective in our debt service discussions has been to increase Comtech's capital position to a level that will allow NASDAQ relisting.

As you would expect, for many reasons, the entire matter of Comtech's balance sheet and debt service requirements is one of our highest priorities.

**Going Forward**

The time required to put Comtech solidly on the road and move it into a positive cash flow position, and the degree of success we will have in achieving this is, to a large extent, a function of our ability to deal effectively with our long-term debt and increase the sales of Comtech's products. Simply put, that is the challenge and that is the opportunity.

Beyond this, other challenges remain - but so does Comtech's energy, resilience and desire to succeed. Spearheading and supporting all of our efforts, of course, are our employees. They are the ones we call upon daily to make this Company work. They are Comtech's future. We thank them. As always, our appreciation is also extended to our shareholders, customers and suppliers for their support and loyalty to the Company.



Fred Kornberg  
Chairman of the Board  
and President

December 11, 1985

**FINANCIAL SECTION TABLE OF CONTENTS**

---

	<u>Page</u>
Consolidated Balance Sheets .....	4-5
Statements of Changes in Shareholders' Equity (Deficiency) .....	6
Consolidated Statements of Operations .....	7
Consolidated Statements of Changes in Financial Position .....	8-9
Notes to Consolidated Financial Statements .....	10-30
Auditors' Opinion .....	31
Management's Discussion and Analysis of Financial Condition and Results of Operations .....	32-36
Summary of Selected Financial Data .....	37
Price Range of Common Stock and Warrants .....	38

## COMTECH INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

JULY 31, 1985 AND 1984 (NOTE 1)

ASSETS	<u>1985</u>	<u>1984</u>
CURRENT ASSETS:		
Cash (including short-term time deposits of \$4,160,000 in 1985)	\$ 4,838,000	\$ 363,000
Accounts receivable - net (Notes 2, 5 and 15)	3,962,000	5,662,000
Inventories (Notes 2, 6 and 15)	2,507,000	2,420,000
Prepaid expenses and other	554,000	215,000
Assets subsequently sold - net (Note 1)		1,035,000
Net current assets of discontinued operations (Note 1)		<u>4,870,000</u>
Total current assets	11,861,000	14,565,000
PROPERTY, PLANT AND EQUIP- MENT - net (Notes 2 and 7)	3,483,000	3,985,000
OTHER ASSETS (Notes 2 and 4)	1,070,000	1,184,000
NET NONCURRENT ASSETS OF DISCONTINUED OPERATIONS (Note 1)		3,238,000
TOTAL	<u><u>\$16,414,000</u></u>	<u><u>\$22,972,000</u></u>

See Notes to Consolidated Financial Statements.

LIABILITIES AND SHAREHOLDERS' DEFICIENCY	<u>1985</u>	<u>1984</u>
CURRENT LIABILITIES:		
Notes payable and current maturities of long-term debt (Note 8)	\$ 2,696,000	\$13,239,000
Accounts payable	1,531,000	3,159,000
Accrued expenses and other (Note 15)	3,996,000	4,049,000
Allowance for estimated losses on contracts (Notes, 2, 3, 11 and 15)	<u>3,220,000</u>	<u>2,742,000</u>
Total current liabilities	<u>11,443,000</u>	<u>23,189,000</u>
LONG-TERM DEBT (Note 8)	<u>10,240,000</u>	<u>11,655,000</u>
OTHER LIABILITIES	<u>30,000</u>	<u>165,000</u>
COMMITMENTS AND CONTINGENCIES (Notes 3 and 11)		
SHAREHOLDERS' DEFICIENCY		
(Notes 4, 8 and 10):		
Preferred stock, \$.10 par value:		
Authorized - 2,000,000 shares;		
Issued - none		
Common stock, \$.10 par value:		
Authorized - 1984, 20,000,000		
Issued -		
1985, 4,730,890 shares;	473,000	469,000
1984, 4,681,646 shares	12,691,000	12,632,000
Additional paid-in capital	(18,283,000)	(24,958,000)
Accumulated deficit	(5,119,000)	(11,857,000)
Treasury stock - 75,000 shares - at cost	<u>(180,000)</u>	<u>(180,000)</u>
Shareholders' deficiency	<u>(5,299,000)</u>	<u>(12,037,000)</u>
TOTAL	<u>\$16,414,000</u>	<u>\$22,972,000</u>

## COMTECH INC. AND SUBSIDIARIES

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (DEFICIENCY)

FOR THE FISCAL YEARS ENDED JULY 31, 1985, 1984 AND 1983 (NOTE 10)

	COMMON STOCK		ADDITIONAL	RETAINED	TREASURY	SHAREHOLDERS'
	SHARES	AMOUNT	PAID-IN	EARNINGS	STOCK	EQUITY
	ISSUED		CAPITAL	(DEFICIT)		(DEFICIENCY)
BALANCE, AUGUST 1, 1982	3,735,232	\$374,000	\$ 3,732,000	\$ 1,519,000		\$ 5,625,000
Shares issued in connection with stock op- tion, warrant, purchase and employment agreements	109,233	11,000	611,000			622,000
Proceeds from stock pur- chase warrants			2,386,000			2,386,000
Net income				1,409,000		1,409,000
BALANCE, JULY 31, 1983	3,844,465	385,000	6,729,000	2,928,000		10,042,000
Shares issued in public offering of common stock	750,000	75,000	5,556,000			5,631,000
Shares issued in connection with stock op- tion, warrant, purchase and employment agreements	87,181	9,000	347,000			356,000
Shares purchased from former officer					\$(180,000)	(180,000)
Net loss				(27,886,000)		(27,886,000)
BALANCE, JULY 31, 1984	4,681,646	469,000	12,632,000	(24,958,000)	(180,000)	(12,037,000)
Shares issued in connection with stock op- tion, warrant, purchase and employment agreements	49,244	4,000	59,000			63,000
Net income				6,675,000		6,675,000
BALANCE, JULY 31, 1985	<u>4,730,890</u>	<u>\$473,000</u>	<u>\$12,691,000</u>	<u>\$(18,283,000)</u>	<u>\$(180,000)</u>	<u>\$( 5,299,000)</u>

See Notes to Consolidated Financial Statements.



## CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE FISCAL YEARS ENDED JULY 31, 1985, 1984 AND 1983

	1985	1984	1983
CONTINUING OPERATIONS:			
Net sales (Notes 2, 3 and 13)	\$18,955,000	\$18,227,000	\$25,509,000
Costs and expenses (Note 14):			
Cost of sales (Note 2)	15,383,000	25,607,000	18,125,000
Selling, general and administrative	4,714,000	8,564,000	5,098,000
Research and development (Note 2)	235,000	862,000	930,000
Interest - net	2,100,000	2,632,000	1,142,000
Total costs and expenses	22,432,000	37,665,000	25,295,000
Operating income (loss) from continuing operations	(3,477,000)	(19,438,000)	214,000
Gain (loss) on sale or write-down of assets (Notes 1 and 15)	2,544,000	(700,000)	
Income (loss) from continuing operations before income taxes	(933,000)	(20,138,000)	214,000
Provision (benefit) for income taxes (Notes 2 and 9)		(557,000)	94,000
INCOME (LOSS) FROM CONTINUING OPERATIONS	(933,000)	(19,581,000)	120,000
DISCONTINUED OPERATIONS - net (Note 12)	5,208,000	(8,305,000)	1,289,000
INCOME (LOSS) BEFORE EXTRAORDINARY CREDIT	4,275,000	(27,886,000)	1,409,000
EXTRAORDINARY CREDIT (Note 12)	2,400,000		
NET INCOME (LOSS)	\$ 6,675,000	\$(27,886,000)	\$ 1,409,000
EARNINGS (LOSS) PER SHARE (Note 2):			
Continuing operations	\$ (.19)	\$(4.14)	\$ .03
Discontinued operations - net	1.08	(1.75)	.33
Income (loss) before extraordinary credit	.89	(5.89)	.36
Extraordinary credit	.50		
Earnings (loss) per share	\$ 1.39	\$(5.89)	\$ .36
Weighted average number of common and common equivalent shares outstanding	4,815,799	4,730,528	3,967,110

See Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

FOR THE FISCAL YEARS ENDED JULY 31, 1985, 1984 AND 1983

	<u>1985</u>	<u>1984</u>	<u>1983</u>
<b>FINANCIAL RESOURCES WERE PROVIDED (USED BY):</b>			
Continuing operations:			
Income (loss) from continuing operations	\$ (933,000)	\$(19,581,000)	\$ 120,000
Charges not affecting working capital:			
Depreciation and amortization of property, plant and equipment	850,000	1,027,000	711,000
Deferred Federal income taxes		(557,000)	23,000
Other - net	280,000	(100,000)	535,000
Funds provided from (used by) continuing operations	197,000	(19,211,000)	1,389,000
Funds provided from (used by) discontinued operations	7,608,000	(7,312,000)	2,080,000
Total from operations*	7,805,000	(26,523,000)	3,469,000
Increase in long-term debt	125,000	3,354,000	17,603,000
Issuance of stock purchase warrants			2,386,000
Issuance of common shares	63,000	5,987,000	622,000
Increase (decrease) in other liabilities	(135,000)	71,000	
Decrease in net noncurrent assets of discontinued operations	3,238,000		
Disposal and reclassification of property, plant and equipment - net	148,000	3,611,000	
Total	<u>11,244,000</u>	<u>(13,500,000)</u>	<u>24,080,000</u>
<b>FINANCIAL RESOURCES WERE USED FOR:</b>			
Purchase of business, less working capital acquired			1,867,000
Purchase of property, plant and equipment	496,000	1,460,000	1,301,000
Reduction in long-term debt	1,706,000	11,386,000	4,302,000
Purchase of treasury stock		180,000	
Increase in net noncurrent assets of discontinued operations		925,000	3,060,000
Other - net		(668,000)	1,011,000
Total	<u>2,202,000</u>	<u>13,283,000</u>	<u>11,541,000</u>
INCREASE (DECREASE) IN WORKING CAPITAL	<u>\$ 9,042,000</u>	<u>\$(26,783,000)</u>	<u>\$12,539,000</u>

See Notes to Consolidated Financial Statements.

## FOR THE FISCAL YEARS ENDED JULY 31, 1985, 1984 AND 1983

	<u>1985</u>	<u>1984</u>	<u>1983</u>
CHANGES IN WORKING CAPITAL BY COMPONENTS:			
Increase (decrease) in current assets:			
Cash	\$ 4,475,000	\$ (2,368,000)	\$(1,407,000)
Accounts receivable - net	(1,700,000)	(2,641,000)	4,532,000
Inventories - net	87,000	(2,015,000)	2,446,000
Prepaid expenses and other	339,000	(535,000)	596,000
Assets subsequently sold - net	(1,035,000)	1,035,000	
Net current assets of discontinued operations	<u>(4,870,000)</u>	<u>(6,078,000)</u>	<u>8,571,000</u>
Total	<u>(2,704,000)</u>	<u>(12,602,000)</u>	<u>14,738,000</u>
(Increase) decrease in current liabilities:			
Notes payable and current maturities of long-term debt	10,543,000	(11,954,000)	(929,000)
Accounts payable	1,628,000	(1,078,000)	(1,140,000)
Accrued expenses and other	53,000	(714,000)	(340,000)
Allowance for estimated losses on contracts	<u>(478,000)</u>	<u>(435,000)</u>	<u>210,000</u>
Total	<u>11,746,000</u>	<u>(14,181,000)</u>	<u>(2,199,000)</u>
INCREASE (DECREASE) IN WORKING CAPITAL	<u>\$ 9,042,000</u>	<u>\$(26,783,000)</u>	<u>\$12,539,000**</u>

\*The extraordinary credit had no impact on working capital in fiscal 1985.

\*\*Includes working capital relating to businesses acquired (see Note 4).

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

**1. RECENT DEVELOPMENTS AND SALES OF ASSETS**

As reflected in the consolidated financial statements, Comtech Inc. and its subsidiaries (the Company) incurred a net loss of \$27,886,000 during fiscal 1984, which was attributable, in part, to the termination of a significant contract as discussed in Note 3 and the operating losses of a subsidiary, Comtech Communications Corp. (CCC) (see Note 4). The net loss resulted in the Company experiencing liquidity problems and having a net shareholders' deficiency of \$12,037,000 at July 31, 1984. As a result of these and other matters, management assessed the Company's operations and future and implemented a plan to sell certain assets and businesses and use the proceeds from such sales to repay debt and replenish working capital.

As part of the Company's plan, during fiscal 1985, it sold the business of two subsidiaries, Comtech Data Corporation (CDC) and CCC, as well as a factory facility formerly used by the Company's Government Systems Division. The accompanying consolidated financial statements have been restated to give effect to CCC and CDC as discontinued operations (see Note 12).

Comtech Data Corporation

On November 7, 1984, the Company sold CDC's net assets to a subsidiary of Fairchild Industries, Inc. for an aggregate consideration of approximately \$12,200,000, the proceeds from which were used to repay all outstanding indebtedness due to banks (\$8,100,000) and other indebtedness (\$1,300,000) (see Note 8). The remainder was used to replenish working capital. The sale resulted in a gain, before applicable income taxes, of \$7,851,000.

Comtech Communications Corp.

On January 23, 1985, the Company sold CCC for an aggregate consideration of \$4,000,000, consisting of \$3,500,000 in cash and a \$500,000 interest-bearing promissory note payable in three semiannual installments through July 23, 1986. The sale of CCC's stock in fiscal 1985 resulted in a pretax gain of approximately \$1,132,000, which gain includes the reversal of a \$4,000,000 reserve recorded at July 31, 1984 (see Note 15). The proceeds from the sale were used to replenish working capital.

Sale of Hauppauge Facility

In October 1984, the Company sold its Hauppauge, New York factory facility for \$6,200,000 in cash, resulting in a gain, after expenses, of \$2,544,000. The net proceeds from the sale were used to repay the first mortgage on the facility, including a prepayment penalty, and the remainder was used to prepay a significant portion of a loan due to the United States Army (see Note 8).

The balance sheet caption "Assets subsequently sold - net" consists of the following at July 31, 1984:

Net carrying value of the Company's Hauppauge, New York manufacturing facility	\$ 2,837,000
First mortgage thereon	<u>(1,802,000)</u>
Net	<u>\$ 1,035,000</u>

Promissory Note Due to Storage Technology Corporation

On July 1, 1985, the Company entered into an agreement with Storage Technology Corporation (STC) under which the Company would issue up to 1,062,550 shares of its common stock to STC in full discharge and satisfaction of a promissory note due to STC with a remaining principal amount of \$2,209,000 (see Note 8).

The agreement also provides for a reduction of the exercise price, from \$12 to \$5 per share, of a warrant held by STC for 450,000 shares of the Company's common stock (see Note 10).

STC is in Chapter 11 reorganization proceedings, and the agreement is subject to the approval of the court having jurisdiction over such proceedings. STC's Creditors' Committee has filed certain objections to the agreement. The court has not yet ruled on the agreement or objections thereto. Accordingly, no impact has been recognized for this transaction in the accompanying consolidated financial statements.

Other

Despite the foregoing matters and other cost containment programs introduced by management, the Company's continuing operations operated at a loss in fiscal 1985, and it continues to have a net shareholders' deficiency. These factors, among others, indicate that the Company may be unable to continue as a going concern.

The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amount and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. The Company's continuation as a going concern is dependent, among other things, upon its ability to generate sufficient cash flow from operations to meet its obligations and ultimately to attain profitable operations.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES

### Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Comtech Inc. and its subsidiaries, all of which are wholly owned. All significant intercompany balances and transactions have been eliminated.

### Sales Recognition

Sales from continuing operations are generally recognized under the unit-of-delivery method of accounting, except for large multi-year funded programs which are accounted for under the percentage-of-completion method of accounting. Retainages and estimated earnings in excess of amounts billed on such multi-year programs are reflected as unbilled receivables.

### Costs and Expenses

Cost of sales is based on actual contract costs incurred and, in the case of partial shipments on long-term contracts, estimated final contract costs. Contract costs include material, direct labor, manufacturing overhead and other direct costs.

Since contracts may extend over periods in excess of one year, revisions in costs and earnings estimates during the course of contract performance are reflected during the accounting period in which the facts which require the revision become known. When estimates indicate a future loss on a contract is probable, a provision for the full amount thereof is charged to current operations. To the extent the charge for the estimated loss exceeds the inventory balance related to the "loss" contract, the excess is credited to the allowance for estimated losses on contracts.

### Inventories

Raw materials and components are stated at the lower of cost (using the first-in, first-out cost flow assumption) or market. Work-in-process is valued at the total material, direct labor, manufacturing overhead and other direct costs incurred under each contract, less amounts charged to cost of sales pursuant to the application of the unit-of-delivery method of revenue recognition.

### Property, Plant and Equipment

Property, plant and equipment are recorded at cost. When property is retired, sold or scrapped, the cost and accumulated depreciation or amortization of such property are eliminated from the accounts, and the resultant gain or loss is reflected in current operations.

Annual depreciation is provided utilizing the straight-line method over the estimated useful service lives of the related assets (buildings and improvements - 40 years, equipment - 3 to 8 years). Leasehold improvements are amortized over the remaining terms of the leases or the useful lives of the improvements, whichever is less.

### Goodwill

The unamortized excess of cost over the purchase value of the net assets acquired, which amounted to \$543,000 and \$557,000 at July 31, 1985 and 1984, respectively, is included in the balance sheet caption "Other assets" and is being amortized on the straight-line basis over 40 years.

### Research and Product Development Costs

The Company charges research and product development costs to operations as incurred except in those cases in which such costs are reimbursable under customer-funded contracts.

### Income Taxes

Where appropriate, the Company provides deferred income taxes for transactions which are reported in different periods for financial reporting purposes than for income tax purposes (see Note 9). At July 31, 1985, no deferred taxes are recorded because of the existence of net operating loss carryforwards. No benefit has been recorded for these carryforwards because future utilization thereof is not assured.

If applicable, investment tax credits are accounted for as reductions of income taxes in the year in which the related assets are placed in service.

Earnings (Loss) Per Share

During each fiscal year in the three year period ended July 31, 1985, the number of shares of the Company's common stock which would be issuable on exercise of outstanding options and warrants in the aggregate exceeded 20 percent of the number of common shares outstanding. Therefore, the treasury stock method of calculating earnings per share was modified to assume that all outstanding options and warrants had been exercised and the assumed proceeds therefrom were used at the beginning of each respective period (i) to repurchase 20 percent of the total outstanding common shares at the average market price per share, (ii) to retire indebtedness and (iii) to invest the balance in United States government securities.

The assumed exercise of all options and warrants was anti-dilutive in each of the three fiscal years in the period ended July 31, 1985.

Reclassifications

Certain amounts relating to fiscal 1984 and 1983 have been reclassified to conform with the fiscal 1985 presentation.

**3. SIGNIFICANT CONTRACTS WITH THE UNITED STATES ARMY**

Radio Contract

In fiscal 1983, the Company commenced a multi-year contract with the United States Army to produce 221 transportable microwave radios for an amended contract price of \$12,100,000. Following discussions, the Army terminated this contract for default in August 1984.

As part of the termination notice, the Army demanded return of certain Government-furnished equipment (GFE) and repayment of unliquidated progress payments amounting to \$1,821,000 and interest thereon commencing with the date of termination and asserted its right to assess the Company for procurement costs, if any.

In November 1984, the Company, which contends that the Army caused or contributed to delays in contract performance, filed an appeal as to the nature of the termination with the Armed Services Board of Contract Appeals. The Company has returned all GFE relating to the terminated contract and is negotiating cancellation settlements with vendors who were to supply materials and services for the contract.



The amount in the balance sheet caption "Allowance for estimated losses on contracts" principally relates to this contract at July 31, 1985 and 1984. No provision for possible reprocurement assessments has been made because management does not believe the Army will reprocure the specific radio covered by the contract. However, the Army has not officially advised the Company of its intentions in this matter and, therefore, the outcome is in doubt. The ultimate loss on this contract cannot be fully determined until the appeal process with the Army and vendor negotiations are completed or otherwise resolved.

During the year ended July 31, 1984, the Company recognized losses of \$6,542,000 on this contract, including the estimated costs associated with termination.

United States Army Satellite Communications Terminal Contract  
(the Army MT Contract)

The Army MT contract, which was substantially completed by July 31, 1985, is the largest contract in the Company's history and was accounted for on the percentage-of-completion method. Net sales from continuing operations in the accompanying Consolidated Statements of Operations include sales pertaining to the Army MT Contract of \$1,854,000 in fiscal 1985, \$1,953,000 in fiscal 1984 and \$8,479,000 in fiscal 1983.

#### 4. ACQUISITIONS

During fiscal 1983, the Company made two acquisitions, both of which were accounted for under the purchase method of accounting and, accordingly, the operations of the acquired businesses are included in the accompanying consolidated financial statements commencing with the dates of their respective acquisitions.

Premier Microwave Corporation (Premier)

On January 28, 1983, the Company acquired the outstanding common stock of Premier for an aggregate consideration, including expenses, of \$3,873,000. Premier designs and manufactures a broad line of microwave components for various radar, missile, communications, telemetry and submarine systems. The amount by which the total purchase price exceeded the net purchase value of Premier's net assets was \$578,000 and was recorded as goodwill (see Note 2).

Comtech Communications Corp.

On July 1, 1983, a newly-formed subsidiary, CCC, acquired the operating assets relating to the COM 2 Product Line from a subsidiary of STC for an aggregate consideration, including expenses of \$250,000, of \$9,933,000, comprised of \$5,311,000 in cash, \$3,314,000 in notes (see Notes 1 and 8), and a five-year warrant to purchase 450,000 shares of the Company's common stock which, for accounting purposes, was valued at \$1,058,000 (see Note 10). CCC was engaged in the manufacture and marketing of microprocessor-controlled telephone voice multiplexors and concentrators. No goodwill resulted from this acquisition.

CCC was sold in January 1985 (see Note 1).

## 5. ACCOUNTS RECEIVABLE

Accounts receivable consist of the following at July 31, 1985 and 1984:

	<u>1985</u>	<u>1984</u>
Amount receivable from the United States Government	\$1,223,000	\$1,973,000
Unbilled receivables (including retainages) on contracts in progress	1,345,000	1,441,000
Accounts receivable from other customers	<u>1,435,000</u>	<u>2,264,000</u>
Total	4,003,000	5,678,000
Less - Allowance for doubtful accounts (Note 15)	<u>41,000</u>	<u>16,000</u>
Accounts receivable - net	<u><u>\$3,962,000</u></u>	<u><u>\$5,662,000</u></u>

Unbilled receivables relate to contracts accounted for on the percentage-of-completion basis. The unbilled amounts are billable upon the completion of performance tests and acceptance by the customer.

## 6. INVENTORIES

Inventories consist of the following at July 31, 1985 and 1984:

	<u>1985</u>	<u>1984</u>
Raw materials and components	\$2,285,000	\$2,221,000
Work-in-process	3,427,000	4,119,000
Finished goods	<u>219,000</u>	<u>207,000</u>
Gross inventories	5,931,000	6,547,000
Less:		
Progress payments not in excess of costs included in work-in-process	294,000	1,140,000
Inventory reserves (Note 15)	<u>3,130,000</u>	<u>2,987,000</u>
Inventories - net	<u><u>\$2,507,000</u></u>	<u><u>\$2,420,000</u></u>

Work-in-process generally relates to contracts which are expected to be completed in less than one year. Title to work-in-process is vested in the customer for those contracts which provide for progress, partial or advance payments to the extent of such payments received. Advance payments received on contracts amounted to \$24,000 and \$218,000 at July 31, 1985 and 1984, respectively, and are included in the balance sheet caption "Accrued expenses and other."

Inventory reserves include reserves for obsolescence and for work-in-process for which there is no contractual coverage.

COMTECH INC. AND SUBSIDIARIES

7. PROPERTY, PLANT AND EQUIPMENT

Changes in property, plant and equipment used by continuing operations were as follows:

<u>Year Ended July 31,</u>	<u>Balance at Beginning of the Year</u>	<u>Additions at Cost</u>	<u>Transfers, Retirements or Sales</u>	<u>Balance at End of the Year</u>
<u>1985</u>				
Land	\$ 58,000			\$ 58,000
Buildings and improvements	899,000		\$ (14,000)	885,000
Equipment	7,679,000	\$ 413,000	(616,000)	7,476,000
Leasehold improvements	<u>443,000</u>	<u>83,000</u>	<u>13,000</u>	<u>539,000</u>
Total	<u>\$ 9,079,000</u>	<u>\$ 496,000</u>	<u>\$ (617,000)</u>	<u>\$ 8,958,000</u>
<u>1984</u>				
Land	\$ 708,000		\$ (650,000) (b)	\$ 58,000
Buildings and improvements	3,442,000	\$ 47,000	(2,590,000) (b)	899,000
Equipment	7,120,000	1,386,000	(827,000)	7,679,000
Leasehold improvements	<u>501,000</u>	<u>27,000</u>	<u>(85,000)</u>	<u>443,000</u>
Total	<u>\$11,771,000</u>	<u>\$1,460,000</u>	<u>\$(4,152,000)</u>	<u>\$ 9,079,000</u>
<u>1983</u>				
Land	\$ 698,000		\$ 10,000 (c)	\$ 708,000
Buildings and improvements	2,905,000	\$ 288,000	249,000 (c)	3,442,000
Equipment	5,025,000	1,982,000 (a)	113,000 (c)	7,120,000
Leasehold improvements	<u>13,000</u>	<u>193,000 (a)</u>	<u>295,000</u>	<u>501,000</u>
Total	<u>\$ 8,641,000</u>	<u>\$2,463,000</u>	<u>\$ 667,000</u>	<u>\$11,771,000</u>

(a) Includes assets of \$1,162,000 acquired as part of the Premier acquisition, but excludes \$2,749,000 acquired as part of the CCC acquisition since all amounts pertaining to CCC are reported as discontinued operations (see Notes 1 and 4).

(b) Transferred to the balance sheet caption "Assets subsequently sold - net" (except for \$33,000 of building improvements) (see Note 1).

(c) Transferred from the balance sheet caption "Other assets".

Changes in accumulated depreciation of property, plant and equipment were as follows:

<u>Year Ended July 31,</u>	<u>Balance at Beginning of the Year</u>	<u>Charged to Profit and Loss</u>	<u>Transfers, Retirements, Renewals or Replacements</u>	<u>Balance at End of the Year</u>
<u>1985</u>				
Buildings and improvements	\$ 164,000	\$ 35,000	\$ (13,000)	\$ 186,000
Equipment	4,853,000	764,000	(472,000)	5,145,000
Leasehold improvements	<u>77,000</u>	<u>51,000</u>	<u>16,000</u>	<u>144,000</u>
Total	<u>\$ 5,094,000</u>	<u>\$ 850,000</u>	<u>\$(469,000)</u>	<u>\$5,475,000</u>
<u>1984</u>				
Building and improvements	\$ 415,000	\$ 119,000	\$(370,000) (a)	\$ 164,000
Equipment	4,153,000	843,000	(143,000)	4,853,000
Leasehold improvements	<u>40,000</u>	<u>65,000</u>	<u>(28,000)</u>	<u>77,000</u>
Total	<u>\$ 4,608,000</u>	<u>\$1,027,000</u>	<u>\$(541,000)</u>	<u>\$5,094,000</u>
<u>1983</u>				
Buildings and improvements	\$ 239,000	\$ 105,000	\$ 71,000 (b)	\$ 415,000
Equipment	3,597,000	564,000	(8,000) (b)	4,153,000
Leasehold improvements	<u>3,000</u>	<u>42,000</u>	<u>(5,000)</u>	<u>40,000</u>
Total	<u>\$ 3,839,000</u>	<u>\$ 711,000</u>	<u>\$ 58,000</u>	<u>\$4,608,000</u>

(a) Transferred to the balance sheet caption "Assets subsequently sold - net" (see Note 1).

(b) Includes accumulated depreciation of assets transferred from "Net noncurrent assets of discontinued operations" (see Note 12) aggregating \$125,000, comprised of building (\$69,000) and equipment (\$56,000).

## 8. LONG-TERM DEBT AND NOTES PAYABLE

Secured Demand Notes Payable to Banks

In July 1984, the Company entered into a credit agreement which provided that it could borrow up to \$2,000,000 in demand loans which bore interest at two percentage points above the prime lending rate. These loans were collateralized by a pledge agreement under which the Company pledged substantially all of its assets to secure the loans outstanding under this agreement and the revolving credit agreement described below. At July 31, 1984, demand loans of \$1,000,000 were outstanding. Such borrowings, which reached a maximum of \$2,000,000, were repaid in November 1984 from the proceeds of the sale of CDC's net assets (see Note 1), at which time the credit agreement was effectively terminated.

Long-Term Debt

Long-term debt consists of the following at July 31, 1985 and 1984:

	<u>1985</u>	<u>1984</u>
13% Subordinated Notes due 1991 (net of an unamortized discount of \$913,000 and \$1,079,000)	\$ 9,087,000	\$ 8,921,000
Promissory note payable to STC	2,209,000	3,314,000
Revolving credit agreement with three banks		6,000,000
Loan payable to the United States Army (including accrued interest of \$616,000 and \$867,000)	787,000	4,739,000
Obligations under capital leases	853,000	920,000
Total long-term debt	<u>12,936,000</u>	<u>23,894,000</u>
Less - Current maturities	<u>(2,696,000)</u>	<u>(12,239,000)</u>
Long-term portion	<u>\$10,240,000</u>	<u>\$11,655,000</u>

13% Subordinated Notes

In February 1983, the Company completed a public offering in which it sold \$10,000,000 principal amount of 13% Subordinated Notes due February 1, 1991 and 800,000 warrants (see Note 10). The net proceeds of the offering were used, in part, to repay indebtedness incurred and replenish working capital expended to acquire Premier (see Note 4), with the remainder used for general corporate purposes. The Company is required to redeem \$2,500,000 principal amount of the notes on both February 1, 1989 and 1990 and the remaining \$5,000,000 on February 1, 1991. Interest is payable semiannually on February 1 and August 1.

Promissory Note Payable to STC

The promissory note payable, which was issued to STC as partial consideration for the purchase of the COM 2 Product Line (see Note 4), is payable in three equal annual installments commencing on July 1, 1984. Interest is payable on a quarterly basis at the prime lending rate. The principal payment due on July 1, 1985 has not been made because of the negotiations relating to the agreement with STC described in Note 1.

Revolving Credit Agreement

In January 1983, the Company entered into a loan agreement with three banks providing the Company with a revolving line of credit of \$6,000,000. Borrowings under this line were to be payable on January 1, 1985 with interest payable quarterly at a rate of 1/2 percentage point above prime. The agreement, among other things, contained certain affirmative and negative covenants and limited the Company's ability to pay dividends, make capital expenditures and enter into lease agreements.

All borrowings under this agreement were repaid in November 1984 from the proceeds of the sale of the net assets of CDC, at which time this agreement was effectively terminated.

Army Loan

In September 1982, the Company and the Office of the Comptroller of the Department of the Army executed a \$4,140,000 loan agreement, the proceeds from which were used to repay the entire outstanding balance of a former term loan. The Army Loan, which was secured by a second mortgage on the Company's Hauppauge, New York manufacturing facility (see Note 1), was repayable in sixty equal monthly installments commencing June 1, 1984, together with interest at a rate set, effective prospectively every six months, by the Secretary of Treasury pursuant to the Contracts Dispute Act of 1978. Such rate is 10.375 percent for the period July 1 to December 31, 1985. Interest accrued, on an uncompounded basis, through June 1, 1984 was scheduled to be paid, without further interest, in equal monthly installments during such sixty-month period.

In November 1984, the Company prepaid \$3,539,000 of this loan from the proceeds of the sale of the Hauppauge facility (see Note 1) and reached an agreement to repay the remaining balance outstanding over a period of 48 months from that date.

Capital Leases

The obligations under capital leases relate to certain equipment leased by the Company having net carrying values (pertaining to continuing operations) of \$824,000 and \$883,000 at July 31, 1985 and 1984.

## Debt Maturities

Long-term debt is scheduled to mature as follows:

<u>Fiscal Year Ending July 31,</u>	<u>Amount</u>
1986	\$ 2,696,000
1987	501,000
1988	521,000
1989	2,631,000
1990	2,500,000
Thereafter	4,087,000
	<u>                    </u>
Total	<u><u>\$12,936,000</u></u>

## 9. INCOME TAXES

Available Carryforwards

For financial reporting purposes, the Company has available net operating tax loss carryforwards of approximately \$14,000,000. It expects that its Federal income tax return for the fiscal year ended July 31, 1985 will include net operating loss carryforwards of approximately \$22,000,000, expiring principally in the period 1996 to 2000. The difference between these two carryforward amounts is principally a result of (i) the Company's policy to account for long-term contracts on the percentage-of-completion or unit-of-delivery method for financial reporting purposes and the completed contract method for income tax purposes and (ii) certain reserves and provisions which are not currently deductible for income tax purposes. Its Federal income tax return is also expected to have investment, foreign and research and development tax credit carryforwards of approximately \$850,000 and a capital loss carryforward of approximately \$1,500,000.

Reconciliation of Effective Rate to Statutory Rate

The Company's effective tax rate for continuing operations was 44 percent for fiscal 1983 which varied from the Federal



statutory rate of 46 percent because of state income taxes, investment tax credits and research and development credits.

Components of Provision for Income Taxes

The provision for income taxes pertaining to continuing operations consists of the following for the fiscal years ended July 31:

	<u>1984</u>	<u>1983</u>
Federal-		
Deferred (benefit)	\$(552,000)	\$ 23,000
State, principally current	<u>(5,000)</u>	<u>71,000</u>
Total	<u><u>\$(557,000)</u></u>	<u><u>\$ 94,000</u></u>

The deferred Federal benefit in fiscal 1984 relates to the reversal of existing net deferred tax credits.

The principal causes for timing differences are (i) the accounting for all contracts on the completed contract method for tax purposes and (ii) provisions establishing certain reserves and allowances being deductible in different periods for financial and tax reporting purposes.

10. SHAREHOLDERS' EQUITY (DEFICIENCY)

Option and Warrant Plans and Agreements

1982 Incentive Stock Option Plan - In December 1982, the shareholders approved the 1982 Incentive Stock Option and Appreciation Plan which provides for the granting to key employees and officers of incentive stock options to purchase up to 500,000 shares of the Company's common stock at prices not less than the fair market value of such shares on the date the option is granted. The plan also provides for the granting of Stock Appreciation Rights (SARs) in conjunction with the options. The SARs entitle the holder to receive payment, in exchange for the surrender in whole or in part of the related option, of an amount equal to the excess of the fair market value at the time of surrender over the aggregate option price of such shares. Such payment may be made in shares of common stock of the Company, in cash, or a combination thereof, as determined by the committee administering the plan.

1976 Incentive Stock Option Plan - No additional options or SARs may be granted under the Company's 1976 Incentive Stock Option Plan. Under this plan, the Company had granted options to officers and key employees at prices which were not less than 85 percent of the fair market value of such shares on the date of grant and are exercisable over a period determined by the Board of Directors at the time of grant.

The difference between the option price and the fair market value on the date of grant for all options issued under the 1976 Incentive Option Plan was considered compensation expense. All options granted under this plan subsequent to January 1, 1982 are at an option price equivalent to 100 percent of the fair market value of the Company's common stock at the date of grant and, therefore, no compensation has been recorded for such options.

Incentive Warrant Plan - The Company's Incentive Warrant Plan for Directors of the Company who were neither officers nor employees of the Company was terminated; however, warrants to purchase 24,500 shares of stock remain outstanding under the Plan. Warrants which had been granted under the Plan become exercisable over a period of ten years.

Other Warrants - In February 1983, the Company sold 800,000 warrants in connection with the issuance of the 13% Subordinated Notes (see Note 8). Each warrant entitles the holder to purchase one share of the Company's common stock at a price of \$11, subject to adjustment, until January 31, 1988. For accounting purposes, these warrants were valued at \$1,328,000. As of July 31, 1985, none have been exercised.

Warrant Held by STC - The Company issued a warrant to STC in July 1983 as partial consideration for the acquisition of the COM 2 Product Line (see Note 4) to purchase 450,000 shares of the Company's common stock at \$12 per share, subject to adjustment, until July 1, 1988. As part of the arrangement with STC described in Note 1, the purchase price will be reduced from \$12 to \$5 per share if the arrangement receives court approval.

For accounting purposes, this warrant was valued at \$1,058,000 at the time of issuance. As of July 31, 1985, no portion of this warrant had been exercised.

Option and Warrant Activity

The following table sets forth summarized information concerning the Company's stock options and warrants:

	<u>1985</u>		<u>1984</u>	
	<u>Number</u>	<u>Exercise Price Range</u>	<u>Number</u>	<u>Exercise Price Range</u>
Options/warrants outstanding at the beginning of the year	1,897,600	\$1.81-\$12.00	1,818,000	\$2.07-\$13.69
Granted	199,300	1.125- 1.59	417,550	1.81- 10.63
Exercised			(11,030)	2.07- 4.56
Expired/cancelled	<u>(488,300)</u>	1.125-11.375	<u>(326,920)</u>	2.07- 13.69
Options/warrants outstanding at the end of the year	<u>1,608,600</u>	1.125-12.00	<u>1,897,600</u>	1.81- 12.00
Options/warrants exercisable at the end of the year	<u>1,403,340</u>	1.94-12.00	<u>1,473,360</u>	2.07- 12.00
Options/warrants- available for grant at the end of the year	<u>364,000</u>		<u>181,700</u>	

Employee Stock Purchase Plan

In December 1981, the shareholders approved an Employee Stock Purchase Plan under which a maximum of 300,000 shares of the Company's authorized and unissued common stock were reserved for offering to employees, other than officers and directors, who have been employed for at least one year and met certain other minimum eligibility requirements. Under the terms of the plan, at the beginning of each six-month period, commencing with the first business day of January 1982, participants are granted the right to purchase up to 100 shares of the Company's common stock at a price equal to 85 percent of the fair market value of such stock at either the beginning or the end of the period, on whichever date the price is lower. Employees electing to participate in the plan may purchase stock by executing a subscription agreement and authorizing payroll deductions. During the fiscal years ended July 31, 1985, 1984 and 1983, employees purchased 27,244, 12,491 and 16,083 shares, respectively. At July 31, 1985, 234,616 shares are reserved for possible future issuances under this plan.

Employment Agreements

Three employees of CDC had contracts under which such employees purchased 200,000 shares of the Company's common stock at a price of \$.10 per share based on the achievement of certain specified earnings milestones. The difference between the fair market value of the Company's common stock on the date each milestone (or portion thereof) was achieved and the purchase price was accounted for as compensation expense. Such compensation charged (credited) to operations amounted to \$27,000 in 1985, \$(98,000) in 1984 and \$297,000 in 1983 and is included in the caption "Discontinued operations - net" in the accompanying Consolidated Statements of Operations.

The Company entered into agreements with two officers under which they received, or were entitled to receive, subject to certain restrictions, an aggregate of 175,000 shares of the Company's common stock at a price of \$.10 per share. The differences between the fair market value of the Company's common stock as of the date of the respective agreements and the purchase price are treated as compensation expense over the term of the respective officers' employment contracts. Compensation expense relating to agreements with officers and employees was \$89,000 in 1985, \$262,000 in 1984 and \$137,000 in 1983.

During fiscal 1984, the Company purchased 75,000 shares of treasury stock from one of these officers upon his resignation.

Public Offering

In August 1983, the Company completed a public offering of 750,000 shares of its common stock, the net proceeds from which amounted to \$5,631,000.

11. COMMITMENTS AND CONTINGENCIES

Letters of Credit

In connection with the performance of work under certain contracts, the Company is required to establish letters of credit and/or performance guarantees. As of July 31, 1985, the Company is committed under an open letter of credit of \$200,000, which is secured by a certificate of deposit.

United States Government Contracts

Certain of the Company's contracts are subject to audit by the Defense Contract Audit Agency and/or the General Accounting Office. Until such audits are completed, the ultimate profit on these contracts cannot be determined; however, in the opinion of management, the final contract settlements will not have a material adverse effect on the Company's financial condition.

Litigation

The Company is a defendant in various suits and claims. Management believes, based on discussions with counsel, that the ultimate liability to the Company in these matters, if any, would not have a material adverse impact on its financial condition.

Operating Leases

The Company has entered into operating lease agreements for equipment, manufacturing and office facilities for initial periods ranging from 3 to 10 years. The scheduled rentals under these agreements, which apply to continuing operations, are as follows:

<u>Fiscal Year Ending July 31,</u>	<u>Amount</u>
1986	\$ 327,000
1987	328,000
1988	315,000
1989	255,000
1990	260,000
Thereafter	<u>518,000</u>
Total	<u>\$2,003,000</u>

Rent expense charged to continuing operations was \$554,000 in 1985, \$716,000 in 1984 and \$578,000 in 1983.

**12. DISCONTINUED OPERATIONS**

The net operating results of all discontinued operations (see Note 1) are included in the caption "Discontinued operations - net" in the accompanying Consolidated Statements of Operations. Discontinued operations in fiscal 1983 also include an insignificant amount of wind-up costs relating to the Company's large antenna business which had been discontinued during fiscal 1981.

Discontinued operations - net consist of the following for the three fiscal years in the period ended July 31, 1985:

	<u>1985</u>	<u>1984</u>	<u>1983</u>
OPERATIONS:			
Net sales	<u>\$6,106,000</u>	<u>\$22,167,000</u>	<u>\$11,080,000</u>
Costs and expenses:			
Cost of sales	4,679,000	18,971,000	6,533,000
Selling, general and administrative	2,205,000	6,145,000	2,027,000
Research and development	624,000	1,365,000	708,000
Interest - net	(27,000)	(9,000)	(20,000)
Provision for write-down of assets		4,000,000	
Total	<u>7,481,000</u>	<u>30,472,000</u>	<u>9,248,000</u>
Operating income (loss) before applicable income taxes	(1,375,000)	(8,305,000)	1,832,000
Provision for income taxes			<u>586,000</u>
Discontinued operations	(1,375,000)	(8,305,000)	1,246,000
GAIN ON DISPOSAL - net of applicable income taxes of \$2,400,000 in 1985 and \$36,000 in 1983	<u>6,583,000</u>		<u>43,000</u>
DISCONTINUED OPERATIONS - net	<u>\$5,208,000</u>	<u>\$(8,305,000)</u>	<u>\$ 1,289,000</u>

The extraordinary credit included in the accompanying Consolidated Statements of Operations for fiscal 1985 represents the benefit realized from the utilization of Federal income tax loss carryforwards in connection with the taxes associated with the gain on disposal of discontinued operations.

### 13. SEGMENT AND PRINCIPAL CUSTOMER INFORMATION

For the purposes of segment reporting, Management considers the Company to operate primarily in one industry, the communications equipment industry.

During the fiscal years ended July 31, 1985, 1984 and 1983 approximately 78, 77 and 77 percent, respectively, of the Company's net sales from continuing operations resulted from contracts with United States Government agencies and prime contractors of such agencies. Such sales are subject to regulatory provisions applicable to government contracts including, among other things, those providing for renegotiation and termination for the convenience of the government.

Approximately 6, 9 and 13 percent of net sales from continuing operations in 1985, 1984 and 1983, respectively, resulted from export sales.

#### 14. SUPPLEMENTARY INCOME STATEMENT INFORMATION

Certain supplementary income statement information relating to continuing operations is as follows for the fiscal years ended July 31, 1985, 1984 and 1983:

	<u>1985</u>	<u>1984</u>	<u>1983</u>
Maintenance and repairs	\$396,000	\$201,000	\$270,000
Amortization of intangibles and deferred expenses	362,000	538,000	571,000

## 15. VALUATION ALLOWANCES AND RESERVES

The following summarizes the activity in the Company's valuation accounts relating to continuing operations:

	<u>Balance at Beginning of Year</u>	<u>Charged to Costs and Expenses</u>	<u>Charged to Other Accounts</u>	<u>Deductions</u>	<u>Balance at End of Year</u>
<u>Allowance for doubtful accounts</u>					
1985	\$ 16,000	\$ 25,000			\$ 41,000
1984	51,000			\$ 35,000	16,000
1983	19,000	30,000	\$ 4,000	2,000	51,000
<u>Allowance for estimated losses on contracts</u>					
1985	\$2,742,000	\$ 424,000	\$ 250,000	\$ 196,000	\$3,220,000
1984	2,307,000	921,000	1,821,000	2,307,000	2,742,000
1983	2,517,000			210,000	2,307,000
<u>Inventory reserves</u>					
1985	\$2,987,000	\$ 86,000	\$ 147,000	\$ 90,000	\$3,130,000
1984	1,131,000	1,887,000		31,000	2,987,000
1983	1,200,000	180,000	22,000	271,000	1,131,000
<u>Reserve for loss on sale of assets</u>					
1985	\$ 700,000				\$ 700,000 (a)
1984		\$ 700,000 (a)			700,000 (a)

(a) Represents the estimated loss relating to the sale of assets, exclusive of \$4,000,000 relating to a reserve for write-downs at CCC. The \$4,000,000 provision was charged to the caption "Discontinued operations - net" in the accompanying Statements of Consolidated Operations (see Notes 1 and 12) and such reserve is included in the balance sheet caption "Net current assets of discontinued operations" at July 31, 1984. The \$700,000 reserve for loss on sale of assets is included in the balance sheet caption "Accrued expenses and other" at July 31, 1985 and 1984.



100 Crossways Park West  
 Woodbury, Long Island, New York 11797  
 (516) 364-9393  
 TWX 510-221-1888

AUDITORS' OPINION

To The Board of Directors  
 and Shareholders of Comtech Inc.:

We have examined the consolidated balance sheets of Comtech Inc. and subsidiaries as of July 31, 1985 and 1984 and the related consolidated statements of operations, changes in shareholders' equity (deficiency) and changes in financial position for each of the three fiscal years in the period ended July 31, 1985. Our examinations were 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.

As discussed in Note 1, there are conditions which may indicate that the Company will be unable to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

As discussed in Note 3, in August 1984, the United States Army terminated one of the Company's major contracts for default and, among other things, demanded repayment of unliquidated progress payments amounting to \$1,821,000. The Army also asserted its right to assess the Company for procurement costs, if any. As a result of the termination, the Company cancelled purchase orders and agreements relating to this contract which were previously placed with vendors. The Company has filed an appeal of the termination with the Armed Services Board of Contract Appeals and is negotiating settlements with vendors. The ultimate loss on this contract cannot be fully determined until the appeal process and vendor negotiations are completed or otherwise resolved.

In our opinion, subject to the effects on the fiscal 1985 and 1984 consolidated financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainties referred to in the preceding two paragraphs been known, such consolidated financial statements present fairly the financial position of Comtech Inc. and subsidiaries at July 31, 1985 and 1984 and the results of their operations and the changes in their financial position for each of the three fiscal years in the period ended July 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

*Deloitte Haskins & Sells*

October 17, 1985

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATION**

---

**Liquidity and Capital Resources**

Beginning in the fiscal year ended July 31, 1984, the Company experienced severe liquidity difficulties largely caused by operating losses during that year, principally incurred by its former Government Systems Division and Comtech Communications Corp. subsidiary. The Company had a net loss for that fiscal year of \$27,886,000. While liquidity difficulties continued during the first half of the year ended July 31, 1985, in the latter half of such period the Company's liquidity improved as a result of the receipt of proceeds from the sale of certain of the Company's assets and subsidiaries.

In August 1984, the U.S. Army terminated for default, assertedly as a result of delay by the Company, the Army Radio Contract and, among other things, demanded repayment of approximately \$1,821,000 of unliquidated progress payments. The Army also asserted the right to assess the Company for reprocurement costs, if any. In addition, the Company has cancelled purchase orders and agreements relating to this contract which were previously placed with vendors. The Company, which contends the Army caused or contributed to delays in performance, has filed an appeal with the Armed Services Board of Contract Appeals as to the nature of the termination and is presently negotiating settlements with vendors. The ultimate loss on this contract cannot be fully determined until the appeal process and vendor negotiations are completed or otherwise resolved.

The Company has undertaken a number of significant actions to curtail its operating losses, reduce its indebtedness and meet its liquidity requirements.

It has discontinued certain of the business activities previously engaged in by its former Government Systems Division and has reassigned to its other operating entities the bulk of such Division's remaining activities, thereby, among other things, eliminating significant facility and other overhead and personnel costs not required for the ongoing activities.

In early October 1984, the Company sold the Hauppauge, Long Island manufacturing facility which had housed the Government Systems Division and applied the net proceeds of approximately \$5,500,000 to reduce indebtedness, including the first mortgage of \$1,876,000 on this facility and a major portion (\$3,539,000) of the Company's loan from the U.S. Army, which had been secured by a second mortgage.

As of July 31, 1985, the unpaid principal balance of the Army loan was \$171,000, which is repayable in equal monthly installments through October 1, 1988, together with interest at an effective rate set prospectively every six months by the Secretary of the Treasury pursuant to the Contract Disputes Act of 1978, as amended. The rate for the period through December 31, 1985 is 10-3/8%. The unpaid balance of interest accrued through June 1, 1984 on the Army loan (\$616,000 as of July 31, 1985) is payable without interest in equal monthly installments ending on October 1, 1988. The current aggregate monthly payment by the Company is approximately \$22,000.

On November 7, 1984, the net assets of the Company's wholly-owned Comtech Data Corporation subsidiary were sold to a subsidiary of Fairchild Industries, Inc. for an aggregate purchase price of approximately \$12,200,000. Of the initial \$9,000,000 received on November 7, 1984, approximately \$8,100,000 was used to repay the Company's entire outstanding secured bank debt, including accrued interest. An additional \$2,400,000 was received on November 26, 1984, of which approximately \$1,300,000 was used to repay other indebtedness, and the balance of the sales proceeds was received in March 1985. Approximately \$2,800,000 of the net proceeds was used to replenish working capital.

On January 23, 1985, the Company sold a wholly-owned subsidiary, Comtech Communications Corp., to Netex Corporation, Inc., a newly formed corporation, for an aggregate consideration of \$4,000,000, consisting of \$3,500,000 in cash and a \$500,000 interest-bearing promissory note payable in three semi-annual installments through July 23, 1986. The net proceeds of the sale were used for working capital. This subsidiary, a start-up operation in existence since July 1983, was involved in the manufacture and sale of voice compression and voice concentration products and had incurred substantial losses in fiscal 1984 and 1985.

The Company, having paid its entire outstanding bank debt, does not currently have a bank credit facility. At July 31, 1985, secured letters of credit were outstanding in the amount of \$200,000. Any new letters of credit will be issued on a secured basis subject to prior bank approval.

Cash and short term investments at July 31, 1985 were \$4,838,000 as compared to \$363,000 at July 31, 1984.

On August 1, 1985, the Company paid \$650,000 of interest on its 13% Subordinated Notes due February 1, 1991. Interest payments are due each August 1 and February 1 until maturity.

On July 1, 1985 the Company entered into an agreement with Storage Technology Corporation ("StorageTek") for the discharge of the Company's promissory note to StorageTek in the outstanding principal amount of \$2,209,000. The Agreement provides, among other things, for the issuance to StorageTek of 850,000 shares of Comtech common stock, plus additional shares, if any, up to 212,550, determined in accordance with a formula relating to the market price of Comtech stock at the time a registration statement covering the Comtech shares is declared effective. The Agreement also provides for the reduction to \$5.00 of the exercise price of the warrant for 450,000 Comtech shares held by StorageTek. StorageTek is in Chapter XI reorganization proceedings, and the Agreement is subject to the approval of the Court which has jurisdiction over StorageTek's proceedings. The Creditors' Committee in the StorageTek proceedings has filed an objection with the Court with respect to the Agreement. While the Company intends to seek a withdrawal of such objection, there can be no assurance that it will be successful in this endeavor.

The Company's continuation as a going concern is dependent, among other things, upon its ability to generate sufficient cash flow from operations to meet its obligations and ultimately to attain profitable operations.

## Results of Operations

### Fiscal Year 1985 Compared to Fiscal Year 1984

For the year ended July 31, 1985, the Company had a net income of \$6,675,000 as compared with a net loss of \$27,886,000 for the prior year.

Sales for fiscal 1985 from continuing operations were \$18,955,000 as compared to \$18,227,000 for fiscal 1984.

Included in fiscal 1985 net income was a loss from continuing operations of \$933,000 (including a gain of \$2,544,000 from the sale of one of its Hauppauge, Long Island manufacturing facilities) as compared with the loss of \$19,581,000 for the year ended July 31, 1984. The financial results for the year ended July 31, 1985 were also significantly impacted by the gain, net of taxes, on the sale of two of the Company's subsidiaries, Comtech Data Corporation and Comtech Communications Corp., of approximately \$6,583,000. The utilization of Federal net operating loss carryforwards contributed \$2,400,000 of extraordinary credit to the results for 1985.

Results for the year ended July 31, 1984, reflected, among things, reversals of estimated revenues of \$6,693,000 previously recognized by the former Government Systems Division, principally in connection with the Army Radio Contract and the Army MT Contract, resulting from changes in estimates of the ultimate gross profits to be realized on these contracts. The Army Radio Contract was terminated in August 1984 and the final system shipment under the Army MT Contract was made in August 1985.

Cost of sales of continuing operations for the year ended July 31, 1985 decreased \$10,224,000 or 40%, compared with 1984. The year ended July 31, 1984 included, among other things, provisions aggregating approximately \$5,272,000 for obsolete and surplus inventory, anticipated losses on certain contracts and certain relocation expenses primarily attributable to the operations of the Company's former Government Systems Division and Comtech Microwave Corp. subsidiary.

Selling, general and administrative costs of continuing operations decreased \$3,850,000 or 45%, principally because the year ended July 31, 1984 included provisions of \$1,647,000 to establish reserves for future expenses related to the Army MT Contract and Army Radio Contract, while the Company established significantly fewer provisions in fiscal 1985 while instituting personnel and other cost reductions.

Research and development expenses of continuing operations decreased \$627,000 or 73% due to lower budgets established for fiscal 1985 as part of the Company's cost containment programs.

Interest expense decreased \$532,000, principally as a result of the repayment of all outstanding bank debt during the second quarter of fiscal 1985.

#### Fiscal Year 1984 Compared to Fiscal Year 1983

For fiscal 1984, the Company had a net loss of \$27,886,000 and sales from continuing operations of \$18,227,000. This compared with net income of \$1,409,000 and sales of \$25,509,000 for fiscal 1983. Total sales (including those of Comtech Data Corporation and Comtech Communications Corp., which are included in discontinued operations) were \$40,394,000 in fiscal 1984 and \$36,589,000 in fiscal 1983.

The net loss of \$27,886,000 was attributable in large part to the termination of the Army Radio Contract, continuing delays in completion of the Army MT Contract, certain asset write-offs and the establishment of inventory reserves, as well as operating losses of Comtech Communications Corp.

The 29% decrease in sales from continuing operations of \$7,282,000 in fiscal 1984, compared with the prior year, reflected in part reversals of estimated revenues recognized by the Government Systems Division, as discussed below, as well as a decline in sales of this Division.

The revenue reversals of the Government Systems Division related primarily to the Army MT Contract. A reduction of \$3,633,000 of the Army MT Contract revenues recognized to April 30, 1984 resulted from a revised estimate of the total gross profit ultimately to be realized from completion of the contract. The gross profit percentage was reduced by approximately 4.3 percentage points in recognition of additional costs incurred due to management and production difficulties encountered by this Division during fiscal 1984.

In August 1984, the Army Radio Contract was terminated. As a result, the Company reversed all revenues recognized on this contract. In fiscal 1983, the Company recognized revenues of \$2,090,000 on this contract.

Cost of sales of continuing operations increased \$7,482,000 for fiscal 1984 or 41% over fiscal 1983. Significant factors contributing to the increase were costs incurred on the Army Radio Contract, including the estimated costs associated with its termination, and costs related to the operations of Premier Microwave Corporation, which were included for all of fiscal 1984 compared with six months of fiscal 1983.

Selling, general and administrative costs of continuing operations increased \$3,466,000 compared with fiscal 1983, of which 48% was attributable to increased costs and provisions to establish reserves required for expenses of the former Government Systems Division.

Income from continuing operations for fiscal 1984 also was adversely impacted by a \$700,000 provision established to cover anticipated losses on the sale of assets.

Interest expense increased in fiscal 1984 as a result of higher debt levels, principally relating to the \$10,000,000 principal amount of subordinated notes issued in February 1983, borrowings under the Company's credit lines and the promissory note issued to StorageTek.

## SUMMARY SELECTED FINANCIAL DATA

(Dollars in thousands, except for per share amounts)

	Fiscal Year Ended July 31,				
	1985(2)	1984(2)	1983(2)	1982	1981
Selected Income Data:					
Net sales from continuing operations (1)	<u>\$18,955</u>	<u>\$ 18,227</u>	<u>\$ 25,509</u>	<u>\$24,805</u>	<u>\$26,420</u>
Pretax income (loss) from continuing operations (1)	<u>\$ (933)</u>	<u>\$(20,138)</u>	<u>\$ 214</u>	<u>\$ 1,287</u>	<u>\$ 1,037</u>
Income (loss) from continuing operations (1)	<u>\$ (933)</u>	<u>\$(19,581)</u>	<u>\$ 120</u>	<u>\$ 724</u>	<u>\$ 527</u>
Net income (loss)	<u>\$ 6,675</u>	<u>\$(27,886)</u>	<u>\$ 1,409</u>	<u>\$ 2,380</u>	<u>\$ 1,194</u>
Earnings (loss) per share:					
Income (loss) from continuing operations (1)	<u>\$ (.19)</u>	<u>\$ (4.14)</u>	<u>\$ .03</u>	<u>\$ .33</u>	<u>\$ .14</u>
Net income (loss)	<u>\$ 1.39</u>	<u>\$ (5.89)</u>	<u>\$ .36</u>	<u>\$ .64</u>	<u>\$ .33</u>
Selected Balance Sheet Data:					
Working Capital (deficit)	<u>\$ 418</u>	<u>\$ (8,624)</u>	<u>\$ 18,159</u>	<u>\$ 5,620</u>	<u>\$ 7,260</u>
Total assets	<u>\$16,414</u>	<u>\$ 22,972</u>	<u>\$ 39,852</u>	<u>\$19,011</u>	<u>\$24,306</u>
Long-term debt, excluding current maturities	<u>\$10,240</u>	<u>\$ 11,655</u>	<u>\$ 19,687</u>	<u>\$ 5,967</u>	<u>\$10,124</u>
Shareholders' equity (deficiency) (3)	<u>\$(5,299)</u>	<u>\$(12,037)</u>	<u>\$ 10,042</u>	<u>\$ 5,625</u>	<u>\$ 2,854</u>

- (1) Amounts have been restated to reflect Comtech Data Corporation and Comtech Communications Corp. as discontinued operations.
- (2) Includes Premier Microwave Corporation in continuing operations from January 28, 1983 (date of acquisition).
- (3) No cash dividends have been declared on Comtech's Common Stock during any period presented.

## PRICE RANGE OF COMMON STOCK AND WARRANTS

The Company's Common Stock and Warrants are traded in the over-the-counter market. Until September 3, 1985, they were quoted on NASDAQ, at which date they were deleted from listing for failure to meet NASDAQ's capital and surplus requirement. Under the rules of the National Association of Securities Dealers, a company is required to have a minimum capital and surplus of \$375,000 in order to remain eligible for quotation on NASDAQ.

The following table sets forth the range of high and low closing bids of the Common Stock and Warrants as reported on NASDAQ for the periods indicated, except for the period after September 3, 1985, which reflects interdealer prices. The prices shown are representative quotations and do not include retail markups, markdowns or commissions and do not necessarily reflect actual transactions.

	Common Stock		Warrants	
	High Bid	Low Bid	High Bid	Low Bid
Fiscal Year ended				
July 31, 1984				
First Quarter.....	\$10-1/2	\$6-3/8	\$4-1/8	\$2-5/8
Second Quarter.....	7	5-1/8	2-3/4	1-7/8
Third Quarter.....	5-1/4	2-5/8	2	5/8
Fourth Quarter.....	2-3/4	1-1/2	5/8	3/8
Fiscal Year ended				
July 31, 1985				
First Quarter.....	2	7/8	3/8	1/8
Second Quarter.....	2-7/8	7/8	1/2	1/8
Third Quarter.....	3-1/16	1-7/8	1/2	1/4
Fourth Quarter.....	2-5/16	1-3/8	1/4	1/8

No dividends were declared during any of the periods indicated. The payments of dividends (other than dividends payable in shares of stock) is prohibited by the Company's Army MT Contract during the term of the contract and is restricted by the indenture dated as of February 1, 1983 between the Company and J. Henry Schroder Bank & Trust Company, as Trustee, under which the Company's 13% Subordinated Notes due February 1, 1991 were issued. In addition, currently the Company is prohibited from paying dividends under the New York Business Corporation Law which provides that dividends may be declared and paid out of surplus only.



**ANNUAL MEETING**

---

Shareholders are cordially invited to attend and participate in the Annual Meeting of Shareholders scheduled for Thursday, January 30, 1986 at 9:30 a.m. at:

White Plains Hotel  
South Broadway in Lyons Place  
White Plains, NY 10601  
(914) 261-8100

**AVAILABILITY OF FORM 10-K**

---

Shareholders may obtain a copy of Form 10-K, exclusive of exhibits free of charge by writing to:

Secretary  
Comtech Inc.  
63 Oser Avenue  
Hauppauge, NY 11788

The Company also will furnish exhibits to the Form 10-K to shareholders who request same upon payment to the company of a \$25 fee.

---

**BOARD OF DIRECTORS**

Fred Kornberg<sup>(1)</sup>  
Chairman

Benjamin Adler<sup>(1)(3)</sup>  
Business and Engineering  
Consultant

George Bugliarello<sup>(2)(3)</sup>  
President,  
Polytechnic Institute of  
New York

Joe E. Davis<sup>(2)</sup>  
Private Investor

Richard L. Goldberg<sup>(1)</sup>  
Partner, Botein Hays  
& Sklar

Sol S. Weiner<sup>(2)(3)</sup>  
Managing Director,  
Stenhouse, Weiner,  
Sherman, Ltd.,  
Management Consultants

- (1) Executive Committee
- (2) Audit Committee
- (3) Compensation Committee

**OFFICERS**

Fred Kornberg  
Chief Executive  
Officer and President

Joseph P. Sherer  
Vice President, General  
Counsel and Secretary

Michael H. Taber  
Corporate Controller and  
Treasurer

**LEGAL COUNSEL**

Botein Hays & Sklar  
200 Park Avenue  
New York, NY 10166

**REGISTRAR & TRANSFER AGENT**

American Transfer Company  
44 Beaver Street  
New York, NY 10004

**INDEPENDENT PUBLIC  
ACCOUNTANTS**

Deloitte Haskins & Sells  
100 Crossways Park West  
Woodbury, NY 11797

**STOCK TRADED - OTC**

Symbol - CMTL

