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PORTA SYSTEMS CORP
Form 10-K
March 31, 2003

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 [FEE REQUIRED]

For the fiscal year ended December 31, 2002

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

For the transition period from _____ to _____

Commission file number 1-8191

PORTA SYSTEMS CORP.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation or organization) 11-2203988
(IRS Employer
Identification No.)

6851 Jericho Turnpike, Syosset, New York 11791
(Address of principal executive offices) (Zip Code)

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

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

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

Common Stock, par value \$.01 per share

None

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

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

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

State aggregate market value of the voting stock held by non-affiliates of the registrant: \$598,767 as of June 30, 2002.

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Indicate the number of shares outstanding of each of the registrant's class of common stock, as of the latest practicable date: 9,972,284 shares of Common Stock, par value \$.01 per share, as of March 19, 2003.

DOCUMENTS INCORPORATED BY REFERENCE

None

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Part I

Item 1. Business

Porta Systems Corp. develops, designs, manufactures and markets a broad range of standard and proprietary telecommunications equipment and integrated software applications for sale domestically and internationally. Our core products, focused on ensuring communications for service providers worldwide, fall into three categories:

Computer-based operation support systems. Our operations support systems, which we call our OSS systems, focus on the access loop and are components of telephone companies' service assurance and service delivery initiatives. The systems primarily focus on trouble management, line testing, network provisioning, inventory and assignment, and automatic activation, and most currently single ended line qualification for the delivery of xDSL high bandwidth services. We market these systems principally to foreign telephone operating companies in established and developing countries primarily in Asia, South and Central America and Europe.

Telecommunications connection and protection equipment. These systems are used to connect copper-wired telecommunications networks and to protect telecommunications equipment from voltage surges. We market our copper connection equipment and systems to telephone operating companies and customer premise systems providers in the United States and foreign countries.

Signal processing equipment. These products, which we sell principally for use in defense and aerospace applications, support copper wire-based communications systems.

Porta Systems Corp. is a Delaware corporation incorporated in 1972 as the successor to a New York corporation incorporated in 1969. Our principal offices are located at 6851 Jericho Turnpike, Syosset, New York 11791; telephone number, 516-364-9300. References to "we," "us," "our," and words of like import refer to Porta Systems Corp. and its subsidiaries, unless the context indicates otherwise.

Forward-Looking Statements

Statements in this Form 10-K annual report may be "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to, statements that express our intentions, beliefs, expectations, strategies, predictions or any other statements relating to our future activities or other future events or conditions. These statements are based on current expectations, estimates and projections about our business based, in part, on assumptions made by management. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may, and probably will, differ materially

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from what is expressed or forecasted in the forward-looking statements due to numerous factors, including those risks discussed from time to time in this Form 10-K annual report, including the risks described under "Risk Factors" and in other documents which we file with the Securities and Exchange Commission and the matters described under "Management's Discussion and Analysis of Financial Condition and Results of Operations." In addition, such statements could be affected by risks and uncertainties related to our financial conditions, factors which affect the telecommunications industry, market and customer acceptance, competition, government regulations and requirements and pricing, as well as general industry and market conditions and growth rates, and general economic conditions. Any forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Form 10-K.

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Risk Factors

We require substantial financing to meet our working capital requirements and our principal lender has no obligation to provide us with any additional financing. We had a working capital deficit at December 31, 2002 of \$34,199,000. As of December 31, 2002, our current liabilities included \$25,070,000 due to our senior lender, all of which becomes due on May 15, 2003. We do not have sufficient resources to pay the senior lender when our obligations to the senior lender mature on May 15, 2003, or to pay principal and interest of \$8,444,000 due at December 31, 2002 on the outstanding subordinated notes that became due on July 3, 2001, and we do not expect to generate the necessary cash from our operations to enable us to make those payments. Because our senior lender is no longer advancing funds to us, at present our only source of funds is from operations. To the extent that our operations do not generate sufficient funds to cover our expenses, it may be necessary for us to seek reorganization or liquidation under the Bankruptcy Code. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

We are incurring losses from our operations, and our losses are continuing. We incurred a net loss of \$4,114,000, or \$0.41 per share (basic and diluted), on sales of \$21,417,000 for 2002, following a loss of \$14,774,000, or \$1.50 per share (basic and diluted) for 2001. In each of these years, our revenue declined significantly from the level of the previous year. Our losses are continuing and we expect that our losses will continue unless we are able both to significantly increase our revenue and reduce our expenses. We cannot give assurance that we will be able to operate profitably in the future, and if we are unable to operate profitably, we may be unable to continue in business.

Because of our decreasing revenues together with problems facing both the telecommunications industry and the economy, we may not be able to continue in business. Our sales declined significantly from 2000 to 2001 and again from 2001 to 2002. Unless we are able to stop the downward trend in sales and generate a significant increase in sales, our reduction in overhead will not be sufficient to enable us to sustain our operations. We cannot assure you that we will be able to increase our sales significantly, if at all. As a result of the deterioration of our operating revenue we are evaluating various options, including the sale of one or more of our divisions as well as a reorganization or liquidation under the Bankruptcy Code.

Our independent auditors have included an explanatory paragraph relating to our ability to continue as a going concern in their report on our financial statements. Because of our substantial losses in 2002, 2001 and 2000, our stockholders' deficit of \$29,935,000 at December 31, 2002, and our working

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capital deficit of \$34,199,000 as of December 31, 2002 our auditors included in their report an explanatory paragraph about our ability to continue as a going concern.

Because of our financial condition, we have not been able to pay certain of our creditors on a timely basis, and some of our creditors have obtained judgments against us. As a result of our continuing financial difficulties, a number of creditors have engaged attorneys or collection agencies or commenced legal actions against us, and some of them have obtained judgments against us. Claimants who have already either commenced litigation or otherwise sought collection are due approximately \$214,000. If we are unable to reach a settlement with these creditors and others who have not yet brought claims, and these claimants obtain judgments against us or seek to enforce a judgment against us, it may be necessary for us, or our senior lender may require us, to seek protection under the Bankruptcy Code.

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Our largest customer has ceased placing orders for OSS products with us and has significantly decreased orders for our copper connection/protection products, which are having a material adverse effect upon our business. Our largest customers are British Telecommunications and Fujitsu Telecommunications LTD, which purchases telecommunications equipment from us for sale to British Telecommunications. Sales to British Telecommunications declined significantly during the past year. British Telecommunications has informally advised us that it will not place orders with us for OSS products until we can demonstrate that we are financially viable. The decline in sales of connection/protection products for British Telecommunications reflects both our financial condition and industry conditions generally. We have not been able to replace the sales made to British Telecommunications and we cannot give any assurance that we will be able to. The reluctance of British Telecommunications to place orders for OSS products may affect the willingness of other telecommunications companies to order new OSS or other products from us. The reduced level of our sales resulting from the decline in sales to British Telecommunications is continuing to impair our business, and, if we are not able to replace these sales, or generate new business from British Telecommunications or Fujitsu, we may not be able to continue in business.

Since we sell to telecommunications companies, our sales are affected by economic and other factors that affect that industry, both domestically and internationally. During the past three years, the telecommunications industry has been affected by an international slowdown, and many, if not most, telecommunications companies have scaled back plans for expansion, which has resulted in a significant drop in the requirements for products including products such as our OSS products and our connection/protection products. We cannot assure you that there will be any positive change in the purchasing patterns of telecommunications companies or that we will benefit from any positive change which may occur.

Because of our financial condition, we may not be able to perform on our contracts which may subject us to loss of business and penalties. We are having and we may continue to have difficulty performing our obligations under our contracts, which could result in the cancellation of contracts, the loss of future business and penalties for non-performance.

We are heavily dependent on foreign sales. Approximately 54% of our sales in 2002 and 2001 and 66% of our sales for 2000, were made to foreign telephone operating companies. In selling to customers in foreign countries, we are exposed to inherent risks not normally present in the case of our sales to United States customers, including extended delays in both completing the

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installation and receiving the final payment from our customers for our Operational Support Systems contracts, as well as further risks relating to political and economic changes. Furthermore, our financial condition has impaired our ability to generate new business in the international market as potential customers express concern about our ability to perform.

We have granted to British Telecommunications rights to our technology. Under our agreement with British Telecommunications, we gave British Telecommunications the right to use our connection/protection technology or have products using our technology manufactured for it by others. As a result, British Telecommunication may have the right to use our technology and purchase products based on our technology from others, which has resulted and may continue to result in a significant decline in our sales to British Telecommunications.

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We experience difficulties with Operations Support Systems contracts. We experience delays in purchaser acceptance of the Operations Support Systems and our receipt of final contract payments in connection with a number of foreign sales. In addition, we have no steady or predictable flow of orders for Operations Support Systems and the negotiation of a contract for an operations support system is an individualized and highly technical process. The installation, testing and purchaser acceptance phases of these contracts may last longer than contemplated by the contracts and, accordingly, amounts due under the contracts may not be collected for extended periods. Furthermore, our Operation Support Systems contracts typically contain performance guarantees by us and clauses imposing penalties if we do not meet "in-service" dates. As a result, it is possible that we may lose money on Operations Support Systems contracts.

Because of our small size and our financial problems, we may have difficulty competing for business. We compete directly with a number of large and small telephone equipment manufacturers in the United States, with Lucent Technologies, Inc. continuing to be our principal United States competitor. Our competitors are using our financial difficulties in successfully competing against us. We anticipate that our loss for 2002, our working capital deficiency and absence of financing may continue to place us in a competitive disadvantage, particularly in seeking Operations Support Systems contracts, where we frequently deal with national telecommunications companies.

We face significant competition for both foreign and domestic sales. In both foreign and domestic markets, we face considerable competition from other United States and foreign telephone equipment manufacturers most of which are larger and have substantially greater financial resources than us. In addition, if we establish facilities in foreign countries, we face risks associated with currency devaluation, difficulties in either converting local currency into dollars or transferring funds to the United States, local tax and currency regulations and political instability.

We require access to current technological developments. We rely primarily on the performance and design characteristics of our products and we try to offer our products at prices and with warranties that will make our products competitive. Our business could be adversely affected if we cannot obtain licenses for such updated technology or self develop state-of-the-art technology. Because of our financial problems, we are not able to devote any significant effort to research and development, which could increase our difficulties in making sales of our products.

We rely on certain key employees. We may be dependent upon the continued

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employment of certain key employees, including our senior executive officers. Our failure to retain such employees may have a material adverse effect upon our business. Because of our financial problems we have experienced key personnel losses. To the extent that these losses continue or are accelerated, we may be unable to provide our customers with necessary service, which could result in the failure to generate new business.

Our stock is subject to the penny stock rules, which may make it difficult for stockholders to sell our stock. Because our stock is traded on the OTC Bulletin Board and our stock price is very low, our stock is subject to the Securities and Exchange Commission's penny stock rules, which impose additional sales practice requirements on broker-dealers which sell our stock to persons other than established customers and institutional accredited investors. These rules may affect the ability of broker-dealers to sell our common stock and may affect the ability of our stockholders to sell any common stock they may own.

We do not pay dividends on common stock.

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Products

Operations Support Systems. We sell our OSS systems primarily to telephone operating companies in established and developing countries in Asia, South and Central America and Europe, and to a lesser extent, in the United States. Our principal OSS systems are computer-based testing, provisioning, activation and trouble management products which include software and capital equipment and typically sell for prices ranging from several hundred thousand to several million dollars.

The testing products are designed to automatically test for and diagnose problems in customer telephone lines and to notify telephone company service personnel of required maintenance. The associated trouble management system provides automated record keeping (including repair and disposition records) and analyzes these records to enable the telephone company to identify recurring problems and equipment deterioration and to fulfill maintenance service level agreement obligations. The integration of these systems provides a service assurance function for telephone companies.

A major component of the testing system is the "test head," which provides the access to, and tests the required telephone line. We have continually developed our test head capability to meet the changing requirements of the customer loop, and have recently introduced our latest advanced technology platform (sixth generation) product, the MKIII. An enhanced version of the MKIII, the Sherlock, will provide the capability to determine whether customer lines are xDSL capable, enabling telephone companies to expeditiously characterize their outside plant, and optimize their responsiveness to market conditions.

Our other software applications, including the automated assignment of facilities and activation of service, form part of a telephone company's service activation function, and can be integrated with the testing and trouble management systems, to provide a comprehensive access loop capability. In addition, if requested by customers, We develop software to meet specific customer requirements, including integration of its systems with telephone company legacy or third party OSS systems.

Our OSS products are complex and, in most applications, incorporate features designed to respond to the purchaser's operational requirements and the particular characteristics of the purchaser's telephone system and operational

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processes. As a result, the negotiation of a contract for an OSS system is an individualized and highly technical process. In addition, contracts for OSS systems frequently provide for manufacturing, delivery, installation, testing and purchaser acceptance phases, which take place over periods ranging from several months to a year or more. These contracts typically contain performance guarantees by us and clauses imposing penalties if "in-service" dates are not met. The installation, testing and purchaser acceptance phases of these contracts may last longer than contemplated by the contracts and, accordingly, amounts due under the contracts may not be collected for extended periods and, in some instances, may not be collected. Delays in purchaser acceptance of the systems and in our receipt of final contract payments have occurred in connection with a number of foreign sales. In addition, we have not experienced a steady or predictable flow of orders for OSS systems.

Telecommunications Connection Equipment. Our copper connection/protection equipment and systems are used by telephone operating companies, by owners of private telecommunications equipment and by manufacturers and suppliers of telephone central office and customer premises equipment. Products of the types comprising our telecommunications connection equipment are included as integral parts of all domestic and foreign telephone and telecommunications systems. Such products are sold in a worldwide market, which generally grows in proportion to increases in the number of telephone subscribers and owners of private telecommunications equipment, as well as to increases in upgrades to modern digital switching technology such as DSL, ADSL, and ISDN lines.

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Our connection equipment consists of connector blocks and protection modules used by telephone companies to interconnect copper-based subscriber lines to switching equipment lines. The protector modules protect central office personnel and equipment from electrical surges. The need for protection products has increased as a result of the worldwide move to digital technology, which is extremely sensitive to damage by electrical overloads, and because private owners of telecommunications equipment now have the responsibility to protect their equipment from damage caused by electrical surges. Line connecting/protecting equipment usually incorporates protector modules to safeguard equipment and personnel from injury due to power surges. Currently, these products include a variety of connector blocks, protector modules and frames used in telephone central switching offices, PBX installations, multiple user facilities and customer premise applications.

We also have developed an assortment of frames for use in conjunction with our traditional line of connecting/protecting products. Frames for the interconnection of copper circuits are specially designed structures which, when equipped with connector blocks and protectors, interconnect and protect telephone lines and distribute them in an orderly fashion allowing access for repairs and changes in line connections. One of our frame products, the CAM frame, is designed to produce computer-assisted analysis for the optimum placement of connections for telephone lines and connector blocks mounted on the frame.

Our copper connection/protection products are used by many of the Regional Bell Operating Companies as well as by independent telephone operating companies in the United States and owners of private telecommunications equipment. These products are also purchased by other companies for inclusion within their systems. In addition, our telecommunications connection products have been sold to telephone operating companies in various foreign countries. This equipment is compatible with existing telephone systems both within and outside the United States and can generally be used without modification, although we do custom design modifications to accommodate the specific needs of our customers.

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Signal Processing Products. Our signal processing products include data bus systems and wideband transformers. Data bus systems, which are the communication standard for military and aerospace systems, require an extremely high level of reliability and performance. Wideband transformers are required for ground noise elimination in video imaging systems and are used in the television and broadcast, medical imaging and industrial process control industries.

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The table below shows, for the last three fiscal years, the contribution made to our sales by each of our major categories of the telecommunications industry:

| Sales by Product Category | | | | | | |
|---|----------------------------|------------------------|----------------------------|------------------------|----------------------------|------------------------|
| Years Ended December 31, | | | | | | |
| | 2002 | 30% | 2001 | 32% | 2000 | 44% |
| | ----- | | ----- | | ----- | |
| (Dollars in thousands) | | | | | | |
| OSS Systems | \$ 6,414 | | \$ 8,874 | | \$22,296 | |
| Line Connecting /Protecting Equipment | 9,598 | 45% | 12,756 | 46% | 20,546 | 40% |
| Signal Processing | 4,523 | 21% | 5,737 | 20% | 7,644 | 15% |
| Other | 882 | 4% | 695 | 2% | 654 | 1% |
| Total | ----- \$21,417 ===== | ----- 100% ===== | ----- \$28,062 ===== | ----- 100% ===== | ----- \$51,140 ===== | ----- 100% ===== |

Markets

We supply equipment and systems to telephone companies which provides improved services to ensure communication to their customers. In addition, we provide businesses with systems which improve their internal telecommunication systems.

Telephone networks in certain regions of the world, notably Latin America, Eastern Europe and certain areas in the Asia/Pacific region, were designed to carry voice traffic and are not well suited for high-speed data transmissions or for other forms of telecommunications that operate more effectively with digital telecommunications equipment and lines. The telephone networks in these countries are also characterized by a very low ratio of telephone lines to population. Countries with emerging telecommunication networks have to rapidly add access lines in order to increase the availability of telephone service and to significantly upgrade the quality of the lines already in service.

Our OSS systems are designed to meet many of the needs of a rapidly changing telephone network. OSS systems facilitate rapid change and expansion without a comparable increase in the requirement for skilled technicians, while the computerized line test system insures increased quality and rapid maintenance and repair of subscriber local loops. The automated database, which computerizes the inventory and maintenance history of all subscriber lines in service, helps to keep the rapid change under control.

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During 2002, approximately 30% of our sales consisted of OSS products and services.

As a telephone company expands the number of its subscriber lines, it also requires additional connection equipment to interconnect and protect those lines in its central offices. We provide a line of copper connection equipment for this purpose. Recent trends towards the transmission of high frequency signals on copper lines are sustaining this market. Less developed countries, such as those with emerging telecommunications networks or those upgrading to digital switching systems, provide a growing market for copper connection and protection equipment.

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The increased sensitivity of the newer digital switches to small amounts of voltage requires the telephone company which is upgrading its systems to digital switching systems to also upgrade its central office connection/protection systems in order to meet these more stringent protection requirements. We supply central office connection/protection systems to meet these needs.

During 2002, approximately 45% of our sales were made to customers in this category.

Our line of signal processing products is supplied to customers in the military and aerospace industry as well as manufacturers of medical equipment and video systems. The primary communication standard in new military and aerospace systems is the MIL-STD-1553 Command Response Data Bus, an application which requires an extremely high level of reliability and performance. Products are designed to be application specific to satisfy the requirements of each military or aerospace program.

Our wideband transformers are required for ground noise elimination in video imaging systems and are used in the television and broadcast, medical imaging and industrial process control industries. If not eliminated, ground noise caused by poor electrical system wiring or power supplies, results in significant deterioration in system performance, including poor picture quality and process failures in instrumentation. The wideband transformers provide a cost effective and quick solution to the problem without the need of redesign of the rest of the system.

During 2002, signal processing equipment accounted for approximately 21% of our sales.

Marketing and Sales

We operate through three business units, which are organized by product line, and with each having responsibility for the sales and marketing of its products.

When appropriate to obtain sales in foreign countries, we may enter into business arrangements and technology transfer agreements covering our products with local manufacturers and participate in manufacturing and licensing arrangements with local telephone equipment suppliers.

In the United States and throughout the world, we use independent distributors in the marketing of all copper based products to the regional bell operating companies and the customer premises equipment market. All distributors marketing copper-based products also market directly competing products. In addition, We continues to promote the direct marketing relationships it developed in the past with telephone operating companies.

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British Telecommunications purchased line connecting/protecting products amounting to \$689,000 (3% of sales) in 2002, \$3,339,000 (12% of sales) in 2001, and \$4,261,000 (8% of sales) in 2000. During these years, we also sold our products to unaffiliated suppliers for resale to British Telecommunications. We have a cross-licensing agreement with British Telecommunications which, in effect, enables British Telecommunications to use certain of our proprietary information to modify or enhance products provided to British Telecommunications and permits British Telecommunications to manufacture or engage others to manufacture those products.

Our OSS systems historically have been sold to foreign telephone operating companies which are government controlled. Recently, we entered into sales, marketing and management co-operative agreements and strategic alliances with various companies.

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During 2000, we entered into a multi-year sales, marketing, and management co-operative agreement with Fujitsu Telecommunications to market Internet infrastructure products. This agreement expired during September 2002. Under the agreement, Fujitsu sold and marketed our advanced Internet infrastructure technologies, including ADSL Single Ended Line Qualification System for broadband services and the sixth generation Sherlock remote test unit to telecom service operators in the United Kingdom, principally British Telecommunications, and certain other European countries. During 2002, we had no sales pursuant to this agreement. During 2001 and 2000, we had sales pursuant to this agreement of \$3,200,000 (11% of sales) and \$12,051,000 (24% of sales), respectively.

Our signal processing products are sold primarily to US military and aerospace prime contractors, and domestic original equipment manufacturers and end users.

The following table sets forth for the last three fiscal years our sales to customers by geographic region:

Sales to Customers By Geographic Region (1)

| | Year Ended December 31, | | | | | |
|----------------|----------------------------|------------------------|----------------------------|------------------------|----------------------------|------------------------|
| | 2002 | | 2001 | | 2000 | |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| | (Dollars in thousands) | | | | | |
| North America | \$10,442 | 49% | \$13,356 | 48% | \$22,795 | 45% |
| United Kingdom | 6,388 | 30% | 8,060 | 29% | 20,244 | 40% |
| Asia/Pacific | 2,725 | 13% | 4,552 | 16% | 5,429 | 10% |
| Other Europe | 1,600 | 7% | 1,761 | 6% | 2,482 | 5% |
| Latin America | 258 | 1% | 288 | 1% | 146 | 0% |
| Other | 4 | 0% | 45 | 0% | 44 | 0% |
| Total Sales | ----- \$21,417 ===== | ----- 100% ===== | ----- \$28,062 ===== | ----- 100% ===== | ----- \$51,140 ===== | ----- 100% ===== |

(1) For information regarding the amount of sales, operating profit or loss and

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identifiable assets attributable to each of our divisions and geographic areas, see Note 22 of Notes to the Consolidated Financial Statements.

In selling to customers in foreign countries, we face inherent risks not normally present in the case of sales to United States customers, including increased difficulty in identifying and designing systems compatible with purchasers' operational requirements; extended delays under OSS systems contracts in the completion of testing and purchaser acceptance phases and difficulty in our receipt of final payments and political and economic change. In addition, to the extent that we establish facilities in foreign countries or to the extent that payment is denominated in the local currency, we face risks associated with currency devaluation, inability to convert local currency into dollars, as well as local tax regulations and political instability.

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Manufacturing

Our computer-based testing products include proprietary testing circuitry and computer programs, which provide platform-independent solutions based on UNIX or UNIX compatible operating systems. The testing products also incorporate disk data storage, teleprinters, file servers and personal computers purchased by us. These products are installed and tested by us at our customers' premises.

At present, our manufacturing operations are conducted at facilities located in Syosset, New York and Matamoros, Mexico. From time to time we also use subcontractors to augment various aspects of our production activities and periodically explore the feasibility of conducting operations at lower cost manufacturing facilities located abroad. In selling to foreign telephone companies, we may be required to provide local manufacturing facilities and, in conjunction with these facilities, we may grant the facility a license to our proprietary technology.

Source and Availability of Components

We generally purchase the standard components used in the manufacture of our products from a number of suppliers. We attempt to assure ourselves that the components are available from more than one source. We purchase all of our MKIII test units from one supplier. We purchase the majority of our workstations and servers used in our OSS systems from Hewlett Packard Corporation. However, we could use other computer equipment in our systems if we were unable to purchase Hewlett Packard products. Other components, such as personal computers and line printers used in connecting with our electronic products, are readily available from a number of sources.

Significant Customers

During the years ended December 31, 2002, 2001 and 2000, our five largest customers accounted for sales of \$9,784,000, or approximately 46% of sales, \$13,444,000, or approximately 48% of sales, and \$28,323,000, or approximately 55% of sales, respectively. Our largest customer in 2002 and 2001 with sales of \$2,725,000 and \$3,485,000, or approximately 13% and 12%, respectively, of sales was Philippine Long Distance Telephone. Our largest customer in 2000 with sales of \$12,051,000, or approximately 24% of sales was Fujitsu Telecommunications. Our sales to Fujitsu Telecommunications were \$3,200,000, or approximately 11% of sales in 2001. A significant amount of sales of our products for use by British Telecommunications were sold to Fujitsu Telecommunications, as purchasing agent for British Telecommunications. As a result, most of the sales to Fujitsu Telecommunications were for use by British Telecommunications. Direct sales to British Telecommunications were \$2,306,000, or 11% of sales, for 2002,

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\$3,339,000, or 12% of sales, for 2001 and \$5,098,000, or 10% of sales, for 2000. During 2000, sales to a Mexican telephone company were \$5,507,000, or approximately 11% of sales. No other customers account for 10% or more of our sales in 2002, 2001 or 2000.

The former Bell operating companies continue to be the ultimate purchasers of a significant portion of our products sold in the United States, while sales to foreign telephone operating companies constitute the major portion of our foreign sales. Our contracts with these customers require no minimum purchases by such customers. Significant customers for the signal processing products include major US aerospace companies, the Department of Defense and original equipment manufacturers in the medical imaging and process control equipment industries. We sell both catalog and custom designed products to these customers. Some contracts are multi-year procurements.

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Backlog

At December 31, 2002, our backlog was approximately \$4,400,000 compared with approximately \$6,100,000 at December 31, 2001. Of the December 31, 2002 backlog, approximately \$3,300,000 represented orders from foreign telephone operating companies. We expect to ship substantially all of our December 31, 2002 backlog during 2003.

Intellectual Property Rights

We own a number of domestic utility and design patents and have pending patent applications for these products. In addition, we have foreign patent protection for a number of our products.

From time to time we enter into licensing and technical information agreements under which we receive or grant rights to produce certain subcomponents used in our products. These agreements are for varying terms and provide for the payment or receipt of royalties or technical license fees.

While we consider patent protection important to the development of our business, we believe that our success depends primarily upon our engineering, manufacturing and marketing skills. Accordingly, we do not believe that a denial of any of our pending patent applications, expiration of any of our patents, a determination that any of the patents which have been granted to us are invalid or the cancellation of any of our existing license agreements would have a material adverse effect on our business.

Competition

The telephone equipment market in which we do business is characterized by intense competition, rapid technological change and a movement to private ownership of telecommunications networks. In competing for telephone operating company business, the purchase price of equipment and associated operating expenses have become significant factors, along with product design and long-standing equipment supply relationships. In the customer premises equipment market, we are functioning in a market characterized by distributors and installers of equipment and by price competition.

We compete directly with a number of large and small telephone equipment manufacturers in the United States, with Lucent Technologies continuing to be our principal United States competitor. Lucent's greater resources, extensive research and development facilities, long-standing equipment supply relationships with the operating companies of the regional holding companies and

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history of manufacturing and marketing products similar in function to those produced by us continue to be significant factors in our competitive environment.

Currently, Lucent and a number of companies with greater financial resources than us produce, or have the design and manufacturing capabilities to produce, products competitive with our products. In meeting this competition, we rely primarily on the engineered performance and design characteristics of our products to comparable performance or design, and endeavors to offer our products at prices and with warranties that will make our products compete world wide.

In connection with overseas sales of our line connecting/protecting equipment, we have met with significant competition from United States and foreign manufacturers of comparable equipment and we expect this competition to continue. In addition to Lucent, a number of our overseas competitors have significantly greater resources than we do.

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We compete directly with a limited number of substantial domestic and international companies with respect to our sales of OSS systems. In meeting this competition, we rely primarily on the features of our line testing equipment, our ability to customize systems and endeavor to offer such equipment at prices and with warranties that make them competitive.

In addition to the quality and price of the products being offered, the financial stability of a supplier, especially for OSS contracts, is a crucial element. Because these contracts require the supplier to spend considerable funds before the project is completed and require ongoing maintenance service, potential customers consider the financial stability of the supplier as a major consideration in awarding a contract. Our financial position, combined with our recent losses, our working capital deficiency and the scheduled expiration of our financing agreement with our senior lender, and the decision of British Telecommunications not to place orders for new OSS products from us and its reduced level of purchases of copper connection/protection products may place us at a competitive disadvantage in seeking new business and new orders for existing customers.

Research and Development Activities

We spent approximately \$2,500,000 in 2002, \$4,400,000 in 2001, and \$5,800,000 in 2000 on research and development activities. All research and development was company sponsored and is expensed as incurred. As a result of our financial difficulties, we have scaled down our research and development effort, which could hurt our ability to offer competitive products.

Employees

As of March 7, 2003, we had 258 employees of which 56 were employed in the United States, 176 in Mexico, 18 in the United Kingdom, 3 in Poland, 4 in Chile, and 1 in China. We believe that our relations with our employees are good, and we have never experienced a work stoppage. Our employees are not covered by collective bargaining agreements, except for our hourly employees in Mexico who are covered by a collective bargaining agreement that expires on December 31, 2003.

Item 2. Properties

We currently lease approximately 14,500 square feet of executive, sales,

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marketing and research and development space and 4,200 square feet of manufacturing space in Syosset, New York. These facilities represent substantially all of our office, plant and warehouse space in the United States. The Syosset, New York leases expire February 2008 and May 2007, respectively. The annual rental related to the New York property is approximately \$277,000.

Our wholly-owned United Kingdom subsidiary leases approximately 11,000 square foot facility in Coventry, England, which facility comprises all of our office, plant and warehouse space. The lease expires in 2019. The aggregate annual rental is approximately \$114,000.

Our wholly-owned Mexican subsidiary owns an approximately 40,000 square foot manufacturing facility in Matamoros, Mexico.

We believe our properties are adequate for our needs.

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Item 3. Legal Proceedings

In July 2001, the holder of a subordinated note in the principal amount of \$500,000 commenced an action against us in the United States District Court for the Southern District of New York seeking payment of the principal and accrued interest on their subordinated notes which were payable in July 2001. The payment of the note is subordinated to payment of our senior debt and we believe that the subordination provision of the note prohibits payment by us. The plaintiff's motion for a summary judgment was denied by the court on the grounds that the terms of the note did not give them permission to obtain a judgment while we remained in default to the senior debt holder. Our obligations under the subordinated notes are reflected as current liabilities on our balance sheet.

In March 2000, we suspended (with pay) Messrs. Ronald Wilkins and Michael Bahlo, two of our executive officers, from their positions pending completion of our investigation of certain matters that had come to our attention. Prior to the completion of this investigation, however, these two executives accepted positions with another company and thereby voluntarily resigned from their positions with us. In February 2001, these two executives, together with a third former executive officer, Mr. Michael Lamb, who similarly resigned from his position with us, filed suit in the Supreme Court for the State of New York, County of New York, entitled Ronald Wilkins, Michael Bahlo and Michael Lamb v. Porta Systems Corp. The complaint asserted various claims against us based on the allegation that each of these three executives was improperly terminated from his employment without cause, and seeks compensatory damages, liquidating damages and attorney's fees. We filed an answer and counterclaim against the plaintiffs. During 2002, we settled all claims related to this action for \$30,000.

In July 1996, an action was commenced against us and certain present and former directors in the Supreme Court of the State of New York, New York County by certain of our stockholders and warrant holders of Porta who acquired their securities in connection with our acquisition of Aster Corporation. The complaint alleges breach of contract against us and breach of fiduciary duty against our directors arising out of an alleged failure to register certain restricted shares and warrants owned by the plaintiffs. The complaint seeks damages of \$413,000; however, counsel for the plaintiff has advised us that additional plaintiffs may be added and, as a result, the amount of damages claimed may be substantially greater than the amount presently claimed. We believe that we have valid defenses to the claims. Discovery is proceeding, although there has been no significant activity in this matter subsequent to

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December 31, 1999.

In June 2002, BMS Corp. served an arbitration demand on us claiming that we breached our agreement to market and sell an update to our MLR product which BMS was to develop. We believe that we have defenses to the claims by BMS and have filed a counterclaim to recover the \$350,000 we advanced to BMS under the contract. The arbitrators have recently been selected and the proceedings will move forward over the next several months.

Item 4. Submission of Matters to a Vote of Securities Holders

During the fourth quarter of 2002, no matters were submitted to a vote of our security holders.

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Part II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

Our common stock is traded on the OTC Bulletin Board under the symbol PYTM. Prior to November 11, 2002, our stock was traded on the American Stock Exchange under the symbol PSI. The following table sets forth, for 2001 and 2002, the quarterly high and low sales prices for our common stock on the consolidated transaction reporting systems for the OTC Bulletin Board and American Stock Exchange listed issues.

| | | High ---- | Low --- |
|------|----------------|--------------|------------|
| 2001 | First Quarter | \$1.06 | \$0.22 |
| | Second Quarter | 0.40 | 0.21 |
| | Third Quarter | 0.30 | 0.10 |
| | Fourth Quarter | 0.17 | 0.05 |
| 2002 | First Quarter | \$0.20 | \$0.07 |
| | Second Quarter | 0.10 | 0.06 |
| | Third Quarter | 0.15 | 0.03 |
| | Fourth Quarter | 0.08 | 0.005 |

We did not declare or pay any cash dividends in 2002 or 2001. It is our present policy to retain earnings, if any, to finance the growth and development of the business, and therefore, we do not anticipate paying cash dividends on our common stock in the foreseeable future. In addition, our agreement with our senior lender prohibits it from paying cash dividends on its common stock.

As of March 19, 2003, we had approximately 979 stockholders of record and the closing price of our common stock was \$0.04.

We did not issue any unregistered securities during 2002.

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Equity Compensation Plan Information

The following table summarizes the equity compensation plans under which our securities may be issued as of December 31, 2002.

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Equity Compensation Plan Information as of December 31, 2002

| Plan Category | Number of securities to be issued upon exercise of outstanding options and warrants | Weighted-average exercise price of outstanding options and warrants | Number of securities remaining available for future issuance under equity compensation plans |
|---|---|---|--|
| Equity compensation plans approved by security holders | 844,030 | \$2.25 | 698,470 |
| Equity compensation plan not approved by security holders | -0- | -0- | 95,750 |
| | 844,030 | \$2.25 | 794,220 |

The plan not approved by security holders is a stock bonus plan that permits issuance of stock on a discretionary basis.

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Item 6. Selected Financial Data

The following table sets forth certain selected consolidated financial information. For further information, see the Consolidated Financial Statements and other information set forth in Item 8 and Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in Item 7:

| | Year Ended December 31, | | | | |
|---|---------------------------------------|-----------|-----------|-----------|-----------|
| | 2002 | 2001 | 2000 | 1999 | 1998 |
| | ----- | | | | |
| | (In thousands, except per share data) | | | | |
| Income Statement Data: | | | | | |
| Sales | \$ 21,417 | \$ 28,062 | \$ 51,140 | \$ 38,936 | \$ 59,343 |
| Operating income (loss) | (2,881) | (11,453) | (5,153) | (9,709) | 4,566 |
| Debt conversion expense | -- | -- | -- | -- | (945) |
| Income (loss) before extraordinary item | (4,114) | (14,774) | (10,176) | (13,686) | 451 |
| Net income (loss) | (4,114) | (14,774) | (10,176) | (13,686) | 527 |

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| | | | | | |
|--|-------------|-------------|-------------|------------|-----------|
| Basic per share amounts: | | | | | |
| Continuing operations | \$ (0.41) | \$ (1.50) | \$ (1.04) | \$ (1.44) | 0.05 |
| Net income (loss) | \$ (0.41) | \$ (1.50) | \$ (1.04) | \$ (1.44) | \$ 0.06 |
| Diluted per share amounts: | | | | | |
| Continuing operations | \$ (0.41) | \$ (1.50) | \$ (1.04) | \$ (1.44) | \$ 0.04 |
| Net income (loss) | \$ (0.41) | \$ (1.50) | \$ (1.04) | \$ (1.44) | \$ 0.05 |
| Cash dividends declared | -- | -- | -- | -- | -- |
| Number of shares used in calculating net income (loss) per share-basic | | | | | |
| | 9,994 | 9,878 | 9,763 | 9,489 | 9,281 |
| Number of shares used in calculating net income (loss) per share-diluted | | | | | |
| | 9,994 | 9,878 | 9,763 | 9,489 | 9,785 |
| Balance Sheet Data: | | | | | |
| Total assets | \$ 14,228 | \$ 17,833 | \$ 34,174 | \$ 43,448 | \$ 52,136 |
| Working capital (deficiency) | \$ (34,199) | \$ (31,236) | \$ (24,152) | \$ 6,135 | \$ 14,262 |
| Current debt maturities | \$ 31,599 | \$ 28,621 | \$ 26,890 | \$ 2,000 | \$ 2,000 |
| Long-term debt excluding current maturities | \$ -0- | \$ -0- | \$ 376 | \$ 21,902 | \$ 17,238 |
| Stockholders' equity (deficit) | \$ (29,935) | \$ (25,849) | \$ (10,792) | \$ (1,387) | \$ 11,984 |

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses reported in those financial statements. These judgments can be complex and consequently actual results could differ from those estimates. Among the more significant estimates included in these consolidated financial statements are revenue recognition, allowance for doubtful accounts receivable, inventory reserves, goodwill valuation and the deferred tax asset valuation allowance. Note 1 of Notes to Consolidated Financial Statements, included elsewhere on this annual report on Form 10-K, includes a summary of the significant accounting policies and methods used in the preparation of our consolidated financial statements.

Revenue Recognition

Revenue, other than from long-term contracts for specialized products, is recognized when a product is shipped. Revenues and earnings relating to long-term contracts for specialized products, principally OSS products, are recognized on the percentage-of-completion basis primarily measured by the attainment of milestones. Anticipated losses, if any, are recognized in the

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period in which they are identified. The percentage-of-completion method is based on judgments and estimates that are complex and actual results may differ from estimates.

Allowance for Doubtful Accounts Receivable

We record an allowance for doubtful accounts receivable based on specifically identified amounts that we believe to be uncollectible. We also record additional allowances based on certain percentages of our aged receivables, which are determined based on historical experience and our assessment of the general financial conditions affecting our customer base. If our actual collections experience changes, revisions to our allowance may be required. We have a limited number of customers with individually large amounts due at any given balance sheet date. Any unanticipated change in one of those customers' credit worthiness, or other matters affecting the collectability of amounts due from such customers, could have a material effect on our results of operations in the period in which such changes or events occur. After all attempts to collect a receivable have failed, the receivable is written off against the allowance.

In the ordinary course of business, we established an allowance for doubtful accounts receivable in the amount of \$1,967,000 and \$2,168,000 as of December 31, 2002 and 2001, respectively. Our allowance for doubtful accounts is a subjective critical estimate that has a direct impact on reported net loss. This reserve is based upon the evaluation of accounts receivable aging and specific exposures.

Inventory Reserves

Inventories are stated at the lower of cost (on the average or first-in, first-out methods) or fair market value. Our stated inventory reflects an inventory obsolescence reserve that represents the difference between the cost of the inventory and its estimated market value. This reserve is calculated based on historical usage and forecasted sales. Actual results may differ from our estimates.

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Goodwill

Goodwill represents the difference between the purchase price and the fair market value of net assets acquired in business combinations treated as purchases. Commencing January 1, 2002, goodwill is an indefinite lived asset and as such is not amortized. On an annual basis, we test the goodwill for impairment. We determine the market value of the reporting unit by considering the projected cash flows generated from the reporting unit to which the goodwill relates.

Deferred Income Tax Valuation Allowance

Deferred taxes result from temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. The temporary differences result from costs required to be capitalized for tax purposes by the US Internal Revenue Code, and certain items accrued for financial reporting purposes in the year incurred but not deductible for tax purposes until paid. Due to our continued losses in 2002 and 2001, a valuation allowance for the entire deferred tax asset was provided due to the uncertainty as to future realization.

Results of Operations

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Our consolidated statements of operations for the three years ended December 31, 2002, 2001 and 2000, respectively, as a percentage of sales is as follows:

| | Years Ended December 31, | | |
|--|--------------------------|-------|-------|
| | 2002 | 2001 | 2000 |
| Sales | 100% | 100% | 100% |
| Cost of sales | 68% | 71% | 70% |
| Gross profit | 32% | 29% | 30% |
| Selling, general and administrative expenses | 30% | 33% | 28% |
| Research and development expenses | 12% | 16% | 12% |
| Goodwill impairment | 3% | 21% | -- |
| Operating loss | (13%) | (41%) | (10%) |
| Interest expense | (8%) | (16%) | (9%) |
| Gain on sale of assets | -- | 2% | -- |
| Gain on sale of investment in joint venture | 2% | -- | -- |
| Equity in net loss of joint venture | -- | -- | -- |
| Other | -- | 1% | (1%) |
| Loss before income taxes and minority interest | (19%) | (54%) | (20%) |
| Income tax benefit (expense) and minority interest | -- | 1% | -- |
| Net loss | (19%) | (53%) | (20%) |

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Results of Operation

Years Ended December 31, 2002 and 2001

Our sales for 2002 were \$21,417,000 compared to \$28,062,000 in 2001, a decrease of \$6,645,000 (24%). The decrease in revenue is attributed to the decline in sales from all divisions.

OSS sales for 2002 were \$6,414,000, compared to 2001 sales of \$8,874,000, a decrease of \$2,460,000 (28%). The decreased sales resulted from the inability to secure new orders primarily from the slowdown in the telecommunication market and from lower levels of contract completion compared to the prior year. We expect to recognize the balance of the revenue from the in process OSS contracts during 2003. Sales of OSS systems are not made on a recurring basis to customers, but are the result of extended negotiations that frequently cover many months and do not always result in a contract. In addition, OSS contracts may include conditions precedent, such as the customer obtaining financing or bank approval, and the contracts are not effective until the conditions are satisfied. Additionally, in April 2002 we disposed of our interest in our Korean joint venture which generated no sales during 2002 and sales of \$1,066,000 during 2001.

Line connection/protection equipment sales for 2002 decreased approximately \$3,158,000 (25%) from \$12,756,000 in 2001 to \$9,598,000 in 2002. The reduced sales level reflected a decrease in volume of sales to United States and United Kingdom customers. The results were adversely affected by the general slowdown

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in the telecommunications industry.

Signal processing revenue for 2002 compared to 2001 decreased by \$1,214,000 (21%) from \$5,737,000 to \$4,523,000. The decrease in sales primarily reflects delays in the receipt of certain anticipated contracts during 2002.

Gross margin increased from 29% in 2001 to 32% in 2002. The margin improvement resulted from a reduction to the costs associated with certain OSS contracts reflecting our ability to replace a high cost software vendor with comparable lower cost software. Offsetting this improvement were lower margins associated with our Line business that was unable to absorb certain fixed expenses in relation to lower sales volume, competitive pricing pressures resulting from the industry's slowdown and additional inventory reserves required based on reduced turnover.

Selling, general and administrative expenses decreased by \$2,933,000 (31%) from \$9,316,000 in 2001 to \$6,383,000 in 2002. This decrease relates primarily to reduced salaries and benefits, consulting services and commissions reflecting our current level of business and to a lesser extent an occupancy benefit from the settlement of our North Carolina lease.

Research and development expenses decreased by \$1,911,000 (43%) from \$4,427,000 in 2001 to \$2,516,000 in 2002. This decrease resulted from our efforts to reduce expenses in all divisions and most significantly the OSS business.

At December 31, 2001, our goodwill was \$3,761,000, all of which related to our Signal division. We determined that this goodwill had been impaired as of June 30, 2002. We engaged in discussions with respect to the sale of that division during the second quarter of 2002, and based on those discussions we estimated that the impairment loss was approximately \$800,000. This amount was charged to operations in the quarter ended June 30, 2002. Furthermore, the negotiations relating to the sale of the Signal division have been discontinued. We cannot give any assurances that further write-downs will not be necessary in the future, although management believes that no additional goodwill impairment charges are necessary at this time.

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Results of Operations (continued)

As a result of the above, we had an operating loss of \$2,881,000 in 2002 versus an operating loss of \$11,453,000 in 2001.

Interest expense for 2002 decreased by \$2,682,000 from \$4,480,000 for 2001 to \$1,798,000 in 2002. The reduced level of interest expense is attributable to our amended agreement with our senior lender whereby the old term loan bears no interest commencing March 1, 2002, until such time as the senior lender, in its sole discretion, notifies us that interest shall be payable.

In April 2002, we sold our 50% interest in our Korean joint venture for \$450,000 to our joint venture partner. Payment was made by the forgiveness of commissions, totaling \$450,000, which we owed to our sales representation company owned by our joint venture partner, with respect to sales made by the Korean joint venture in Korea.

As the result of the foregoing, the 2002 net loss was \$4,114,000, \$.41 per share (basic and diluted), compared with a net loss of \$14,774,000, \$1.50 per share (basic and diluted) for 2001.

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Our losses are continuing into 2003, and we cannot give any assurance that we will be able to operate profitably in the future. As a result of the deterioration of our operating revenue resulting from both market conditions and our financial condition, we are evaluating various options, including the sale of one or more of our divisions as well as a reorganization under the Bankruptcy Code.

Years Ended December 31, 2001 and 2000

Our sales for 2001 were \$28,062,000 compared to \$51,140,000 in 2000, a decrease of \$23,078,000 (45%). The decrease in revenue is attributed to the decline in sales from all divisions.

OSS sales for 2001 were \$8,874,000, compared to 2000 sales of \$22,296,000, a decrease of \$13,422,000 (60%). The decline in sales from 2000 to 2001 is attributed to the completion during 2000 of certain sales contracts secured during 1999 and failure to secure new contracts as a result of the negative impact of reduced opportunities in Europe, delays we encountered in obtaining software from a vendor necessary to complete certain contracts and our financial difficulties. Sales of OSS systems are not made on a recurring basis to customers, but are the result of extended negotiations that frequently cover many months and do not always result in a contract. In addition, OSS contracts may include conditions precedent, such as the customer obtaining financing or bank approval, and the contracts are not effective until the conditions are satisfied.

Line connection/protection equipment sales for 2000 decreased approximately \$7,790,000 (38%) from \$20,546,000 in 2000 to \$12,756,000 in 2001. The reduced sales level reflected a decrease in volume of sales to United States, United Kingdom and Mexican customers. The results were adversely affected by the general slowdown in the telecommunications industry.

Signal processing revenue for 2001 compared to 2000 decreased by \$1,907,000 (25%) from \$7,644,000 to \$5,737,000. The decrease in sales primarily reflects delays in the receipt of certain anticipated contracts and a general slowdown in the order rate from customers during 2001.

Gross margin decreased from 30% in 2000 to 29% in 2001. The decrease in gross margin is primarily attributed to the lower sales volume in the OSS division causing inefficiency resulting from our inability to absorb our fixed expenses associated with the OSS contracts over our revenue base.

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Results of Operations (continued)

Selling, general and administrative expenses decreased by \$5,257,000 (36%) from \$14,573,000 in 2000 to \$9,316,000 in 2001. The decrease from 2000 to 2001 primarily reflects reduced professional legal expenses and decreased expenses reflecting our reorganization of our sales and marketing efforts of the OSS division.

Research and development expenses decreased by \$1,403,000 (24%) from \$5,830,000 in 2000 to \$4,427,000 in 2001. The decreased expense in 2001 resulted from our efforts to reduce our expenses primarily related to the OSS business.

In December 2001, we determined that \$5,802,000 of goodwill, which represented all of the goodwill associated with our OSS business unit, was impaired, and we recorded an impairment loss in that amount. This assessment was based on the continued decline in sales and losses generated by the business

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unit over the past several years and the declining prospects for additional sales of the products based on the older technology that originally gave rise to the goodwill. In addition, there were no negotiations in progress for the sale of the OSS division.

As a result of the above, we had an operating loss of \$11,453,000 in 2001 versus an operating loss of \$5,153,000 in 2000.

Interest expense for 2001 decreased by \$20,000 from \$4,500,000 for 2000 to \$4,480,000 in 2001.

During 2001, we sold our Glen Cove, New York facility for \$1,850,000 and recognized a gain on the sale of \$684,000, net of expenses of \$180,000. Of the net proceeds of \$1,670,000, \$474,000 was used to reduce outstanding principal and \$350,000 to reduce outstanding interest obligations to our senior lender. We retained the remaining proceeds of \$846,000 for working capital purposes.

As of December 31, 2001, we had a net income tax benefit of \$203,000 which is comprised of income tax expense of \$58,000 and benefit of \$261,000. The benefit reflects the reduction of an accrual for potential tax liability to one of our subsidiaries that had previously operated in Puerto Rico as a result of the expiration of the statute of limitations.

As the result of the foregoing, the 2001 net loss was \$14,774,000, \$1.50 per share (basic and diluted), compared with a net loss of \$10,176,000, \$1.04 per share (basic and diluted) for 2000.

Liquidity and Capital Resources

At December 31, 2002, we had cash and cash equivalents of \$779,000 compared with \$1,204,000 at December 31, 2001. Our working capital deficit was \$34,199,000 at December 31, 2002 compared to a working capital deficit of \$31,236,000 at December 31, 2001. The working capital deficit reflects the current liabilities to the senior and subordinated lenders together with the effect of the reduced level of business, which resulted in reduced cash, receivables and inventory. During 2002, we used \$3,238,000 of cash to support our operations. Our principal source of funds during 2002 was borrowings from our senior lender. Our senior lender is no longer advancing us any funds. As a result, our only source of funds is from operations. To the extent that we are not able to generate sufficient funds to cover our expenses we may have to consider reorganization or liquidation under the Bankruptcy Code.

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Liquidity and Capital Resources (continued)

As of December 31, 2002, our debt includes \$25,070,000 of senior debt which matures on May 15, 2003, and \$6,144,000 principal amount of subordinated debt which became due on July 3, 2001. We were unable to pay the interest payment on the subordinated notes of approximately \$2,300,000 which represents interest from July 2000 through December 2002. At December 31, 2002, we did not have sufficient resources to pay either the senior lender or the subordinated lenders and it is unlikely that we can generate such cash from our operations. Further, our senior lender has precluded us from making payments on the subordinated debt.

On March 19, 2003, our senior lender and we agreed to an extension to May 15, 2003 of the existing agreement that had expired on December 31, 2002.

As of December 31, 2002, we had \$385,000 outstanding of 6% Debentures which

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matured July 2, 2002. The interest accrued on the 6% Debentures is payable on July 1 of each year. Due to the restriction imposed by our senior lender precluding us from making any payments on indebtedness to any subordinated debt holder, we were unable to pay the interest due on July 1, 2001. Thus, interest due at December 31, 2002 was \$58,000. Additionally, we have been notified by the trustee that the non-payment of the interest caused an event of default.

As of December 31, 2002, we had outstanding \$6,144,000 of subordinated notes, all of which became due during 2001. We did not have the resources to pay, and we did not pay, either the principal or interest on the subordinated notes totaling \$8,444,000, and are restricted by our senior lender from making such payments. The holder of a subordinated note in the principal amount of \$500,000 has commenced an action seeking payment of the principal and interest on his note. However, the court denied the holder's motion for a summary judgment on the grounds that the terms of the note did not give him permission to obtain a judgment while we remained in default to the senior debt holder.

As a result of our continuing financial difficulties:

- o we are having and we may continue to have difficulty performing our obligations under our contracts, which could result in the cancellation of contracts or the loss of future business and penalties for non-performance;
- o a number of creditors have engaged attorneys or collection agencies or commenced legal actions against us, and some of them have obtained judgments against us; and
- o we have continued to suffer a significant decline in revenue in 2002 from 2001 following a significant decline in revenue in 2001 from 2000.

Claimants who have already either commenced litigation or otherwise sought collection or who have obtained judgments against us are due approximately \$214,000. If we are unable to reach a settlement with these creditors and others who have not yet brought claims, and these claimants obtain judgments against us or, in the case of creditors who have already obtained judgments, if the creditors seek to enforce the judgment, it may be necessary for us, or our senior lender may require us, to seek protection under the Bankruptcy Code.

The creditors include five former senior executives who have deferred compensation agreements with us. The total payments due under these agreements are approximately \$1.9 million, of which \$133,000 was due at December 31, 2002 and an additional \$196,000 becomes due in 2003. The claimants commenced litigation that has been adjourned pending settlement. We are in the latter stages of settlement negotiations with these creditors.

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Liquidity and Capital Resources (continued)

We are seeking to address our need for liquidity by exploring alternatives, including the possible sale of one or more of our divisions. During 2001 and 2002 we were engaged in discussions with respect to the possible sale of our divisions; however, those negotiations were terminated without an agreement having been reached, and we may not be able to sell those divisions on acceptable, if any, terms. Furthermore, if we sell a division, we anticipate that a substantial portion of the net proceeds will be paid to our senior lender and we will not receive any significant amount of working capital from such a sale. During 2001 and 2002, we have taken steps to reduce overhead and

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headcount. We will continue to look to reduce costs while we seek additional business from new and existing customers.

Because of our present stock price, it is highly unlikely that we will be able to raise funds through the sales of our equity securities, and our financial condition prevents us from issuing debt securities. In the event that we are unable to extend our debt obligations and sell one or more of our divisions, we cannot assure you that we will be able to continue in operations. Furthermore, we believe that our losses and our financial position are having and will continue to have an adverse effect upon our ability to develop new business as competitors and potential customers question our ability both to perform our obligations under any agreements we may enter and to continue in business. Because of our financial condition, British Telecommunications, which is one of our largest customers, is not placing orders with us for OSS products, and has advised us that it will not place orders for OSS products until we can demonstrate that we are financially viable. However, British Telecommunication continues to place orders for OSS maintenance and modest orders for line test products. The loss of this customer would have a material adverse effect upon our operations. In addition, our auditors included in their report an explanatory paragraph about our ability to continue as a going concern.

Item 7A. Quantitative and Qualitative Disclosure About Market Risk.

Although we conduct operations outside of the United States, most of our contracts and sales are dollar denominated. A portion of the revenue from our United Kingdom operations and the majority of our United Kingdom expenses are denominated in Sterling. Any Sterling-denominated receipts are promptly converted into United States dollars. We do not engage in any hedging or other currency transactions. For 2002, the currency translation adjustment was not significant in relation to our total revenue.

Item 8. Financial Statements and Supplementary Data.

See Exhibit I

Item 9. Changes In and Disagreements With Accountants On Accounting and Financial Disclosure.

Not Applicable

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Part III

Item 10. Directors and Executive Officers

Set forth below is information concerning our directors:

| Name | Principal Occupation or Employment | Director Since |
|-------------------------|--|----------------|
| ---- | ----- | ----- |
| William V. Carney(1) | Chairman of the board and chief executive officer | 1970 |
| Michael A. Tancredi | Senior vice president, secretary and treasurer | 1970 |
| Warren H. Esanu(1), (2) | Of counsel to Esanu Katsky Korins & Siger, LLP, attorneys at law | 1997 |

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| | | |
|----------------------------|---|------|
| Herbert H. Feldman(1), (2) | President, Alpha Risk Management, Inc., independent risk management consultants | 1989 |
| Marco M. Elser | Managing director of Elser & Co., an investment advisory firm | 2000 |

-
- (1) Member of the executive committee.
 (2) Member of the audit and compensation committees.

Mr. Carney has been chairman of the board and chief executive officer since October 1996. He was vice chairman from 1988 to October 1996, senior vice president from 1989 to October 1996, chief technical officer since 1990 and secretary from 1977 to October 1996. He also served as senior vice president-mechanical engineering from 1988 to 1989, senior vice president-connector products from 1985 to 1988, senior vice president-manufacturing from 1984 to 1985 and senior vice president-operations from 1977 to 1984. Since December 2002, Mr. Carney has worked for us on a part-time basis.

Mr. Tancredi has been senior vice president, secretary and treasurer since January 1997. He has been vice president-administration since 1995 and treasurer since 1978, having served as vice president-finance and administration from 1989 to 1995 and vice president-finance from 1984 to 1989.

Mr. Esanu has been a director since April 1997 and also served as a director from 1989 to 1996. He was also our chairman of the board from March 1996 to October 1996. He has been of counsel to Esanu Katsky Korins & Siger, LLP, attorneys at law, for more than the past five years. Mr. Esanu is also a founding partner and chairman of Paul Reed Smith Guitars Limited Partnership (Maryland), a leading manufacturer of premium-priced electrical guitars. He is also a senior officer and director of a number of privately held real estate investment and management companies.

Mr. Elser has been the managing director of Elser & Co., an investment advisory firm more than the past five years. He has also been associated with Northeast Securities, a US-based broker dealer and is responsible for the Italian office, which he founded in 1994.

Mr. Feldman has been president of Alpha Risk Management, Inc., independent risk management consultants, for more than the past five years.

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Set forth is information concerning our executive officers:

| Name of Executive Officer | Position | Age |
|---------------------------|--|-----|
| William V. Carney | Chairman of the board and chief executive officer | 66 |
| Michael A. Tancredi | Senior vice president, secretary and treasurer | 73 |
| Edward B. Kornfeld | Senior vice president-operations and chief financial officer | 59 |

All of our officers serve at the pleasure of the board of directors. Messrs. Carney and Tancredi are also members of the board of directors as stated above. There is no family relationship between any of the executive officers

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listed below.

Mr. Kornfeld, 59, has been senior vice president-operations since 1996 and chief financial officer since October 1995. Since June 2002, Mr. Kornfeld has also been a partner of the firm of Tatum CFO Partners, which provides chief financial officer services to medium and large companies; however, he continues to devote full time effort to our business. He was vice president-finance from October 1995 until 1996. For more than five years prior thereto, Mr. Kornfeld held positions with several companies for more than five years, including Excel Technology Inc. (Quantronix Corp.) and Anorad Corporation.

Item 11. Executive Compensation

The following table shows the compensation we paid to our chief executive officer and the only executive officer, other than the chief executive officer, whose salary and bonus earned exceeded \$100,000 for the year ended December 31, 2002.

Summary Compensation Table

| Name and Principal Position ----- | Year ---- | Annual Compensation ----- | | Long-Term Compensation (Awa | Op |
|--|--------------|------------------------------|----------------|--|----------|
| | | Salary ----- | Bonus ----- | Restricted Stock Awards (Dollars) ----- | (N -- |
| William V. Carney, Chairman of the board and chief executive officer | 2002 | \$240,000 | -- | -- | |
| | 2001 | 240,000 | -- | -- | |
| | 2000 | 240,000 | -- | -- | |
| Edward B. Kornfeld, Senior vice president - operations and chief financial officer | 2002 | 192,000 | -- | -- | |
| | 2001 | 192,000 | -- | -- | |
| | 2000 | 192,000 | -- | -- | |

 "All Other Compensation" includes a payment to the executive's account pursuant to our 401(k) Plan, premiums paid with respect to the equity split dollar program (in 2000), group life insurance in amounts greater than that available to all employees and special long term disability coverage.

Compensation to Mr. Kornfeld does not include fees of \$21,000 paid in 2002 to Tatum CFO Partners, of which Mr. Kornfeld is a partner.

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Set forth below is a chart that shows, for 2002, the components of "All Other Compensation" listed in the Summary Compensation Table.

| | Mr. Carney ----- | Mr. Kornfeld ----- |
|------------------------|---------------------|-----------------------|
| 401(k) Match | \$3,000 | \$2,700 |
| Supplemental Insurance | 6,858 | 2,322 |

Certain of our officers named in the summary compensation table or their affiliates are parties to employment or other agreements providing for compensation during and after their employment.

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During 2002, we did not grant Mr. Carney or Mr. Kornfeld any options, and neither of them exercised any options to purchase shares of our common stock. As of December 31, 2002, Mr. Carney held options to purchase 180,000 shares of common stock and Mr. Kornfeld held options to purchase 88,000 shares of common stock. All of these options are currently exercisable and, because the exercise price is less than the market price of the common stock, they were not in-the-money options and, accordingly, their options had nominal value at December 31, 2002.

Employment Agreements. We have amended our prior employment agreement with Mr. Carney whereby he is required to work at a rate of two and one-half days per week and half of his current base pay is deferred to the termination of his amended employment agreement of December 31, 2005. No further compensation shall be paid to Mr. Carney, including the deferral, provided that Mr. Carney's employment with us does not terminate prior to December 31, 2005.

We have entered into an employment agreement with Mr. Kornfeld. The agreement continues on a year-to-year basis, from January 1 of each year, unless terminated on prior notice of not less than 90 days. Salary is determined by the board, except that the salary may not be reduced except as a part of a salary reduction program applicable to all executive officers. Upon death or termination of employment as a result of a disability, the officer or his estate is to receive a payment equal to three months salary. Upon a termination without cause Mr. Kornfeld is entitled to receive his then current salary for six months plus one month for each full year of service up to a maximum aggregate of 24 months. In the event that the executive is covered by an executive severance agreement, including the salary continuation agreements (as described below), which provides for payments upon termination subsequent to a "change of control," the executive would be entitled to the greater of the severance arrangements as described in this paragraph or the severance payments under the executive severance agreements. We also have month-to-month agreement with Tatum CFO Partners of which Mr. Kornfeld is a partner, pursuant to which we pay Tatum CFO Partners \$3,000 per month.

Salary Continuation Agreement. We are party to a salary continuation agreement with Mr. Kornfeld. The salary continuation agreement provides that, in the event that a change of control occurs and the executive's employment with us is subsequently terminated by us other than for cause, death or disability, or is terminated by the executive as a result of a substantial alteration in the executive's duties, compensation or other benefits, the executive shall be entitled to the payment of an amount equal to his monthly salary at the rate in effect as of the date of his termination (or, if higher, as in effect immediately prior to the change in control) plus the pro rata monthly amount of his most recent annual bonus paid immediately before the change of control multiplied by 24. For purposes of the salary continuation agreement, a change of control is defined as one which would be required to be reported in response to the proxy rules under the Securities Exchange Act of 1934, as amended, the acquisition of beneficial ownership, directly or indirectly, by a person or group of persons of our securities representing 25% or more of the combined voting power of our then outstanding securities, or, during any period of two consecutive years, if individuals who at the beginning of such period constituted the board cease

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for any reason to constitute at least a majority thereof unless the election of each new director was nominated or ratified by at least two-thirds of the directors then still in office who were directors at the beginning of the period. The change of control must occur during the term of the salary continuation agreement, which is currently through December 31, 2003 and is

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renewed automatically unless we give timely notice prior to January 1 of any year of our election not to renew the agreement. If such a change of control occurs during the effectiveness of the salary continuation agreement, any termination of such covered employee during the 18 months following the change of control will result in the payment of the compensation described above.

Item 12. Principal Holders of Securities and Security Holdings of Management

The following table and discussion provides information as to the shares of common stock beneficially owned on March 7, 2003 by:

- o each director;
- o each officer named in the summary compensation table;
- o each person owning of record or known by us, based on information provided to us by the persons named below, to own beneficially at least 5% of our common stock; and
- o all officers and directors as a group.

| Name ----- | Shares of Common Stock Beneficially Owned ----- | Percentage of Outstanding Common Stock ----- |
|---|--|---|
| William V. Carney | 303,021 | 3.0% |
| Michael A. Tancredi | 114,238 | 1.1% |
| Warren H. Esanu | 116,500 | 1.2% |
| Herbert H. Feldman | 76,000 | * |
| Marco M. Elser | 325,592 | 3.3% |
| Edward B. Kornfeld | 114,317 | 1.1% |
| Ralph DePascale | 19,572 | * |
| Christopher Miller | 6,796 | * |
| All directors and officers as a group (8 individuals) ----- | 1,076,036 | 10.8% |

* Less than 1%

Except as otherwise indicated each person has the sole power to vote and dispose of all shares of common stock listed opposite his name.

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The number of shares owned by our directors and officers named in the summary compensation table includes shares of common stock which are issuable upon exercise of options and warrants that are exercisable at March 7, 2003 or will become exercisable within 60 days after that date. Set forth below is the number of shares of common stock issuable upon exercise of those options and warrants for each of these directors and officers.

| Name ----- | Shares ----- |
|---------------------|-----------------|
| William V. Carney | 180,000 |
| Michael A. Tancredi | 75,000 |
| Warren H. Esanu | 61,500 |
| Herbert H. Feldman | 56,000 |
| Marco M. Elser | 10,000 |
| Edward B. Kornfeld | 88,000 |
| Ralph De Pascale | 14,500 |
| Christopher Miller | 6,000 |

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All officers and directors as a group 491,000

The shares of common stock issuable upon exercise of Mr. Esanu's options and warrants include warrants to purchase 12,500 shares of common stock issuable upon warrants held by Elmira Realty Management Corp. pension and profit sharing plan. Mr. Esanu has the sole voting and dispositive power with respect to shares issuable upon exercise of these warrants. All other directors and officers named in the table hold only options.

Item 13. Certain Relationships and Related Transactions

During 2002, Warren H. Esanu, a director, served as a member of our audit and compensation committees. During 2002, the law firm of Esanu Katsky Korins & Siger, LLP, to which Mr. Esanu is of counsel, provided legal services to us, for which it received fees of \$237,591. Esanu Katsky Korins & Siger, LLP is continuing to render legal services to us during 2003.

Item 14. Controls and Procedures

Our chief executive officer and chief financial officer have supervised and participated in an evaluation of the effectiveness of our disclosure controls and procedures as of a date within 90 days of the date of this report, and based on their evaluations, they believe that our disclosure controls and procedures (as defined in Rule 13a-14(c) of the Securities Exchange Act of 1934, as amended) are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. As a result of the evaluation, there were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

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Part IV

Item 15. Exhibits, Financial Statements Schedules and Reports on Form 8-K.

(a) Document filed as part of this Annual Report on Form 10-K:

(i) Financial Statements.

See Index to Consolidated Financial Statements under Item 8 hereof.

(ii) Financial Statement Schedules.

None

Schedules not listed above have been omitted for the reasons that they were inapplicable or not required or the information is given elsewhere in the financial statements.

Separate financial statements of the registrant have been omitted since restricted net assets of the consolidated subsidiaries do not exceed 25% of consolidated net assets.

(b) Reports on Form 8-K

None.

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(c) Exhibits

| Exhibit No. ----- | Description of Exhibit |
|----------------------|--|
| 3.1 | Certificate of Incorporation of the Company, as amended to date, incorporated by reference to Exhibit 4 (a) of the Company's Annual Report on Form 10-K for the year ended December 31, 1991. |
| 3.2 | Certificate of Designation of Series B Participating Convertible Preferred Stock, incorporated by reference to Exhibit 3.2 of the Company's Annual Report on Form 10-K for the year ended December 31, 1995. |
| 3.3 | By-laws of the Company, as amended to date, incorporated by reference to Exhibit 3.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 1995. |
| 4.1 | Amended and Restated Loan and Security Agreement dated as of November 28, 1994, between the Company and Foothill ("Foothill") Capital Corporation, incorporated by reference to Exhibit 2 to the Company's Current Report on Form 8-K dated November 30, 1994. |
| 4.2 | Amendment Number One dated February 13, 1995 to the Amended and Restated Loan and Security Agreement dated as of November 28, 1994 between the Company and Foothill, incorporated by reference to Exhibit 4.7 of the Company's Annual Report on Form 10K for the year ended December 31, 1995. |
| 4.3 | Amendment Number Two dated March 30, 1995 to the Amended and Restated Loan and Security Agreement dated as of November 28, 1994 between the Company and Foothill, incorporated by reference to Exhibit 4.7.2 of the Company's Annual Report on Form 10K for the year ended December 31, 1995. |
| 4.4 | Amended and Restated Secured Promissory Note dated February 13, 1995, incorporated by reference to Exhibit 4.9 of the Company's Annual Report on Form 10K for the year ended December 31, 1995. |
| 4.5 | Amendment Number Three to Amended and Restated Loan and Security Agreement dated March 12, 1996, between the Company and Foothill, incorporated by reference to Exhibit 4.11 of the Company's Annual Report on Form 10K for the year ended December 31, 1995. |
| 4.6 | Warrant to Purchase Common Stock of the Company dated November 28, 1994 executed by the Company in favor of Foothill, incorporated by reference to Exhibit 6 to the Company's Current Report on Form 8-K dated November 30, 1994. |
| 4.7 | Lockbox Operating Procedural Agreement dated as of November 28, 1994 among Chemical Bank, the Company and Foothill, incorporated by reference to Exhibit 7 to the Company's Current Report on Form 8-K dated November 30, 1994. |

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Exhibits (continued)

| Exhibit No. | Description of Exhibit |
|-------------|--|
| 4.8 | Combined Amendment No. Four dated as of March 1, 2002 to Amended and Restated Loan and Security agreement between Foothill and the Company. |
| 4.9 | Combined Amendment No. Five dated as of May 10, 2002 to Amended and Restated Loan and Security agreement between Foothill and the Company. |
| 4.10 | Combined Amendment No. Six dated as of March 19, 2003 to Amended and Restated Loan and Security agreement between Foothill and the Company. |
| 10.1 | Form of Executive Salary Continuation Agreement, incorporated by reference to Exhibit 19 (cc) of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1985. |
| 10.2 | Lease dated November 6, 2002 between the Company and Long Island Industrial Group LLC. |
| 10.3 | Lease dated May 1, 2002 between the Company and Long Island Industrial Group LLC. |
| 22 | Subsidiaries of the Company, incorporated by reference to Exhibit 22.1 of the Company's Annual Report on Form 10K for the year ended December 31, 1995. |
| 23 | Consent of Independent Certified Public Accountants. |

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(b) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PORTA SYSTEMS CORP.

Dated March 31, 2003

By /s/ William V. Carney

William V. Carney
Chairman of the Board and
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated. Each person whose signature appears below hereby authorizes William V. Carney and Edward B. Kornfeld or either of them acting in the absence of the others, as his true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution for him and in his name, place and stead, in any and all capacities to sign any and all amendments to this report, and to file the same, with all exhibits thereto and other documents in connection therewith, with the

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Securities and Exchange Commission.

| Signature | Title | Date |
|--|---|----------------|
| /s/William V. Carney ----- William V. Carney | Chairman of the Board, Chief Executive Officer and Director Principal (Executive Officer) | March 31, 2003 |
| /s/Edward B. Kornfeld ----- Edward B. Kornfeld | Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer) | March 31, 2003 |
| /s/Warren H. Esanu ----- Warren H. Esanu | Director | March 31, 2003 |
| /s/Michael A. Tancredi ----- Michael A. Tancredi | Director | March 31, 2003 |
| /s/Herbert H. Feldman ----- Herbert H. Feldman | Director | March 31, 2003 |
| /s/Marco Elser ----- Marco Elser | Director | March 31, 2003 |

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CERTIFICATION OF CHIEF EXECUTIVE AND FINANCIAL OFFICERS

The undersigned chief executive officer and chief financial officer of the Registrant do hereby certify that this Annual Report on Form 10-K fully complies with the requirements of Section 13(a) or 15(d) of the Securities Act of 1934, as amended, and that the information contained in this report fairly presents, in all material respects, the financial condition and results of operations of the Registrant at the dates and for the periods shown in such report.

Dated March 31, 2003

By /s/William V. Carney

William V. Carney
Chairman of the Board
and Chief Executive Officer

Dated March 31, 2003

By /s/Edward B. Kornfeld

Edward B. Kornfeld
Senior Vice President
and Chief Financial Officer

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William V. Carney does hereby certify that he is the duly elected and incumbent chief executive officer of Porta Systems Corp ("the issuer") and he does hereby certify, with respect to the issuer's Form 10-K for the year ended December 31, 2002 (the "report") as follows:

1. He has reviewed the report;
2. Based on his knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;
3. Based on his knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;
4. He and the other certifying officer are responsible for establishing and maintaining disclosure controls and procedures, as defined in Rule 13a-14(c) of the Securities Exchange Act of 1934, as amended, for the issuer and have:
 - i. Designed such disclosure controls and procedures to ensure that material information relating to the issuer, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the periodic reports are being prepared;
 - ii. Evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report (the "Evaluation Date"); and
 - iii. Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of the Evaluation Date
5. He and the other certifying officer have disclosed to the issuer's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):
 - i. All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
 - ii. Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
6. He and the other certifying officer have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

By /s/ William V. Carney

William V. Carney
Chief Executive Officer

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Edward B. Kornfeld does hereby certify that he is the duly elected and incumbent chief financial officer of Porta Systems Corp. (the "issuer") and he does hereby certify, with respect to the issuer's Form 10-K for the year ended December 31, 2002 (the "report") as follows:

1. He has reviewed the report;
2. Based on his knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

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3. Based on his knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;
4. He and the other certifying officer are responsible for establishing and maintaining disclosure controls and procedures, as defined in Rule 13a-14(c) of the Securities Exchange Act of 1934, as amended, for the issuer and have:
 - i. Designed such disclosure controls and procedures to ensure that material information relating to the issuer, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the periodic reports are being prepared;
 - ii. Evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report (the "Evaluation Date"); and
 - iii. Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of the Evaluation Date
5. He and the other certifying officer have disclosed to the issuer's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):
 - i. All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
 - ii. Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
6. He and the other certifying officer have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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By /s/Edward B. Kornfeld

Edward B. Kornfeld
Chief Financial Officer

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Exhibit I

Item 8. Financial Statements and Supplementary Data

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| Consolidated Financial Statements and Notes: | |
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Report of Independent Certified Public Accountants

The Board of Directors and Stockholders
Porta Systems Corp.
Syosset, New York

We have audited the accompanying consolidated balance sheets of Porta Systems Corp. and subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations and comprehensive loss, stockholders' deficit, and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and

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significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Porta Systems Corp. and subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Notes 1 and 6 to the consolidated financial statements, effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets."

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has suffered substantial losses from operations in 2002, 2001, and 2000 and, as of December 31, 2002, has a stockholders' deficit of \$29,935,000 and a working capital deficit of \$34,199,000. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/BDO SEIDMAN, LLP

BDO SEIDMAN, LLP

Melville, New York
March 13, 2003

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PORTA SYSTEMS CORP. AND SUBSIDIARIES
Consolidated Balance Sheets
December 31, 2002 and 2001
(in thousands, except shares and par value)

| | Assets ----- | 2002 ---- | 2001 ---- |
|--|-----------------|--------------|--------------|
| Current assets: | | | |
| Cash and cash equivalents | | \$ 779 | 1,204 |
| Accounts receivable - trade, less allowance for doubtful accounts of \$1,967 in 2002 and \$2,168 in 2001 | | 4,654 | 4,284 |
| Inventories | | 3,363 | 5,206 |
| Prepaid expenses and other current assets | | 329 | 852 |
| | | ----- | ----- |
| Total current assets | | 9,125 | 11,546 |
| Property, plant and equipment, net | | 1,802 | 2,328 |
| Goodwill, net | | 2,961 | 3,761 |
| Other assets | | 340 | 198 |
| | | ----- | ----- |
| Total assets | | \$ 14,228 | 17,833 |
| | | ===== | ===== |

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Liabilities and Stockholders' Deficit

| | | |
|---|-----------|----------|
| Current liabilities: | | |
| Senior debt | \$ 25,070 | 22,095 |
| Subordinated notes | 6,144 | 6,144 |
| 6% Convertible subordinated debentures | 385 | 382 |
| Accounts payable | 5,241 | 7,023 |
| Accrued expenses | 2,640 | 3,417 |
| Accrued interest payable | 2,639 | 1,593 |
| Accrued commissions | 566 | 1,607 |
| Deferred compensation | 329 | 196 |
| Income taxes payable | 302 | 314 |
| Short-term loans | 8 | 11 |
| | ----- | ----- |
| Total current liabilities | 43,324 | 42,782 |
| | ----- | ----- |
| Deferred compensation | 839 | 900 |
| | ----- | ----- |
| Total long-term liabilities | 839 | 900 |
| | ----- | ----- |
| Total liabilities | 44,163 | 43,682 |
| | ----- | ----- |
| Commitments and contingencies | | |
| Stockholders' deficit: | | |
| Preferred stock, no par value; authorized 1,000,000 shares, none issued | -- | -- |
| Common stock, par value \$.01; authorized 20,000,000 shares, issued 10,003,224 and 9,947,421 shares in 2002 and 2001, respectively | 100 | 99 |
| Additional paid-in capital | 76,059 | 76,056 |
| Accumulated deficit | (100,023) | (95,909) |
| Accumulated other comprehensive loss: | | |
| Foreign currency translation adjustment | (4,133) | (4,157) |
| | ----- | ----- |
| | (27,997) | (23,911) |
| Treasury stock, at cost, 30,940 shares | (1,938) | (1,938) |
| | ----- | ----- |
| Total stockholders' deficit | (29,935) | (25,849) |
| | ----- | ----- |
| Total liabilities and stockholders' deficit | \$ 14,228 | 17,833 |
| | ===== | ===== |

See accompanying notes to consolidated financial statements.

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PORTA SYSTEMS CORP. AND SUBSIDIARIES
Consolidated Statements of Operations and
Comprehensive Loss Years ended
December 31, 2002, 2001 and 2000
(in thousands, except per share amounts)

| | 2002 | 2001 | 2000 |
|---------------|-----------|--------|--------|
| | ---- | ---- | ---- |
| Sales | \$ 21,417 | 28,062 | 51,140 |
| Cost of sales | 14,599 | 19,970 | 35,890 |
| | ----- | ----- | ----- |

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| | | | |
|---|------------|----------|----------|
| Gross profit | 6,818 | 8,092 | 15,250 |
| | ----- | ----- | ----- |
| Selling, general and administrative expenses | 6,383 | 9,316 | 14,573 |
| Research and development expenses | 2,516 | 4,427 | 5,830 |
| Goodwill impairment | 800 | 5,802 | -- |
| | ----- | ----- | ----- |
| Total expenses | 9,699 | 19,545 | 20,403 |
| | ----- | ----- | ----- |
| Operating loss | (2,881) | (11,453) | (5,153) |
| Interest expense | (1,798) | (4,480) | (4,500) |
| Interest income | 7 | 31 | 129 |
| Gain on sale of assets | -- | 684 | -- |
| Gain on sale of investment in joint venture | 450 | -- | -- |
| Equity in net loss of joint venture | -- | (175) | -- |
| Other income (expense), net | 119 | 191 | (813) |
| | ----- | ----- | ----- |
| Loss before income taxes and minority interest | (4,103) | (15,202) | (10,337) |
| Income tax benefit (expense) | (11) | 203 | (227) |
| Minority interest | -- | 225 | 388 |
| | ----- | ----- | ----- |
| Net loss | \$ (4,114) | (14,774) | (10,176) |
| | ===== | ===== | ===== |
| Other comprehensive income (loss): | | | |
| Foreign currency translation adjustments | 24 | (360) | 99 |
| Comprehensive loss | \$ (4,090) | (15,134) | (10,077) |
| | ===== | ===== | ===== |
| Basic per share amounts: | | | |
| Net loss per share of common stock | \$ (0.41) | (1.50) | (1.04) |
| | ===== | ===== | ===== |
| Weighted average shares of common stock outstanding | 9,994 | 9,878 | 9,763 |
| | ===== | ===== | ===== |
| Diluted per share amounts: | | | |
| Net loss per share of common stock | \$ (0.41) | (1.50) | (1.04) |
| | ===== | ===== | ===== |
| Weighted average shares of common stock outstanding | 9,994 | 9,878 | 9,763 |
| | ===== | ===== | ===== |

See accompanying notes to consolidated financial statements.

F-4

PORTA SYSTEMS CORP. AND SUBSIDIARIES
Consolidated Statements of Stockholders' Deficit
Years ended December 31, 2002, 2001 and 2000
(In thousands)

| Common Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive (Loss) | Accumulated Deficit | Trea Sto |
|------------------|---------------------|----------------------------------|---|------------------------|-------------|
| No. of Shares | Par Value Amount | | | | |
| ----- | ----- | ----- | ----- | ----- | ----- |

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| | | | | | | |
|---|--------|-------|-----------|------------|--------------|--------|
| Balance at December 31, 1999 | 9,639 | \$ 96 | \$ 75,310 | \$ (3,896) | \$ (70,959) | \$ (1) |
| Net loss 2000 | -- | -- | -- | -- | (10,176) | |
| Common stock issued | 178 | 2 | 174 | -- | -- | |
| Warrants issued or re-priced | -- | -- | 496 | -- | -- | |
| Foreign currency translation adjustment | -- | -- | -- | 99 | -- | |
| Balance at December 31, 2000 | 9,817 | 98 | 75,980 | (3,797) | (81,135) | (1) |
| Net loss 2001 | -- | -- | -- | -- | (14,774) | |
| Common stock issued | 130 | 1 | 37 | -- | -- | |
| Warrants re-priced | -- | -- | 39 | -- | -- | |
| Foreign currency translation adjustment | -- | -- | -- | (360) | -- | |
| Balance at December 31, 2001 | 9,947 | 99 | 76,056 | (4,157) | (95,909) | (1) |
| Net loss 2002 | -- | -- | -- | -- | (4,114) | |
| Common stock issued | 56 | 1 | 3 | -- | -- | |
| Foreign currency translation adjustment | -- | -- | -- | 24 | -- | |
| Balance at December 31, 2002 | 10,003 | \$100 | \$ 76,059 | \$ (4,133) | \$ (100,023) | \$ (1) |

See accompanying notes to consolidated financial statements

F-5

PORTA SYSTEMS CORP. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Note 21) Years ended December 31,
2002, 2001 and 2000
(In thousands)

| | 2002 | 2001 | 2000 |
|---|------------|----------|----------|
| | ---- | ---- | ---- |
| Cash flows from operating activities: | | | |
| Net loss | \$ (4,114) | (14,774) | (10,176) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | | |
| Depreciation and amortization | 713 | 1,909 | 1,909 |
| Goodwill impairment | 800 | 5,802 | 5,802 |
| Amortization of debt discounts | 3 | 6 | 6 |
| Gain on sale of investment in joint venture | (450) | -- | -- |
| Non-cash financing expenses | -- | 123 | 123 |
| Gain on sale of assets | -- | (684) | (684) |
| Minority interest | -- | (225) | (225) |
| Equity in loss of joint venture | -- | 175 | 175 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (370) | 3,141 | 3,141 |
| Inventories | 1,843 | 1,944 | 1,944 |
| Prepaid expenses | 523 | 278 | 278 |
| Other assets | (142) | 867 | 867 |
| Accounts payable, accrued expenses and other liabilities | (2,044) | (2,341) | (2,341) |

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| | | | |
|--|---------|---------|--|
| Net cash used in operating activities | (3,238) | (3,779) | |
| | ----- | ----- | |
| Cash flows from investing activities: | | | |
| Net proceeds from the sale of assets | -- | 1,670 | |
| Capital expenditures, net | (124) | (196) | |
| | ----- | ----- | |
| Net cash provided by (used in) investing activities | (124) | 1,474 | |
| | ----- | ----- | |
| Cash flows from financing activities: | | | |
| Proceeds from senior debt | 2,975 | 2,222 | |
| Repayments of senior debt | -- | (873) | |
| Proceeds from subordinated debentures and warrants | -- | -- | |
| Proceeds from the issuance of common stock | 4 | 38 | |
| Proceeds (repayments) of notes payable/short-term loans | (3) | 10 | |
| | ----- | ----- | |
| Net cash provided by financing activities | 2,976 | 1,397 | |
| | ----- | ----- | |
| Effect of exchange rate changes on cash and cash equivalents | (39) | (254) | |
| | ----- | ----- | |
| Decrease in cash and cash equivalents | (425) | (1,162) | |
| Cash and equivalents - beginning of year | 1,204 | 2,366 | |
| | ----- | ----- | |
| Cash and equivalents - end of year | \$ 779 | 1,204 | |
| | ===== | ===== | |

See accompanying notes to consolidated financial statements.

F-6

PORTA SYSTEMS CORP. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 2001 and 2000

(1) Summary of Significant Accounting Policies

Nature of Operations and Principles of Consolidation

Porta Systems Corp. ("Porta" or the "Company") designs, manufactures and markets systems for the connection, protection, testing and administration of public and private telecommunications lines and networks. The Company has various patents for copper and software based products and systems that support voice, data, image and video transmission. Porta's principal customers are the U.S. regional telephone operating companies and foreign telephone companies.

The accompanying consolidated financial statements include the accounts of Porta and its majority-owned or controlled subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

Revenue Recognition

Revenue, other than from long-term contracts for specialized products, is recognized when a product is shipped. Revenues and earnings relating to long-term contracts for specialized products are recognized on the percentage-of-completion basis primarily measured by the attainment of milestones. Anticipated losses, if any, are recognized in the period in which they are identified.

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Concentration of Credit Risk

Financial instruments, which potentially subject Porta to concentrations of credit risk, consist principally of cash and accounts receivable. At times such cash in banks exceeds the FDIC insurance limit.

As discussed in notes 17 and 22, substantial portions of Porta's sales are to customers in foreign countries. The Company's credit risk with respect to new foreign customers is reduced by obtaining letters of credit for a substantial portion of the contract price, and by monitoring credit exposure related to each customer.

Cash Equivalents

The Company considers investments with original maturities of three months or less at the time of purchase to be cash equivalents. Cash equivalents consist of commercial paper.

Accounts Receivable

Accounts receivable are customer obligations due under normal trade terms. The Company sells its products directly to customers, to distributors and original equipment manufacturers involved in a variety of industries including, telecommunications and military/aerospace. The Company performs continuing credit evaluations of its customers' financial condition and although it generally does not require collateral, letters of credit may be required from customers in certain circumstances.

(Continued)

F-7

PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

The Company records an allowance for doubtful accounts receivable based on specifically identified amounts that it believes to be uncollectible. The Company also records additional allowances based on certain percentages of its aged receivables, which are determined based on historical experience and its assessment of the general financial conditions affecting its customer base. If the Company's actual collection experience changes, revisions to its allowance may be required. The Company has a limited number of customers with individually large amounts due at any given balance sheet date.

Inventories

Inventories are stated at the lower of cost (on the average or first-in, first-out methods) or market.

Property, Plant and Equipment

Property, plant and equipment are carried at cost. Leasehold improvements are amortized over the term of the lease. Depreciation is computed using the straight-line method over the related assets' estimated lives.

Deferred Computer Software

The Company engages solely in development of software products for specific customer contracts and as such costs are charged to cost of sales at the

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time revenues on such contracts are recognized.

Goodwill

Goodwill represents the difference between the purchase price and the fair market value of net assets acquired in business combinations treated as purchases. Commencing January 1, 2002, goodwill is an indefinite lived asset and as such is not amortized. On an annual basis, or more frequently if certain events occur, the Company tests the goodwill for impairment. The Company determines the market value of the reporting unit by considering the projected cash flows generated from the reporting unit to which the goodwill relates.

Income Taxes

Deferred income taxes are recognized based on the differences between the tax bases of assets and liabilities and their reported amounts in the financial statements that will result in taxable or deductible amounts in future years. Further, the effects of tax law or rate changes are included in income as part of deferred tax expense or benefit for the period that includes the enactment date (note 14).

Foreign Currency Translation

Assets and liabilities of foreign subsidiaries are translated at year-end rates of exchange, and revenues and expenses are translated at the average rates of exchange for the year. Gains and losses resulting from translation are accumulated in a separate component of stockholders' equity. Gains and losses resulting from foreign currency transactions (transactions denominated in a currency other than the functional currency) are included in operations.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

Net Loss Per Share

Basic net loss per share is based on the weighted average number of shares outstanding. Diluted net loss per share is based on the weighted average number of shares outstanding plus the dilutive effect of potential shares of common stock, as if such shares had been issued. For 2002, 2001 and 2000, no dilutive potential shares of common stock were added to compute diluted loss per share because the effect would be anti-dilutive.

Reclassifications

Certain reclassifications have been made to conform prior years' consolidated financial statements to the 2002 presentation.

Accounting for Stock-Based Compensation

The Company applies the intrinsic value method as outlined in APB Opinion No. 25, "Accounting for Stock Issued to Employees", and related Interpretations in accounting for stock options. Under the intrinsic value method, no compensation expense is recognized if the exercise price of the Company's employee stock options equals the market price of the

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underlying stock on the date of the grant. Accordingly, no compensation cost has been recognized. SFAS No. 123, "Accounting for Stock-Based Compensation", requires the Company to provide pro forma information regarding net loss and net loss per common share as if compensation cost for the Company's stock option programs had been determined in accordance with the fair value method prescribed therein. The following table illustrates the effect on net loss and loss per common share as if the fair value method had been applied to all outstanding and unvested awards in each period presented.

| | Year Ended December 31 | | |
|---|--------------------------------------|-------------|-------------|
| | 2002 | 2001 | 2000 |
| | ----- | | |
| | 2002 | 2001 | 2000 |
| | ----- | | |
| | (In millions, except per share data) | | |
| Net loss, as reported | \$(4,114) | \$(14,774) | \$(10,176) |
| Deduct: Total stock-based employee compensation expense determined under fair value method for all awards | (1) | (13) | (217) |
| | ----- | | |
| Pro forma net loss | \$ (4,115) | \$ (14,787) | \$ (10,393) |
| | ===== | | |
| Loss per common share: | | | |
| Basic - as reported | \$ (0.41) | \$ (1.50) | \$ (1.04) |
| | ===== | | |
| Basic - pro forma | \$ (0.41) | \$ (1.50) | \$ (1.06) |
| | ===== | | |
| Diluted - as reported | \$ (0.41) | \$ (1.50) | \$ (1.04) |
| | ===== | | |
| Diluted - pro forma | \$ (0.41) | \$ (1.50) | \$ (1.06) |
| | ===== | | |

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

Accounting for the Impairment of Long-Lived Assets

The Company follows the Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". Long-lived assets other than goodwill are evaluated for impairment when events or changes in circumstances indicate the carrying amount of the assets may not be recoverable through the estimated undiscounted future cash flows from the use of these assets.

Use of Estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these consolidated financial statements are the estimated allowance for doubtful accounts receivable, inventory reserves,

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percentage of completion for long-term contracts, goodwill valuation and the deferred tax asset valuation allowance. Actual results could differ from those and other estimates.

New Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 146 ("SFAS 146"), "Accounting for Costs Associated with Exit or Disposal Activities". This statement covers restructuring type activities beginning with plans initiated after December 31, 2002. Should the Company enter into activities covered by this standard after that date, the provisions of SFAS 146 would be applied. As a result of this standard, there is no impact on the Company's consolidated financial position or results of operations for the periods presented.

In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS 148"). SFAS 148 provides alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation as originally provided by SFAS No. 123 "Accounting for Stock-Based Compensation". Additionally, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosure in both the annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method used on reported results. The transitional requirements of SFAS 148 will be effective for all financial statements for fiscal years ending after December 15, 2002. The disclosure requirements shall be effective for financial reports containing condensed financial statements for interim periods beginning after December 31, 2002. The Company has adopted the disclosure portion of this statement for the fiscal year ended December 31, 2002. The application of this standard will have no impact on the Company's consolidated financial position or results of operations. The Company expects to continue to utilize the intrinsic value method of accounting for stock-based employee compensation.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

(2) Liquidity

As of December 31, 2002, the Company's debt included \$25,070,000 of senior debt including principal and interest, which, as a result of a March 2003 extension, matures on May 15, 2003, and principle amount \$6,144,000 of subordinated debt, which matured on July 3, 2001. The Company was unable to pay the principal (\$6,144,000) or interest (\$2,300,000) on the subordinated notes. The amount of interest represents interest from July 2000 through December 2002. At December 31, 2002, the Company did not have sufficient resources to pay either the senior lender or the subordinated lenders and it is likely that it cannot generate such cash from its operations, and the senior lender had precluded the Company from making payments on the subordinated debt. Accordingly, all senior and subordinated debt are classified as current liabilities at December 31, 2002 (note 7).

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In March 2003, the Company and its senior lender agreed to an amended and restated loan and security agreement extending the due date of the indebtedness to May 15, 2003. As part of this agreement, the senior lender continues to preclude the Company from making any payments on indebtedness to any subordinated creditors, but the Company is not prohibited from paying accounts payable in the normal course of business.

As of December 31, 2002, the Company had remaining outstanding \$385,000 of 6% Debentures which matured on July 2, 2002. Due to the restriction imposed by the Company's senior lender precluding it from making any payments on indebtedness to any subordinated debt holder, the Company was unable to pay the interest due of \$23,000 which was due on each of July 1, 2001 and 2002, and it was unable to pay the principal of \$385,000 which was due on July 2, 2002. Additionally, the Company has been notified by the trustee that the non-payment caused an event of default.

As a result of its continuing financial difficulties:

- o the Company is having and may continue to have difficulty performing its obligations under its contracts, which could result in the cancellation of contracts or the loss of future business and penalties for non-performance;
- o a number of creditors have engaged attorneys or collection agencies or commenced legal actions against the Company, and some of them have obtained judgments against the Company; and
- o the Company continued to suffer a significant decline in revenue in 2002 from 2001 following a significant decline in revenue in 2001 from 2000.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

Claimants who have already either commenced litigation or otherwise sought collection or have obtained a judgment against the Company are due approximately \$214,000. If Porta is unable to reach a settlement with these creditors and others who have not yet brought claims, and these claimants obtain judgments against the Company or seek to enforce judgments against the Company, it may be necessary for it, or its senior lender may require it, to seek protection under the Bankruptcy Code.

The creditors include five former senior executives who have deferred compensation agreements with the Company. The total payments due under these agreements are approximately \$1.9 million, of which \$133,000 was due at December 31, 2002 and an additional \$196,000 becomes due in 2003. The claimants commenced litigation that has been adjourned pending settlement. The Company is in the latter stages of settlement negotiations with these creditors.

The Company is seeking to address its need for liquidity by exploring alternatives, including the possible sale of one or more of its divisions. During 2001 and 2002, the Company was engaged in discussions with respect to the possible sale of its divisions; however, those negotiations were terminated without an agreement having been reached.

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Furthermore, if the Company sells a division, the agreement with the Company's senior lender requires it to pay the net proceeds to the senior lender. As a result of this provision and the Company's obligations to the holders of subordinated debt, unless the lenders consent to the Company retaining a portion of the net proceeds from any sale for its operations, the Company will not receive any significant amount, and may not receive any, of the net proceeds from any such sale for working capital.

During 2001 and 2002, the Company has taken steps to reduce overhead, including a reduction in personnel. The Company will continue to look to reduce costs while it seeks additional business from new and existing customers. Because of its present stock price, it is highly unlikely that the Company will be able to raise funds through the sales of its equity securities, and Porta's financial condition prevents it from issuing debt securities. In the event that the Company is unable to extend its debt obligations and sell one or more of its divisions, it cannot be assured that the Company will be able to continue in operations. Furthermore, the Company believes that its losses and its financial position, together with the continuing economic climate affecting the telecommunications industry generally, are having and will continue to have an adverse effect upon its ability to develop new business as competitors and potential customers question its ability both to perform its obligations under any agreements it may enter and to continue in business. The Company has been informally advised by British Telecommunications, which is one of its largest customers that, because of Porta's financial position, this customer will not place orders with the Company for its OSS products until it can demonstrate that it is financially viable. However, this customer continues to place orders for OSS maintenance and modest orders for line test products. The loss of this customer would have a material adverse effect upon the Company's operations.

These financial statements have been prepared assuming that the Company will continue as a going concern and, accordingly, do not include any adjustments that might result from the outcome of the uncertainties described above.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

(3) Accounts Receivable

Accounts receivable are customer obligations due under normal trade terms. The Company sells its products directly to customers, to distributors and original equipment manufacturers involved in a variety of industries including, telecommunications and military/aerospace. The Company performs continuing credit evaluations of its customers' financial condition and although it generally does not require collateral, letters of credit may be required from customers in certain circumstances. Senior management reviews accounts receivable on a monthly basis to determine if any receivables will potentially be uncollectible. Included are any accounts receivable balances that are determined to be uncollectible, along with a general reserve, in the overall allowance for doubtful accounts. After all attempts to collect a receivable have failed, the receivable is written off against the allowance. Based on the information available to the Company, it believes the allowance for doubtful accounts

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as of December 31, 2002 is adequate. However, actual write-offs might exceed the recorded allowance.

Accounts receivable included approximately \$873,000 and \$500,000 at December 31, 2002 and 2001, respectively, of revenues earned but not yet contractually billable relating to long-term contracts for specialized products. All such amounts at December 31, 2002 are expected to be billed in 2003. In addition, accounts receivable included approximately \$300,000 and \$311,000 at December 31, 2002 and 2001, respectively, of retainage balances due on various long-term contracts. All such amounts, net of reserves, at December 31, 2002 are expected to be collected in 2003 and all such amounts, net of reserves, at December 31, 2001, were collected in 2002. The allowance for doubtful accounts receivable was \$1,967,000 and \$2,168,000 as of December 31, 2002 and 2001, respectively. The allowance for doubtful accounts was increased by provisions of \$23,000, \$0, and \$730,000 and decreased by write-offs of \$224,000, \$309,000, and \$132,000 for the years ended December 31, 2002, 2001, and 2000, respectively.

(4) Inventories

Inventories consist of the following:

| | December 31, | |
|----------------------|--------------|-----------|
| | 2002 | 2001 |
| | ----- | ----- |
| Parts and components | \$1,767,000 | 3,217,000 |
| Work-in-process | 208,000 | 192,000 |
| Finished goods | 1,388,000 | 1,797,000 |
| | ----- | ----- |
| | \$3,363,000 | 5,206,000 |
| | ===== | ===== |

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES
Notes to Consolidated Financial Statements, Continued

(5) Property, Plant and Equipment

Property, plant and equipment consists of the following:

| | December 31 | | |
|-------------------------------|-------------|------------|---------------|
| | 2002 | 2001 | Estimated |
| | ----- | ----- | useful lives |
| | ----- | ----- | ----- |
| Land | \$ 132,000 | 132,000 | -- |
| Buildings | 1,110,000 | 1,060,000 | 20-50 years |
| Machinery and equipment | 7,821,000 | 7,221,000 | 3-8 years |
| Furniture and fixtures | 2,551,000 | 2,557,000 | 5-10 years |
| Transportation equipment | 74,000 | 84,000 | 4 years |
| Tools and molds | 3,774,000 | 4,108,000 | 8 years |
| Leasehold improvements | 858,000 | 822,000 | Term of lease |
| | ----- | ----- | |
| | 16,320,000 | 15,984,000 | |
| Less accumulated depreciation | | | |

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| | | |
|------------------|--------------|------------|
| and amortization | 14,518,000 | 13,656,000 |
| | ----- | ----- |
| | \$ 1,802,000 | 2,328,000 |
| | ===== | ===== |

During 2001, the Company sold its Glen Cove, New York facility for \$1,850,000 and recognized a gain on the sale of \$684,000, net of expenses of \$180,000. Of the net proceeds of \$1,670,000, \$474,000 was used to reduce outstanding principal and \$350,000 to reduce outstanding interest obligations to the Company's senior lender. The Company retained the remaining proceeds of \$846,000 for working capital purposes.

(6) Goodwill

Effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets". This statement established financial accounting and reporting standards for acquired goodwill and other intangible assets. Specifically, the standard addresses how acquired intangible assets should be accounted for after they have been recognized in the financial statements. In accordance with SFAS No. 142, intangible assets, including purchased goodwill, must be evaluated for impairment. Those intangible assets that will continue to be classified as goodwill or as other intangibles with indefinite lives are no longer amortized.

Effective January 1, 2002, the Company ceased amortization of goodwill resulting in a decrease of \$795,000 in amortization for the year ended December 31, 2002 compared to the same period in 2001. Instead of amortizing goodwill over a fixed period of time, the Company will measure the fair value of the acquired business at least annually to determine if goodwill has been impaired. In addition, the Company completed the first step of the goodwill transitional impairment test, which requires determining the fair value of the reporting units as of January 1, 2002 and comparing it to the carrying value of the reporting units net assets. The Company determined that there was no impairment loss resulting from the transitional impairment test as of January 1, 2002.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

As of December 31, 2002 and 2001, unamortized goodwill was \$2,961,000 and \$3,761,000, respectively. During the second quarter of 2002, the Company was engaged in discussions with respect to the sale of the Signal division. Based on those discussions the Company determined that goodwill was impaired and it estimated that the amount of the impairment was \$800,000. This amount was charged to operations in the quarter ended June 30, 2002. Furthermore, the Company cannot give assurances that further write-downs will not be necessary.

In December 2001, the Company determined that \$5,802,000 of goodwill associated with its OSS business unit was impaired and as such recorded an impairment loss. This assessment was based on the continued decline in sales and losses generated by the business unit over the past several years and the declining prospects for additional sales of the products based on the older technology that originally gave rise to the goodwill.

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The following schedule presents adjusted net loss, basic net loss per share and diluted net loss per share, exclusive of goodwill amortization expense, had the standard been adopted for those periods.

| | Year Ended June 30 | | |
|--|---------------------------------------|-------------|------------|
| | 2002 | 2001 | 2000 |
| | ----- | ----- | ----- |
| | (In thousands, except per share data) | | |
| Reported net loss | \$(4,114) | \$(14,774) | \$(10,176) |
| Add back: | | | |
| Goodwill amortization | -- | 795 | 719 |
| Adjusted net loss | \$ (4,114) | \$ (13,979) | \$ (9,457) |
| | ===== | ===== | ===== |
| Basic net loss per common share: | | | |
| Reported net loss | \$ (0.41) | \$ (1.50) | \$ (1.04) |
| Goodwill amortization | -- | .08 | .07 |
| Adjusted net loss | \$ (0.41) | \$ (1.42) | \$ (0.97) |
| | ===== | ===== | ===== |
| Diluted net earnings per common share: | | | |
| Reported net loss | \$ (0.41) | \$ (1.50) | \$ (1.04) |
| Goodwill amortization | -- | .08 | .07 |
| Adjusted net loss | \$ (0.41) | \$ (1.42) | \$ (0.97) |
| | ===== | ===== | ===== |

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES
Notes to Consolidated Financial Statements, Continued

(7) Senior Debt

On December 31, 2002 and 2001, Porta's senior debt consisted of debt under its credit facility in the amount of \$25,070,000 and \$22,095,000, respectively. The current agreement with the senior lender, as amended in March 2002 and March 2003 and described below, expires on May 15, 2003 and, accordingly, the senior debt has been classified as a current liability. (See Note 2)

In March 2003, the Company's senior lender agreed to an extension to May 15, 2003 of the existing agreement that had expired on December 31, 2002.

In March 2002, the senior lender agreed to an amended and restated loan and security agreement whereby a new term loan was established with a maximum principal amount of \$1,500,000 and subsequently increased in May 2002 to \$2,250,000. The agreement allowed the Company to draw monies subject to the senior lender's receipt and approval of a weekly disbursement budget. Any advances under this agreement were at the discretion of the senior lender. Obligations under the new term loan bear interest at 12%, which interest shall accrue monthly and be added to the principal until September 1, 2002 when interest for the month of August 2002 became payable and current interest became payable. The agreement provides that all indebtedness prior to March 1, 2002 is reflected as an old term loan

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in the amount of \$22,610,000, which includes the principal balance due at December 31, 2001 plus accrued interest through March 1, 2002. The old term loan bears no interest until such time as the senior lender in its sole discretion notifies the Company that interest shall be payable. Additionally, the senior lender prohibited the Company from making any payments on indebtedness to any subordinated creditors, but the Company is not prohibited from paying accounts payable in the ordinary course of business. Finally, the agreement allowed for standby letters of credit not to exceed a maximum of \$573,000. As of December 31, 2002, the Company did not have any standby letters of credit outstanding. As of December 31, 2002, the Company has borrowed \$2,250,000, the maximum principal amount under the new term loan, and the total principal and interest on the new term loan was \$2,460,000.

As consideration for an April 2001 loan amendment, the Company agreed to reduce the exercise price of the outstanding warrants to purchase approximately 570,000 shares of common stock held by its senior lender to \$0.25 per share. The value of the reduction in exercise price was \$39,000, which was recorded as interest expense and additional paid in capital. As of December 31, 2002, 100,000 of these warrants remain outstanding.

(8) 6% Convertible Subordinated Debentures

As of December 31, 2002 and 2001, the Company had outstanding \$385,000 and \$382,000 of its 6% convertible subordinated debentures due July 1, 2002 (the "Debentures"), net of original issue discount of \$0 and \$3,000, respectively. The face amount of the outstanding Debentures was \$385,000 at both December 31, 2002 and 2001. The Company has not paid interest on these Debentures since July 2000, and its senior lender prohibits it from making any payments of principal and interest (note 7). At December 31, 2002 and 2001, accrued interest on the debentures was \$58,000 and \$35,000, respectively. The trustee of the Debentures gave notice to the Company that the non-payment caused an event of default.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

(9) Subordinated Notes

As of December 31, 2002 and 2001, \$6,144,000 of Subordinated Notes were outstanding. As of December 31, 2002, \$6,144,000 of principal and \$2,300,000 of accrued interest were due and payable. However, Porta did not have the resources to pay the \$6,144,000 principal and \$2,300,000 of interest due on the subordinated debt. In addition, the senior lender had precluded the Company from making payments on the subordinated debt (note 7). During 2001, one of the noteholders unsuccessfully attempted to obtain a judgment compelling the Company to pay the past due Notes and related interest (note 20).

(10) Joint Venture

In April 2002, the Company sold its 50% interest in its Korean joint venture company, for \$450,000 to its joint venture partner. Payment was made by the forgiveness of commissions, totaling \$450,000, which were owed to its sales representation company owned by the Company's joint

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venture partner, with respect to sales made by the joint venture in Korea. The investment in the joint venture had previously been written down to zero as the Company's share of the losses of the joint venture exceeded its investment. Therefore, the transaction was reflected as a \$450,000 reduction in accrued commissions and a non-cash gain on sale of investment in joint venture.

Prior to October 1, 2001, the Company consolidated the operations of the joint venture since the Company could obtain a controlling interest at its election and the joint venture was entirely dependent on the Company for the products it sold and the receipt of management assistance from the Company. The joint venture partner's interest is shown as a minority interest through September 30, 2001. Based on the expiration of the option agreement, the reduced volume of products sold to the joint venture and reduced level of management assistance provided to the joint venture, the Company's share of the losses on its investment were recorded on the equity method effective October 1, 2001. As such losses are in excess of Porta's investment, and the Company does not guaranty such excess losses, the investment in the joint venture was carried at \$0 as of December 31, 2001.

(11) Stockholders' Equity

At December 31, 2002, the Company had outstanding (a) warrants issued to its senior lender to purchase 100,000 shares of common stock, which are currently exercisable at \$0.25 per share and expire on June 6, 2005, and (b) warrants issued to a vendor to purchase 15,000 shares of common stock, which are currently exercisable at \$1.8125 per share and expire in May, 2005.

In connection with an amendment of the Subordinated Notes in April 2000, the Company agreed to issue to the noteholders New Warrants to purchase an aggregate 127,500 shares of Common Stock at \$3.00 per share, the value of which was determined to be \$140,000 and recorded as deferred financing expenses and additional paid in capital in 2000. Additional non-cash interest expense of \$84,000 and \$56,000 was recorded during 2000 and 2001, respectively, in connection with this transaction.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

(12) Employee Benefit Plans

Porta has deferred compensation agreements with certain present and former officers and employees, with benefits commencing at retirement equal to 50% of the employee's base salary, as defined. Payments under the agreements will be made for a period of fifteen years following the earlier of attainment of age 65 or death. During 2002, 2001 and 2000, Porta accrued approximately \$122,000, \$166,000 and \$180,000, respectively, under these agreements.

In 1986, Porta established the Porta Systems Corp. 401(k) Savings Plan for the benefit of eligible employees, as defined in the Savings Plan. Participants contribute a specified percentage of their base salary up to a maximum of 15%. Porta will match a participant's contribution by an amount equal to 25% of the first 6% contributed by the participant. A

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participant is 100% vested in the balance to his credit. For the years ended December 31, 2002, 2001 and 2000, Porta's contribution amounted to \$47,000, \$54,000 and \$72,000, respectively.

In 1999, Porta established the Employee Stock Purchase Plan for the benefit of eligible employees, as defined in the Purchase Plan, which permits employees to purchase Porta's common stock at discounts up to 10%. Porta has reserved 1,000,000 shares of Porta stock for issuance under the plan. During 2002 and 2001, 55,803 and 130,256 shares, respectively, were issued pursuant to the Purchase Plan.

Porta does not provide any other post-retirement benefits to any of its employees.

(13) Incentive Plans

During 1999, Porta established an Employee Stock Bonus Plan whereby stock may be given to non-officers or directors to recognize the contributions of employees. A maximum of 95,750 shares of common stock is reserved for issuance pursuant to the Bonus Plan. No shares of common stock were issued pursuant to the Bonus Plan during 2002, 2001 and 2000.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

Porta's 1996 Stock Incentive Plan ("1996 Plan") covers 450,000 shares of common stock. Incentive stock options cannot be issued subsequent to ten years from the date the 1996 Plan was approved. Options under the 1996 Plan may be granted to key employees, including officers and directors of the Company and its subsidiaries, except that members and alternate members of the stock option committee are not eligible for options under the 1996 Plan. The exercise prices for all options granted were equal to the fair market value at the date of grant and vest as determined by the board of directors. In addition, the 1996 Plan provides for the automatic grant to non-management directors of non-qualified options to purchase 2,000 shares on May 1st of each year commencing May 1, 1996, with an exercise price equal to the average closing price of the last ten trading days of April of each year.

Porta's 1998 Non-Qualified Stock Option Plan ("1998 Plan") covers 450,000 shares of common stock. Options under the 1998 Plan may be granted to key employees, including officers and directors of the Company and its subsidiaries. The exercise prices for all options granted were equal to the fair market value at the date of grant and vest as determined by the board of directors.

Porta's 1999 Incentive and Non-Qualified Stock Option Plan ("1999 Plan") covers 400,000 shares of common stock. Incentive stock options cannot be issued subsequent to ten years from the date the 1999 Plan was approved. Options under the 1999 Plan may be granted to key employees, including officers and directors of the Company and its subsidiaries, except that members and alternate members of the stock option committee are not eligible for options under the 1999 Plan. The exercise prices for all options granted were equal to the fair market value at the date of grant and vest as determined by the board of directors. In addition, the 1999 Plan provides for the automatic grant to non-management directors of

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non-qualified options to purchase 5,000 shares on May 1st of each year commencing May 1, 1999, based upon the average closing price of the last ten trading days of April of each year; provided, however, that the non-management directors will not be granted non-qualified options pursuant to the 1999 Plan for any year to the extent options are granted under the 1996 Plan for such year.

During 1999, pursuant to an employment contract with an officer, Porta issued options to purchase 15,000 shares of common stock at \$1.75 per share. The exercise prices approximated market value on the date of issuance. The options expire in May 2005. As of December 31, 2002, all of these options have been forfeited.

(Continued)

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PORTA SYSTEMS CORP. AND SUBSIDIARIES Notes to Consolidated Financial Statements, Continued

The weighted-average fair values of options granted were \$0.05, \$0.23 and \$1.62 per share for options granted in 2002, 2001 and 2000, respectively.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions for 2002, 2001 and 2000:

| | 2002 | 2001 | 2000 |
|---------------------|------------------|------------------|------------------|
| | ----- | ----- | ----- |
| Dividends: | \$0.00 per share | \$0.00 per share | \$0.00 per share |
| Volatility: | 100% | 100% | 57.64%-68.70% |
| Risk-free interest: | 4.22%-5.48% | 4.22%-5.48% | 5.54%-6.53% |
| Expected term: | 5 - 9.6 years | 5 -9.6years | 5 years |

A summary of the status of Porta's stock option plans as of December 31, 2002, 2001, and 2000, and changes during the years ending on those dates is presented below:

| | 2002 | | 2001 | | 2000 | |
|---------------------------------|-----------------|--|-----------------|--|-----------------|-------------------------|
| | ----- | ----- | ----- | ----- | ----- | ----- |
| | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price | Shares | Weigh Avera Exerc |
| | Under Option | ----- | Under Option | ----- | Under Option | ----- |
| Outstanding beginning of year | 801,705 | \$3.96 | 949,713 | \$2.55 | 870,538 | \$2.5 |
| Granted | 15,000 | 0.07 | 55,000 | 0.29 | 108,500 | 3.1 |
| Exercised | -- | | -- | | (6,000) | 1.5 |
| Forfeited | (215,175) | 2.11 | (203,008) | 2.58 | (23,325) | 2.8 |
| | ----- | | ----- | | ----- | |
| Outstanding end of year | 601,530 | \$3.96 | 801,705 | \$3.96 | 949,713 | \$2.5 |
| | ===== | | ===== | | ===== | |
| Options exercisable at year-end | 567,647 | | 698,105 | | 807,780 | |
| | ===== | | ===== | | ===== | |

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The following table summarizes information about stock options outstanding under the stock option plans at December 31, 2002:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | |
|-----------------------------|----------------------------|-------------------------------|------------------------------------|----------------------------|--|
| | Outstanding at 12/31/02 | Remaining Contractual Life | Weighted-average Exercise Price | Exercisable at 12/31/02 | Weighted- average Exercise Price |
| ----- | ----- | ----- | ----- | ----- | ----- |