

SPECTRUM CONTROL INC  
Form 10-Q  
June 27, 2003

**SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10Q**

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Period Ended May 31, 2003

Commission File Number 0-8796

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**Spectrum Control, Inc.**

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Exact name of registrant as specified in its charter

Pennsylvania

25-1196447

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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification Number)

8031 Avonia Road; Fairview, Pennsylvania

16415

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(Address)

(Zip Code)

Registrant's telephone number, including area code:

(814) 474-2207

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Former name, former address and former fiscal year, if changed since last report

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 the filing requirements for at least the past 90 days. Yes  No

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

| <b>Class</b>         | <b>Number of Shares Outstanding<br/>as of June 16, 2003</b> |
|----------------------|---|
| Common, no par value | 12,928,977  |

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**SPECTRUM CONTROL, INC. AND SUBSIDIARIES**

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**SPECTRUM CONTROL, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Balance Sheets**  
**(Unaudited)**

| ( Dollar Amounts in Thousands )   | May 31,<br><u>2003</u> | November 30,<br><u>2002</u> |
|---|------------------------|-----------------------------|
| <b>Assets</b>   |                        |                             |
| Current Assets  |                        |                             |
| Cash and cash equivalents   | \$ 22,133              | \$ 19,934                   |
| Accounts receivable, less allowances of \$ 953<br>in 2003 and \$ 896 in 2002                              | 10,469                 | 10,035                      |
| Inventories   | 13,493                 | 14,494                      |
| Deferred income taxes   | 1,869                  | 1,869                       |
| Income tax refund receivable  | 820                    | 833                         |
| Prepaid expenses and other current assets   | <u>1,055</u>           | <u>614</u>                  |
| Total current assets  | <u>49,839</u>          | <u>47,779</u>               |
| Property, Plant And Equipment, Net  | <u>14,013</u>          | <u>15,543</u>               |
| Other Assets  |                        |                             |
| Goodwill, net   | 18,019                 | 18,019                      |
| Other noncurrent assets   | <u>507</u>             | <u>483</u>                  |
| Total other assets  | <u>18,526</u>          | <u>18,502</u>               |
| Total Assets  | <u>\$ 82,378</u>       | <u>\$ 81,824</u>            |
| <b>Liabilities And Stockholders' Equity</b>   |                        |                             |
| Current Liabilities   |                        |                             |
| Accounts payable  | \$ 2,934               | \$ 3,033                    |
| Income taxes payable  | 154                    | 175                         |
| Accrued liabilities   | 1,902                  | 1,685                       |
| Current portion of long-term debt   | <u>285</u>             | <u>285</u>                  |
| Total current liabilities   | <u>5,275</u>           | <u>5,178</u>                |
| Long-Term Debt  | 2,127                  | 2,391                       |
| Deferred Income Taxes   | 3,628                  | 3,580                       |
| Stockholders' Equity  |                        |                             |
| Common stock, no par value, authorized<br>25,000,000 shares, issued 13,604,977<br>shares in 2003 and 2002 | 43,777                 | 43,777                      |
| Retained earnings   | 31,532                 | 31,116                      |
| Treasury stock, 676,000 shares in 2003<br>and 657,600 shares in 2002, at cost                             | (3,628)                | (3,537)                     |
| Accumulated other comprehensive loss  | <u>(333)</u>           | <u>(681)</u>                |
| Total stockholders' equity  | <u>71,348</u>          | <u>70,675</u>               |

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Total Liabilities And Stockholders' Equity \$ 82,378 \$ 81,824

The accompanying notes are an integral part of the financial statements.

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**SPECTRUM CONTROL, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Operations**  
**(Unaudited)**

( Amounts in Thousands Except Per Share Data )

|  | Three Months Ended |                | Six Months Ended |                  |
|--|--------------------|----------------|------------------|------------------|
|  | <u>May 31,</u>     |                | <u>May 31,</u>   |                  |
|  | <u>2003</u>        | <u>2002</u>    | <u>2003</u>      | <u>2002</u>      |
| Net sales  | \$ 15,470          | \$ 14,353      | \$ 30,716        | \$ 25,846        |
| Cost of products sold                                | <u>11,983</u>      | <u>11,780</u>  | <u>23,966</u>    | <u>22,339</u>    |
| Gross margin   | 3,487              | 2,573          | 6,750            | 3,507            |
| Selling, general and<br>administrative expense       | <u>3,103</u>       | <u>3,126</u>   | <u>6,223</u>     | <u>6,015</u>     |
| Income ( loss ) from operations                      | 384                | (553)          | 527              | (2,508)          |
| Other income ( expense ) :                           |                    |                |                  |                  |
| Interest expense                                     | (28)               | (35)           | (57)             | (77)             |
| Other income and expense, net                        | <u>44</u>          | <u>885</u>     | <u>203</u>       | <u>1,040</u>     |
|  | <u>16</u>          | <u>850</u>     | <u>146</u>       | <u>963</u>       |
| Income ( loss ) before provision<br>for income taxes | 400                | 297            | 673              | (1,545)          |
| Provision for income taxes ( benefit )               | <u>152</u>         | <u>115</u>     | <u>257</u>       | <u>(583)</u>     |
| Net income ( loss )                                  | <u>\$ 248</u>      | <u>\$ 182</u>  | <u>\$ 416</u>    | <u>\$ (962)</u>  |
| Earnings ( loss ) per common share :                 |                    |                |                  |                  |
| Basic  | <u>\$ 0.02</u>     | <u>\$ 0.01</u> | <u>\$ 0.03</u>   | <u>\$ (0.07)</u> |
| Diluted  | <u>\$ 0.02</u>     | <u>\$ 0.01</u> | <u>\$ 0.03</u>   | <u>\$ (0.07)</u> |
| Average number of common shares<br>outstanding :     |                    |                |                  |                  |
| Basic  | <u>12,934</u>      | <u>13,134</u>  | <u>12,940</u>    | <u>13,118</u>    |
| Diluted  | <u>12,955</u>      | <u>13,235</u>  | <u>12,961</u>    | <u>13,118</u>    |

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Dividends per share \$ - \$ - \$ - \$ -

The accompanying notes are an integral part of the financial statements.

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**SPECTRUM CONTROL, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Cash Flows**  
**(Unaudited)**

( Dollar Amounts in Thousands )

|  | Six Months Ended |                  |
|--|------------------|------------------|
|  | <u>May 31,</u>   |                  |
|  | <u>2003</u>      | <u>2002</u>      |
| Cash Flows From Operating Activities :   |                  |                  |
| Net income (loss)  | \$ 416           | \$ (962)         |
| Adjustments to reconcile net income (loss) to<br>net cash provided by operating activities : |                  |                  |
| Depreciation   | 1,899            | 2,361            |
| Amortization   | 29               | 30               |
| Deferred income taxes  | 48               | (130)            |
| Changes in assets and liabilities:   |                  |                  |
| Accounts receivable  | (134)            | 2,246            |
| Inventories  | 1,072            | 1,310            |
| Prepaid expenses and other assets  | (472)            | 1,653            |
| Accounts payable and accrued expenses  | <u>71</u>        | <u>(248)</u>     |
| Net cash provided by operating activities  | <u>2,929</u>     | <u>6,260</u>     |
| Cash Flows From Investing Activities :   |                  |                  |
| Proceeds from sale of property, plant and equipment  | -                | 1,034            |
| Purchase of property, plant and equipment  | <u>(368)</u>     | <u>(169)</u>     |
| Net cash provided by (used in) investing activities  | <u>(368)</u>     | <u>865</u>       |
| Cash Flows From Financing Activities :   |                  |                  |
| Repayment of long-term debt  | (264)            | (359)            |
| Purchase of common stock   | (91)             | (15)             |
| Net proceeds from issuance of common stock   | =                | <u>147</u>       |
| Net cash used in financing activities  | <u>(355)</u>     | <u>(227)</u>     |
| Effect of exchange rate changes on cash  | <u>(7)</u>       | <u>(15)</u>      |
| Net increase in cash and cash equivalents  | 2,199            | 6,883            |
| Cash and cash equivalents, beginning of period   | <u>19,934</u>    | <u>12,442</u>    |
| Cash and cash equivalents, end of period   | <u>\$ 22,133</u> | <u>\$ 19,325</u> |

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Cash paid during the period for :

|              |       |       |
|--------------|-------|-------|
| Interest     | \$ 84 | \$ 69 |
| Income taxes | 170   | 179   |

The accompanying notes are an integral part of the financial statements.

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#### **SPECTRUM CONTROL, INC. AND SUBSIDIARIES** **Notes to Condensed Consolidated Financial Statements** **May 31, 2003** **(Unaudited)**

##### Note 1 - Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the accompanying financial statements include all adjustments which are normal, recurring and necessary to present fairly the results for the interim periods. Operating results for interim periods are not necessarily indicative of the results that may be expected for the year.

The condensed consolidated financial statements include the accounts of Spectrum Control, Inc. and its Subsidiaries ("the Company"). To facilitate timely reporting, the fiscal quarters of the Company's German subsidiary, Spectrum Control GmbH, are based upon a fiscal year which ends October 31. All significant intercompany accounts are eliminated upon consolidation.

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

The balance sheet at November 30, 2002 has been derived from the audited financial statements at that date but does not include all of the information and notes required by generally accepted accounting principles for complete financial statements.

For further information, refer to the consolidated financial statements and notes thereto included in the Spectrum Control, Inc. and Subsidiaries annual report on Form 10-K for the fiscal year ended November 30, 2002.

##### Note 2 - Nature of Operations

The Company designs and manufactures control products and systems for the electronics industry, and has operations in the United States, Mexico and Germany. The Company offers a broad line of signal, power, and frequency control products which are used to condition, regulate, transmit, receive, or govern electronic performance. Although its products are used in many industries worldwide, the Company's largest markets are telecommunications equipment and military/aerospace.

##### Note 3 - Inventories

Inventories by major classification are as follows (in thousands):

May 31,                      November 30,

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|                     | <u>2003</u>     | <u>2002</u>     |
|---------------------|-----------------|-----------------|
| Finished goods      | \$ 2,057        | \$ 2,510        |
| Work - in - process | 4,760           | 4,803           |
| Raw materials       | <u>6,676</u>    | <u>7,181</u>    |
|                     | <u>\$13,493</u> | <u>\$14,494</u> |

Inventories are presented net of aggregate inventory reserves of \$3,155,000 at May 31, 2003 and \$3,980,000 at November 30, 2002.

Note 4 - Property, Plant and Equipment

Property, plant and equipment by major classification are as follows (in thousands):

|                               | May 31,<br><u>2003</u> | November 30,<br><u>2002</u> |
|-------------------------------|------------------------|-----------------------------|
| Land and improvements         | \$ 1,127               | \$ 1,127                    |
| Buildings and improvements    | 10,876                 | 10,879                      |
| Machinery and equipment       | <u>26,773</u>          | <u>26,357</u>               |
|                               | 38,776                 | 38,363                      |
| Less accumulated depreciation | <u>24,763</u>          | <u>22,820</u>               |
|                               | <u>\$14,013</u>        | <u>\$15,543</u>             |

Note 5 - Goodwill

Effective December 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"). SFAS No. 142 changes the accounting for goodwill and other intangible assets with indefinite lives from an amortization method to an impairment-only approach. Amortization of goodwill and intangible assets with indefinite lives, including such assets recorded in past business combinations, ceases upon adoption of SFAS No. 142. Accordingly, no amortization of goodwill was recognized in the accompanying condensed consolidated statements of operations for the periods ended May 31, 2003 and 2002. On an annual basis, and when there is reason to suspect that the carrying value of goodwill has been diminished or impaired, goodwill must be tested for impairment and a writedown of the asset may be necessary. No impairment losses have been recognized in any of the periods presented herein.

Goodwill by reportable segment is as follows (in thousands):

|   | May 31,<br><u>2003</u> | November 30,<br><u>2002</u> |
|---|------------------------|-----------------------------|
| Signal integrity products                       | \$10,557               | \$10,557                    |
| Power integrity products and management systems | 3,686                  | 3,686                       |
| Frequency control products                      | <u>3,776</u>           | <u>3,776</u>                |
|   | <u>\$18,019</u>        | <u>\$18,019</u>             |

Changes in the carrying amount of goodwill are summarized as follows (in thousands):

|                    |                  |
|--------------------|------------------|
| Three Months Ended | Six Months Ended |
|--------------------|------------------|

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|                               | <u>May 31,</u>   |                  | <u>May 31,</u>   |                  |
|-------------------------------|------------------|------------------|------------------|------------------|
|                               | <u>2003</u>      | <u>2002</u>      | <u>2003</u>      | <u>2002</u>      |
| Goodwill, beginning of period | \$ 18,019        | \$ 14,243        | \$ 18,019        | \$ 14,243        |
| Goodwill acquired             | -                | -                | -                | -                |
| Goodwill impairment losses    | =                | =                | =                | =                |
| Goodwill, end of period       | <u>\$ 18,019</u> | <u>\$ 14,243</u> | <u>\$ 18,019</u> | <u>\$ 14,243</u> |

Note 6 - Other Noncurrent Assets

Other noncurrent assets by major classification are as follows (in thousands):

|                                     | <u>May 31,</u> | <u>November 30,</u> |
|-------------------------------------|----------------|---------------------|
|                                     | <u>2003</u>    | <u>2002</u>         |
| Intangible assets:                  |                |                     |
| Patents and patent rights           | \$ 574         | \$ 574              |
| Debt issuance costs                 | <u>205</u>     | <u>205</u>          |
|                                     | 779            | 779                 |
| Less accumulated amortization       | <u>515</u>     | <u>485</u>          |
|                                     | <u>264</u>     | <u>294</u>          |
| Other assets:                       |                |                     |
| Forward currency exchange contracts | -              | 17                  |
| Deferred charges                    | <u>243</u>     | <u>172</u>          |
|                                     | <u>243</u>     | <u>189</u>          |
| Other noncurrent assets             | <u>\$ 507</u>  | <u>\$ 483</u>       |

Amortization of intangible assets is expected to be approximately \$60,000 for each of the next five fiscal years.

Note 7 - Debt Agreement

The Company maintains a \$6,000,000 line of credit with its principal lending institution (the "Bank"), with interest rates on borrowings at or below the prevailing prime rate. During the periods ended May 31, 2003 and 2002, no borrowings were outstanding under this line of credit arrangement. The line of credit agreement contains certain covenants, the most restrictive of which require the Company to maintain designated minimum levels of net worth and profitability and impose certain restrictions on the Company regarding additional indebtedness. At May 31, 2003, the Company was in compliance with these debt covenants.

Effective February 28, 2003, the line of credit agreement was amended. Under the amended agreement, future borrowings if any, will be secured by the Company's accounts receivable. The amended line of credit agreement expires April 30, 2005.

Note 8 - Derivatives and Hedging Activities

From time to time, the Company enters into forward currency exchange contracts in the regular course of business to manage its exposure against foreign currency fluctuations on sales denominated in foreign currencies. The terms of these contracts are generally nine months or less.



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At May 31, 2003, the Company had no forward contracts outstanding.

### Note 9 - Earnings (Loss) Per Common Share

The following table sets forth the computation of basic and diluted earnings (loss) per common share for the periods indicated:

|                                   | <u>Three Months Ended</u> |                | <u>Six Months Ended</u> |                  |
|-----------------------------------|---------------------------|----------------|-------------------------|------------------|
|                                   | <u>May 31,</u>            |                | <u>May 31,</u>          |                  |
|                                   | <u>2003</u>               | <u>2002</u>    | <u>2003</u>             | <u>2002</u>      |
| Numerator for basic and           |                           |                |                         |                  |
| diluted earnings (loss) per       |                           |                |                         |                  |
| common share (in thousands):      |                           |                |                         |                  |
| Net income (loss)                 | <u>\$ 248</u>             | <u>\$ 182</u>  | <u>\$ 416</u>           | <u>\$ (962)</u>  |
| Denominator for basic             |                           |                |                         |                  |
| earnings (loss) per common        |                           |                |                         |                  |
| share (in thousands):             |                           |                |                         |                  |
| Weighted average                  |                           |                |                         |                  |
| shares outstanding                | <u>12,934</u>             | <u>13,134</u>  | <u>12,940</u>           | <u>13,118</u>    |
| Denominator for diluted           |                           |                |                         |                  |
| earnings (loss) per common        |                           |                |                         |                  |
| share (in thousands):             |                           |                |                         |                  |
| Weighted average                  |                           |                |                         |                  |
| shares outstanding                | 12,934                    | 13,134         | 12,940                  | 13,118           |
| Effect of dilutive securities:    |                           |                |                         |                  |
| Stock options                     | 21                        | 98             | 21                      | -                |
| Stock warrants                    | -                         | <u>3</u>       | -                       | -                |
|                                   | <u>12,955</u>             | <u>13,235</u>  | <u>12,961</u>           | <u>13,118</u>    |
| Earnings (loss) per common share: |                           |                |                         |                  |
| Basic                             | <u>\$ 0.02</u>            | <u>\$ 0.01</u> | <u>\$ 0.03</u>          | <u>\$ (0.07)</u> |
| Diluted                           | <u>\$ 0.02</u>            | <u>\$ 0.01</u> | <u>\$ 0.03</u>          | <u>\$ (0.07)</u> |

Options to purchase 791,250 shares of Common Stock, at a weighted average exercise price of \$7.58 per share, were outstanding at May 31, 2003 but were not included in the computation of diluted earnings per share because their inclusion would be antidilutive. At May 31, 2002, options and warrants to purchase 953,633 shares of Common Stock, at a weighted average exercise price of \$7.19 per share, were similarly excluded.

### Note 10- Comprehensive Income (Loss)

The components of comprehensive income (loss) are as follows (in thousands):

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|   | Three Months Ended<br><u>May 31,</u> |               | Six Months Ended<br><u>May 31,</u> |                   |
|---|--------------------------------------|---------------|------------------------------------|-------------------|
|   | <u>2003</u>                          | <u>2002</u>   | <u>2003</u>                        | <u>2002</u>       |
| Net income (loss)                           | \$ 248                               | \$ 182        | \$ 416                             | \$ (962)          |
| Foreign currency translation<br>adjustments | 92                                   | 85            | 365                                | (31)              |
| Change in fair value of derivatives         | =                                    | <u>49</u>     | <u>(17)</u>                        | <u>(41)</u>       |
| Comprehensive income (loss)                 | <u>\$ 340</u>                        | <u>\$ 316</u> | <u>\$ 764</u>                      | <u>\$ (1,034)</u> |

The components of accumulated other comprehensive loss are as follows (in thousands):

|  | May 31,<br><u>2003</u> | November 30,<br><u>2002</u> |
|--|------------------------|-----------------------------|
| Foreign currency translation adjustments | \$ (333)               | \$ (698)                    |
| Derivative financial instruments gain    | =                      | <u>17</u>                   |
| Accumulated other comprehensive loss     | <u>\$ (333)</u>        | <u>\$ (681)</u>             |

Note 11- Stock Options

The Company accounts for stock-based compensation issued to its employees and directors in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", and related Interpretations. Accordingly, the Company has elected to adopt the "disclosure only" provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS No. 148"). SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 requires new prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results.

For SFAS No. 148 purposes, the fair value of each option granted under the Company's stock option plans is estimated as of the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 2.00% in 2003 and 2002; volatility factor of the expected market price of the Company's Common Stock of 0.50 in 2003 and 0.58 in 2002; dividend yield of 0.00% each year; and a weighted average expected option life of five years.

If the Company had elected to recognize the compensation cost of its stock option plans based on the fair value method of accounting, net income (loss) and earnings (loss) per common share would have been increased (decreased) to the pro forma amounts below ( in thousands, except per share data):

|                                  | Three Months Ended<br><u>May 31,</u> |             | Six Months Ended<br><u>May 31,</u> |             |
|----------------------------------|--------------------------------------|-------------|------------------------------------|-------------|
|                                  | <u>2003</u>                          | <u>2002</u> | <u>2003</u>                        | <u>2002</u> |
| Net income (loss)<br>as reported | \$ 248                               | \$ 182      | \$ 416                             | \$ (962)    |
| Less: Stock-based employee       |                                      |             |                                    |             |

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|                                    |              |              |              |                   |
|------------------------------------|--------------|--------------|--------------|-------------------|
| compensation expense               |              |              |              |                   |
| determined under fair value        |              |              |              |                   |
| method, net of related tax effects | <u>175</u>   | <u>137</u>   | <u>350</u>   | <u>274</u>        |
| Pro forma net income (loss)        | <u>\$ 73</u> | <u>\$ 45</u> | <u>\$ 66</u> | <u>\$ (1,236)</u> |
| Earnings (loss) per common share:  |              |              |              |                   |
| Basic, as reported                 | \$ 0.02      | \$ 0.01      | \$ 0.03      | \$ (0.07)         |
| Basic, pro forma                   | 0.01         | 0.00         | 0.01         | (0.09)            |
| Diluted, as reported               | 0.02         | 0.01         | 0.03         | (0.07)            |
| Diluted, pro forma                 | 0.01         | 0.00         | 0.01         | (0.09)            |

Note 12- Reportable Operating Segments

The Company was founded as a solutions - oriented company, designing and manufacturing products to suppress or eliminate electromagnetic interference ("EMI"). In recent years, the Company has broadened its focus and product lines to become a control products and systems company, providing a wide range of components and systems used to condition, regulate, transmit, receive, or govern electronic performance. Effective December 1, 2002, the Company realigned its business segments to better reflect its current strategic focus.

The Company's current operations are conducted in three reportable segments: signal integrity products; power integrity products and management systems; and frequency control products. The Company's Signal Integrity Products Group designs and manufactures a broad range of low pass EMI filters, surface mount EMI filters, filtered arrays, filtered connectors, gaskets, and specialty ceramic capacitors. The Power Integrity Products and Management Systems Group designs and manufactures numerous power integrity products (power line filters, power entry modules, multisection filters, power terminal blocks, and custom power filter assemblies) and power management systems (power distribution units, remote power management systems, fuse interface panels, breaker interface panels, and custom power distribution systems). Our recently developed Frequency Control Products Group designs and manufactures ceramic resonators and bandpass filters, ceramic patch antennas, duplexers, lumped element filters, cavity filters, waveguide filters, and related products and systems. The reportable segments are each managed separately because they manufacture and sell distinct products with different production processes.

The Company evaluates performance and allocates resources to its reportable segments based upon numerous factors, including segment income or loss before income taxes. The accounting policies of the reportable segments are the same as those utilized in the preparation of the Company's consolidated financial statements. However, substantially all of the Company's selling expenses, general and administrative expenses, and nonoperating expenses are not allocated to the Company's reportable operating segments and, accordingly, these expenses are not deducted in arriving at segment income or loss. Segment reportable assets are comprised of certain tangible assets (property, plant, equipment, and inventories) and goodwill.

Prior period amounts in the following tables have been restated to correspond with the new business segment presentation. For each period presented, the accounting policies and procedures used to determine segment income (loss) have been consistently applied. Reportable segment information for the periods ended May 31, 2003 and 2002 is as follows (in thousands):

|                                     | <u>Signal<br/>Integrity<br/>Products</u> | <u>Power<br/>Integrity<br/>Products and<br/>Mgt. Systems</u> | <u>Frequency<br/>Control<br/>Products</u> | <u>Total</u> |
|-------------------------------------|--|--|---|--------------|
| Three Months Ended May 31:          |  |  |   |              |
| <u>2003</u>                         |  |  |   |              |
| Revenue from unaffiliated customers | \$ 10,932                                | \$ 2,795   | \$ 1,743                                  | \$ 15,470    |
| Segment income (loss)               | 2,970                                    | 151  | (15)                                      | 3,106        |

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|                 |        |       |       |        |
|-----------------|--------|-------|-------|--------|
| Segment assets  |        |       |       |        |
| Tangible assets | 17,416 | 7,126 | 1,655 | 26,197 |
| Goodwill        | 10,557 | 3,686 | 3,776 | 18,019 |

2002

|                                     |        |       |       |        |
|-------------------------------------|--------|-------|-------|--------|
| Revenue from unaffiliated customers | 11,187 | 2,740 | 426   | 14,353 |
| Segment income (loss)               | 2,732  | (411) | (109) | 2,212  |
| Segment assets                      |        |       |       |        |
| Tangible assets                     | 22,528 | 8,390 | 648   | 31,566 |
| Goodwill                            | 10,557 | 3,686 | -     | 14,243 |

|                          |  |  |   |              |
|--------------------------|--|--|---|--------------|
|                          | <u>Signal<br/>Integrity<br/>Products</u> | <u>Power<br/>Integrity<br/>Products and<br/>Mgt. Systems</u> | <u>Frequency<br/>Control<br/>Products</u> | <u>Total</u> |
| Six Months Ended May 31: |  |  |   |              |

2003

|                                     |           |          |          |           |
|-------------------------------------|-----------|----------|----------|-----------|
| Revenue from unaffiliated customers | \$ 21,722 | \$ 5,589 | \$ 3,405 | \$ 30,716 |
| Segment income (loss)               | 5,969     | 50       | (29)     | 5,990     |
| Segment assets                      |           |          |          |           |
| Tangible assets                     | 17,416    | 7,126    | 1,655    | 26,197    |
| Goodwill                            | 10,557    | 3,686    | 3,776    | 18,019    |

2002

|                                     |        |         |       |        |
|-------------------------------------|--------|---------|-------|--------|
| Revenue from unaffiliated customers | 20,050 | 5,007   | 789   | 25,846 |
| Segment income (loss)               | 4,241  | (1,103) | (310) | 2,828  |
| Segment assets                      |        |         |       |        |
| Tangible assets                     | 22,528 | 8,390   | 648   | 31,566 |
| Goodwill                            | 10,557 | 3,686   | -     | 14,243 |

A reconciliation of total reportable segment income to consolidated income (loss) before provision for income taxes for the periods ended May 31, 2003 and 2002 is as follows (in thousands):

|                                      |                    |             |                  |             |
|--------------------------------------|--------------------|-------------|------------------|-------------|
|                                      | Three Months Ended |             | Six Months Ended |             |
|                                      | <u>May 31,</u>     |             | <u>May 31,</u>   |             |
|                                      | <u>2003</u>        | <u>2002</u> | <u>2003</u>      | <u>2002</u> |
| Total income for reportable segments | \$ 3,106           | \$ 2,212    | \$ 5,990         | \$ 2,828    |

Unallocated amounts:

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|   |               |               |               |                   |
|---|---------------|---------------|---------------|-------------------|
| Selling, general and administrative expense                     | (2,722)       | (2,765)       | (5,463)       | (5,336)           |
| Interest expense  | (28)          | (35)          | (57)          | (77)              |
| Other income  | <u>44</u>     | <u>885</u>    | <u>203</u>    | <u>1,040</u>      |
| Consolidated income (loss) before provision for<br>income taxes | <u>\$ 400</u> | <u>\$ 297</u> | <u>\$ 673</u> | <u>\$ (1,545)</u> |

### Note 13 - Contingencies

The Company is subject to certain legal proceedings and claims arising in the ordinary course of business. In the opinion of management, the amount of any ultimate liability with respect to these actions will not materially affect the Company's consolidated financial position or results of operations.

### Note 14 - Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46, "Consolidation of Variable Interest Entities". This Interpretation applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. The Company has evaluated the provisions of this Interpretation and determined that it will not have an impact on its consolidated financial statements upon adoption.

In April 2003, the FASB issued Statement of Financial Accounting Standards No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS No. 149"). SFAS No. 149 improves financial reporting by requiring contracts with comparable characteristics be accounted for similarly. The Statement clarifies the circumstances in which a contract with an initial net investment meets the characteristics of a derivative and when a derivative contains a financing component, and amends certain other existing pronouncements. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003. The Company is currently evaluating the provisions of this Statement.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS No. 150"). The Statement improves the accounting for certain financial instruments that, under previous guidance, issuers could account for as equity. The new Statement requires those instruments be classified as liabilities in statements of financial position. SFAS No. 150 also requires disclosures about alternative ways of settling financial instruments and the capital structure of entities whose shares are mandatorily redeemable. Most of the guidance in SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company is currently evaluating the provisions of the Statement.

### Top of Report

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## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis may be understood more fully by reference to the consolidated financial statements, notes to the consolidated financial statements, and management's discussion and analysis contained in the Spectrum Control, Inc. and Subsidiaries annual report on Form 10-K for the fiscal year ended November 30, 2002. All references to "we", "us", "our", or the "Company" in the following discussion and analysis mean Spectrum Control, Inc. and its Subsidiaries.

### **Overview**

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We were founded as a solutions-oriented company, designing and manufacturing products to suppress or eliminate electromagnetic interference ("EMI"). In recent years, we broadened our focus and product lines to become a control products and systems company, providing a wide range of components and systems used to condition, regulate, transmit, receive, or govern electronic performance. Although our components and systems are used in many industries worldwide, our largest markets are telecommunications equipment and military/aerospace which represented 42.0% and 30.0%, respectively, of our fiscal 2002 sales. In telecommunications, our products are used in numerous systems including wireless base stations, optical networks, broadband switching equipment, and global positioning systems. Military/aerospace applications for our products include missile defense systems, smart weapons and munitions, secure communications, simulation equipment, and avionics upgrades. Our other markets include medical instrumentation, industrial equipment, computer, and automotive.

Our operations are currently conducted in three reportable segments: signal integrity products; power integrity products and management systems; and frequency control products. Our Signal Integrity Products Group designs and manufactures a broad range of low pass EMI filters, surface mount EMI filters, filtered arrays, filtered connectors, gaskets, and specialty ceramic capacitors. Our Power Integrity Products and Management Systems Group designs and manufactures numerous power integrity products (power line filters, power entry modules, multisection filters, power terminal blocks, and custom power filter assemblies) and power management systems (power distribution units, remote power management systems, fuse interface panels, breaker interface panels, and custom power distribution systems). Our recently developed Frequency Control Products Group designs and manufactures ceramic resonators and bandpass filters, ceramic patch antennas, duplexers, lumped element filters, cavity filters, waveguide filters, and related products and systems.

### Acquisition

On July 19, 2002, the Company acquired all of the outstanding common stock of FSY Microwave, Inc. ("FSY"). FSY, based in Columbia, Maryland, designs and manufactures various microwave filters, including lumped element filters, cavity filters, waveguide filters, and related products and systems. These products are a natural complement and extension to the Company's existing ceramic-based wireless product offerings of resonators, bandpass filters, and patch antennas. The aggregate cash purchase price for FSY was approximately \$6.5 million including legal fees and other costs directly related to the acquisition. The purchase price was entirely funded through the Company's available cash reserves. The results of operations of the acquired business have been included in the accompanying consolidated financial statements since the date of acquisition. Accordingly, FSY net sales of \$1.1 million for the three months ended May 31, 2003 and \$2.3 million for the six months ended May 31, 2003 have been included in the Company's consolidated net sales, and are reported within the Company's Frequency Control Products Group for operating segment purposes.

### Forward-Looking Information

The following discussion includes certain "forward-looking statements" within the meaning of the federal securities laws, including statements regarding: (1) our belief as to future market conditions and operating margins, (2) our anticipated capital expenditures, and (3) our expected future operating requirements and financing needs. The words "believe", "expect", "anticipate" and similar expressions identify forward-looking statements. These forward-looking statements are subject to certain risks and uncertainties which could cause actual results to differ materially from historical results or those anticipated. Factors that could cause or contribute to such differences include those discussed in "Risk Factors That May Affect Future Results", as well as those discussed elsewhere herein. Readers are cautioned not to place undue reliance on these forward-looking statements.

### Results of Operations

The following table sets forth certain financial data, as a percentage of net sales, for the three months and six months ended May 31, 2003 and 2002:

|   | Three Months Ended |             | Six Months Ended |             |
|---|--------------------|-------------|------------------|-------------|
|   | <u>May 31,</u>     |             | <u>May 31,</u>   |             |
|   | <u>2003</u>        | <u>2002</u> | <u>2003</u>      | <u>2002</u> |
| Net sales                                   | 100.0 %            | 100.0 %     | 100.0 %          | 100.0 %     |
| Cost of products sold                       | <u>77.5</u>        | <u>82.1</u> | <u>78.0</u>      | <u>86.4</u> |
| Gross margin                                | 22.5               | 17.9        | 22.0             | 13.6        |
| Selling, general and administrative expense | <u>20.0</u>        | <u>21.8</u> | <u>20.3</u>      | <u>23.3</u> |

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|   |              |              |              |                |
|---|--------------|--------------|--------------|----------------|
| Income (loss) from operations                   | 2.5          | (3.9)        | 1.7          | (9.7)          |
| Other income (expense)                          |              |              |              |                |
| Interest expense                                | (0.2)        | (0.2)        | (0.2)        | (0.3)          |
| Other income and expense, net                   | <u>0.3</u>   | <u>6.2</u>   | <u>0.7</u>   | <u>4.0</u>     |
| Income (loss) before provision for income taxes | 2.6          | 2.1          | 2.2          | (6.0)          |
| Provision for income taxes (benefit)            | <u>1.0</u>   | <u>0.8</u>   | <u>0.8</u>   | <u>(2.3)</u>   |
| Net income (loss)                               | <u>1.6 %</u> | <u>1.3 %</u> | <u>1.4 %</u> | <u>(3.7) %</u> |

The following table sets forth the Company's net sales by reportable operating segments for the three months and six months ended May 31, 2003 and 2002 (in thousands):

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | <u>May 31,</u>     |                  | <u>May 31,</u>   |                  |
|   | <u>2003</u>        | <u>2002</u>      | <u>2003</u>      | <u>2002</u>      |
| Signal Integrity Products                       | \$ 10,932          | \$ 11,187        | \$ 21,722        | \$ 20,050        |
| Power Integrity Products and Management Systems | 2,795              | 2,740            | 5,589            | 5,007            |
| Frequency Control Products                      | <u>1,743</u>       | <u>426</u>       | <u>3,405</u>     | <u>789</u>       |
|   | <u>\$ 15,470</u>   | <u>\$ 14,353</u> | <u>\$ 30,716</u> | <u>\$ 25,846</u> |

Second Quarter 2003 Versus Second Quarter 2002

Net Sales

Our net sales increased by \$1.1 million during the period, with consolidated net sales of \$15.5 million in the second quarter of fiscal 2003 and \$14.4 million in the comparable quarter of 2002. This increase primarily reflects the impact of FSY product sales. Sales of signal integrity products amounted to \$10.9 million in the current quarter, versus \$11.2 million in the same quarter last year. Power integrity product sales also decreased slightly during the period, from \$2.5 million in the second quarter of fiscal 2002 to \$2.3 million in the current quarter. Sales of power management systems amounted to \$486,000 in the current period, an increase of \$225,000 from the second quarter of last year. Sales of frequency control products totaled \$1.7 million in the current quarter, including FSY product shipments of \$1.1 million. In the comparable quarter of last year, sales of frequency control products were \$426,000, consisting mostly of ceramic resonators, bandpass filters, and patch antennas. With the acquisition of FSY, we currently offer our customers a much broader line of frequency control products. Overall, average selling prices remained relatively stable throughout all of our product lines.

Customer orders received in the second quarter of fiscal 2003 amounted to \$15.0 million, up 2.5% from the comparable period of 2002. Our sales order backlog was approximately \$24.1 million at May 31, 2003, compared to \$24.5 million at the end of last fiscal year.

Early in 2001 the telecommunications equipment market, our largest market, began to experience a severe industry-wide downturn. Although this unprecedented downturn has recently demonstrated some signs of moderating, overall market demand for telecommunications equipment continues to be volatile with the timing and extent of the market's recovery still uncertain. We cannot forecast with any degree of certainty when an increase in telecom equipment spending may be expected, nor can we forecast what normal customer spending levels may be once this structural market correction is completed.

Gross Margin

In the second quarter of 2003, gross margin was \$3.5 million or 22.5% of sales. For the second quarter of last year, gross margin was \$2.6 million or 17.9% of sales. With the severe slowdown in the telecommunications equipment industry and a weak overall economy adversely affecting our other markets, our sales in the second quarter of fiscal 2002 were significantly below previously planned levels. As a result, gross margin in last year's second quarter was negatively impacted by labor inefficiencies and lower absorption of fixed manufacturing overhead. Throughout fiscal 2002, we identified and implemented numerous cost reduction programs to better align our operations with current business expectations. As a result of these efforts, gross margin throughout fiscal 2003 is expected to

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approximate 21.0% to 22.5% of net sales. At May 31, 2003, we had a total workforce of 795 employees, including FSY personnel of 84. A year ago, we had a total workforce of 856 employees. In light of current business conditions, we will continue to review our organization and cost structure to further reduce operating expenses and improve efficiencies.

### Selling, General and Administrative Expense

Aggregate selling, general and administrative expense remained relatively constant throughout the period. In the second quarter of 2003 and 2002, selling expense amounted to \$1.8 million. As a percentage of sales, selling expense was 11.4% in 2003 and 12.3% in 2002. This decreased percentage principally reflects the impact of higher sales volume and certain fixed selling expenses. General and administrative expense was approximately \$1.3 million in the second quarter of fiscal 2003 and 2002.

### Other Income and Expense

We hold numerous United States and foreign patents relating to polymer multilayer ("PML") technology. We realized license fee income of \$850,000 in the second quarter of fiscal 2002 upon the granting of certain PML technology licenses. Although these licenses, as well as other PML licenses that we have previously granted, require royalties to be paid to us upon the sale of products utilizing PML technology, it is not known what future commercial value, if any, these patents and related licenses may have.

Investment income of \$48,000 in 2003 and \$34,000 in 2002 was realized from temporary cash investments.

## Six Months 2003 Versus Six Months 2002

### Net Sales

For the first half of fiscal 2003, our net sales increased by \$4.9 million or 18.8%, with consolidated sales of \$30.7 million in 2003 and \$25.8 million in 2002. In addition to FSY product sales, this increase reflects greater shipment volume for substantially all of our signal and power integrity product lines. Sales of signal integrity products amounted to \$21.7 million in the first six months of fiscal 2003, up \$1.7 million or 8.3% from the comparable period last year. Power integrity product sales increased by \$582,000 during the period, from \$4.2 million in the first half of fiscal 2002 to \$4.8 million in the current period. Sales of power management systems were flat at \$746,000 in 2003 and 2002. Although we believe the long-term market potential for these advanced power systems remains strong, their initial market introduction and penetration has been severely hampered by the poor current telecom market conditions. Sales of frequency control products totaled \$3.4 million in the first six months of fiscal 2003, including FSY product shipments of \$2.3 million. In the comparable period last year, sales of frequency control products were \$789,000. Average selling prices remained relatively constant throughout most of our product lines. Total customer orders received in the first half of fiscal 2003 amounted to \$30.6 million, compared to \$27.7 million in the same period last year.

### Gross Margin

For the first six months of fiscal 2003, gross margin was \$6.8 million or 22.0% of sales. In the first six months of fiscal 2002, gross margin was \$3.5 million or 13.6% of sales. The gross margin in 2002 was significantly below historical levels, primarily reflecting lower than anticipated sales volume and manufacturing inefficiencies caused by the abrupt downturn in product demand by our telecommunications equipment customers.

### Selling, General and Administrative Expense

During the first half of fiscal 2003, selling expense amounted to \$3.6 million or 11.7% of sales, compared to \$3.4 million or 13.3% of sales for the same period last year. The decrease in selling expense, as a percentage of sales, principally reflects the impact of higher sales volume and certain fixed selling expenses. In addition, effective sales commission rates decreased in 2003 and certain advertising expenditures were reduced. General and administrative expense was approximately \$2.6 million in the first six months of fiscal 2003 and 2002. In 2003, increases in legal and professional fees were substantially offset by reductions in certain variable general and administrative expenses.

### Other Income and Expense

With reduced bank indebtedness and lower average interest rates, interest expense decreased slightly during the period. For the first half of fiscal 2003, interest expense was \$57,000, a decrease of \$20,000 from the first half of last year.



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PML license and royalty fee income was \$98,000 during the first six months of 2003, compared to \$850,000 in the same period last year. Income from short-term investments amounted to \$109,000 in 2003 and \$120,000 in 2002.

### Income Taxes

Our effective income tax rate was 38.2% in 2003 and 37.7% in 2002, compared to an applicable statutory federal and state income tax rate of approximately 40.0%. Differences between the effective tax rate and statutory income tax rate principally arise from state tax provisions and foreign income tax rates.

### Risk Factors That May Affect Future Results

In fiscal year 2002, approximately 42.0% of our sales were to customers in the telecommunications industry. Our four largest customers, original equipment manufacturers of telecommunications equipment, represented an aggregate 17.0% of our total consolidated net sales in 2002. Since early in 2001, the telecommunications equipment industry has experienced a severe slowdown. If this slowdown continues or intensifies, it will have a material negative impact on our future operating performance. In addition, our results of operations may be negatively affected in the future by a variety of other factors including: competitive pricing pressures, new technologies which decrease the demand for our products, new product offerings by our competitors, product cost changes, changes in the overall economic climate, cancellation of existing customer order backlog, unanticipated impairment of assets, changes in the availability of raw materials, and changes in product mix.

### Liquidity, Capital Resources and Financial Condition

We maintain a \$6.0 million line of credit with our principal lending institution, PNC Bank, N.A. of Erie, Pennsylvania (the "Bank"), with interest rates on borrowings at or below the prevailing prime rate. At May 31, 2003, no borrowings were outstanding under the line of credit. The line of credit agreement contains certain covenants, the most restrictive of which require us to maintain designated minimum levels of net worth and profitability and impose certain restrictions on us regarding additional indebtedness. At May 31, 2003, we were in compliance with all debt covenants. Our ability to borrow in the future under this credit facility is dependent on our ongoing compliance with the restrictive covenants. Whether we continue to comply with these covenants is largely dependent on our ability to attain certain levels of operating performance and profitability in the future, for which there can be no assurance. Effective February 28, 2003, the line of credit agreement was amended. Under the amended agreement, future borrowings if any, will be secured by our accounts receivable. The amended line of credit agreement expires on April 30, 2005.

Our wholly-owned German subsidiary maintains an unsecured Euro line of credit with a German financial institution aggregating approximately \$1.1 million (Euro 1.0 million). At May 31, 2003, no borrowings were outstanding under this line of credit. Future borrowings, if any, will bear interest at rates below the prevailing prime rate and will be payable upon demand.

At May 31, 2003, we had net working capital of \$44.6 million, compared to \$42.6 million at November 30, 2002. Our current ratio remained very strong throughout the first six months of fiscal 2003. At May 31, 2003, current assets were 9.45 times current liabilities, compared to 9.23 at the end of fiscal 2002.

In response to the poor overall market conditions, and as part of our related cost containment programs, we continue to control our capital expenditures to minimum required amounts. In the first six months of fiscal 2003, our capital expenditures for property, plant and equipment amounted to \$368,000. These capital expenditures were primarily for manufacturing equipment and tooling to enhance efficiencies in our ceramic capacitor operations. At May 31, 2003, we had not entered into any material commitments for capital expenditures.

We have adopted a stock repurchase program. Under this program, we may repurchase up to \$6.0 million of the Company's outstanding Common Stock. Acquired shares are to be purchased in the open market or through privately negotiated transactions at prevailing market prices. Funding for these repurchases is expected to come from available cash reserves and borrowings under our revolving line of credit facilities. The amount and timing of the shares repurchased are based on our ongoing assessment of the Company's capital structure, liquidity, and the market price of the Company's Common Stock. The repurchased shares are held as treasury stock. During the first half of fiscal 2003, 18,400 shares were repurchased at an aggregate cost of \$91,000. Since the adoption of the stock repurchase program, 676,000 shares have been repurchased at a total cost of \$3.6 million.

As of May 31, 2003, our obligations and firm commitments are as follows (in thousands):

#### Payments Due by Period

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| <u>Contractual obligations</u> | <u>Total</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>Thereafter</u> |
|--------------------------------|--------------|-------------|-------------|-------------|-------------|-------------------|
| Long-term debt                 | \$ 2,412     | \$ 21       | \$ 285      | \$ 390      | \$ 290      | \$ 1,426          |
| Operating leases               | 2,344        | 416         | 768         | 559         | 377         | 224               |

Current financial resources, including working capital and existing lines of credit, and anticipated funds from operations are expected to be sufficient to meet operating cash requirements throughout fiscal year 2003, including scheduled long-term debt repayment, lease commitments, planned capital equipment expenditures and possible stock repurchases. There can be no assurance, however, that unplanned capital replacement or other future events will not require us to seek additional debt or equity financing and, if so required, that it will be available on terms acceptable to us.

Net cash generated by operating activities amounted to \$2.9 million during the first six months of fiscal 2003. This positive cash flow reflects our profitable operating performance, as well as improved inventory turnover rates and related inventory reductions. During the first half of 2003, as a result of various inventory control procedures, aggregate inventories decreased by \$1.1 million. Net cash generated by operating activities amounted to \$6.3 million during the first six months of fiscal 2002. This strong operating cash flow includes the refund of \$2.2 million of prepaid federal income taxes. In addition, as a result of lower sales volume and production requirements, accounts receivable and inventories decreased by \$2.2 million and \$1.3 million, respectively, during the first six months of fiscal 2002.

At May 31, 2003, goodwill represented 21.9% of total assets and 25.3% of stockholders' equity. In addition to \$3.8 million of goodwill recognized in connection with the acquisition of FSY, a majority of our recorded goodwill was recognized in 1999 in connection with our acquisition of substantially all of the assets of the Signal Conditioning Products Division of AMP Incorporated. Effective December 1, 2001, we adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"). SFAS No. 142 changes the accounting for goodwill and other intangible assets with indefinite lives from an amortization method to an impairment-only approach. Accordingly, no amortization of goodwill was recognized in the accompanying condensed consolidated statements of operations for the periods ended May 31, 2003 and 2002. On an annual basis, and when there is reason to suspect that the carrying value of goodwill has been diminished or impaired, goodwill must be tested for impairment and a writedown of the asset may be necessary. No impairment losses have been recognized in any of the periods presented herein.

### Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46, "Consolidation of Variable Interest Entities". This Interpretation applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. We have evaluated the provisions of this Interpretation and determined that it will not have an impact on our consolidated financial statements upon adoption.

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In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150, "Accounting for Certain Financial Instruments with characteristics of both Liabilities and Equity" ("SFAS No. 150"). The Statement improves the accounting for certain financial instruments that, under previous guidance, issuers could account for as equity. The new Statement requires those instruments be classified as liabilities in statements of financial position. SFAS No. 150 also requires disclosures about alternative ways of settling financial instruments and the capital structure of entities whose shares are mandatorily redeemable. Most of the guidance in SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We are currently evaluating the provisions of this Statement.

### Critical Accounting Policies

The methods, estimates and judgments we use in applying our most critical accounting policies have a significant impact on the results we report in our financial statements. The U.S. Securities and Exchange Commission has defined the most critical accounting policies as the ones that are most important to the portrayal of our financial condition and results, and require us to make our most difficult and

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subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, we believe our most critical accounting policies relate to the valuation and carrying amounts of accounts receivable, inventories, long-lived assets, and deferred tax assets.

We evaluate the collectibility of our accounts receivable based on a combination of factors including an assessment of the customer's financial condition and the length of time a receivable is past due. At May 31, 2003, our allowance for doubtful accounts was \$953,000, or approximately 8.3% of our aggregate accounts receivable. In determining the adequacy of this allowance, we have assumed that the current severe downturn in the telecommunications equipment industry will stabilize sometime in fiscal 2003. If this stabilization does not occur, or if market conditions deteriorate further, our customers may not be able to meet their financial obligations to us. Accordingly, our estimate of the recoverability of amounts due us could be reduced by a material amount.

At May 31, 2003, we had recorded inventory reserves in the aggregate amount of \$3.2 million for excess and slow-moving items. In determining the adequacy of these reserves, we considered numerous factors including current customer forecasts and estimated usage. Should these forecasts and estimates change due to market, technological or other factors, the net realizable value of our inventories may be materially less than our current carrying values.

With the adoption of SFAS No. 142, we review goodwill for possible impairment at least annually. Impairment losses are recognized when the implied fair value of goodwill is less than its carrying value. The implied fair value of goodwill is contingent upon many factors, including estimates of future discounted operating cash flows. Long-lived assets other than goodwill are reviewed for impairment whenever indicators of possible impairment exist. Impairments are recognized when the expected future operating cash flows derived from such assets are less than their carrying values. No impairment losses have been recognized in any of the periods presented herein. However, our future cash flow expectations assume that the current poor market conditions throughout the telecommunications equipment industry will begin to significantly improve in 2004. If long-term market conditions do not improve significantly, our long-lived assets may become materially impaired.

We record valuation allowances to reduce deferred tax assets when it is more likely than not that some portion of the asset may not be realized. Presently, we believe that all deferred tax assets will more likely than not be realized and a valuation allowance is not required. We evaluate the need for valuation allowances on a regular basis and make adjustments as needed. These adjustments, when made, may have a materially negative impact on our financial statements.

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### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

#### Foreign Currency

Certain of our European sales and related selling expenses are denominated in Euros, British Pounds Sterling, and other local currencies. In addition, certain of our operating expenses are denominated in Mexican Pesos. As a result, fluctuations in currency exchange rates may affect our operating results and cash flows. To manage our exposure to the Euro and British Pound Sterling, we occasionally enter into forward currency exchange contracts. At May 31, 2003, no forward currency exchange contracts were outstanding. For each of the periods presented herein, currency exchange rate gains and losses were not material.

#### Interest Rate Exposure

We have market risk exposure relating to possible fluctuations in interest rates. From time to time, we utilize interest rate swap agreements to minimize the risks and costs associated with variable rate debt. We do not enter into derivative financial instruments for trading or speculative purposes. The interest rate swap agreements are entered into with major financial institutions thereby minimizing the risk of credit loss. At May 31, 2003, no interest rate swap agreements were outstanding.

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**Item 4. Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures

The Company's Chief Executive Officer and Chief Financial Officer have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures as defined in the Securities Exchange Act of 1934 Rules 13a-14 (c) and 15d-14 (c) as of a date within 90 days of the filing date of this quarterly report on Form 10-Q (the "Evaluation Date"). Based on their review and evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its consolidated subsidiaries would be made known to them by others within those entities in a timely manner, particularly during the period in which this quarterly report on Form 10-Q was being prepared, and that no changes are required at this time.

(b) Change in Internal Controls

There were no significant changes in the Company's internal controls or in other factors that could significantly affect the Company's internal controls subsequent to the Evaluation Date, or any significant deficiencies or material weaknesses in such internal controls requiring corrective actions. As a result, no corrective actions were taken.

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**Part II. Other Information**

**Item 4. Submission of Matters to a Vote of Security Holders**

The Annual Meeting of Shareholders of the Company was held on April 7, 2003 at the Clarion Hotel, 2800 West Eighth Street, Erie, Pennsylvania at 9:00 a.m. All proposals as described in the Company's Proxy Statement dated March 1, 2003 were approved. Below are details of the matters voted upon at the meeting:

Proposal 1 - Election of Directors

Elections were held for three (3) directors to serve until the 2006 Annual Meeting of Shareholders. The results of the votes are as follows:

| <u>Name</u>         | <u>Votes For</u> | <u>Votes Against</u> |
|---------------------|------------------|----------------------|
| J. Thomas Gruenwald | 9,459,203        | 1,403,667            |
| Melvin Kutchin      | 9,457,503        | 1,405,367            |
| Gerald A. Ryan      | 9,461,703        | 1,401,167            |

The terms of the following directors extend beyond the Annual Meeting date: Edwin R. Bindseil, John P. Freeman, John M. Petersen, Richard A. Southworth, and James F. Toohey.

Proposal 2 - Amendment to Stock Option Plan

The 1996 Non-Employee Directors' Stock Option Plan (the "Plan") was amended by the Board of Directors in March 2002, subject to approval by the shareholders. The only change to the Plan was to increase the number of options from 7,500 to 12,000 granted annually under the Plan to each non-employee Director. The results of the votes are as follows:

| <u>Votes For</u> | <u>Votes Against</u> | <u>Abstentions</u> |
|------------------|----------------------|--------------------|
| 8,439,465        | 1,631,325            | 792,080            |

Proposal 3 - Appointment of Auditors

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Upon recommendation of the Audit Committee, the Board of Directors resolved to appoint Ernst & Young LLP as the Company's auditors for the fiscal year ending November 30, 2003, subject only to ratification by the shareholders. The results of the votes are as follows:

| <u>Votes For</u> | <u>Votes Against</u> | <u>Abstentions</u> |
|------------------|----------------------|--------------------|
| 9,456,610        | 1,276,035            | 130,225            |

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**Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits

99.1 - Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the quarter for which this report is filed.

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Exhibit 99.1

CERTIFICATION

Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906  
of the Sarbanes-Oxley Act of 2002

Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, each of the undersigned officers of Spectrum Control, Inc. (the "Company"), does hereby certify, to such officer's knowledge, that:

The Quarterly Report on Form 10-Q for the quarter ended May 31, 2003 (the "Form 10-Q") of the Company fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: June 25, 2003

/s/Richard A. Southworth

Richard A. Southworth  
President and Chief Executive Officer

Dated: June 25, 2003

/s/John P. Freeman

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John P. Freeman  
Senior Vice President and  
Chief Financial Officer

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**Signature**

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

Spectrum Control, Inc.  
(Registrant)

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CERTIFICATION

I, Richard A. Southworth, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Spectrum Control, Inc. (the "registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this quarterly 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 our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: June 25, 2003

/s/RICHARD A. SOUTHWORTH

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President and Chief Executive Officer

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CERTIFICATION

I, John P. Freeman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Spectrum Control, Inc. (the "registrant");
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this quarterly 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 our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: June 25, 2003

/s/JOHN P. FREEMAN

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Senior Vice President  
and Chief Financial Officer

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