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Teltone Corporation 1984 Annual Report

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*Cover Photo:
Mt. Shuksan in the
North Cascade range.*

Financial Highlights

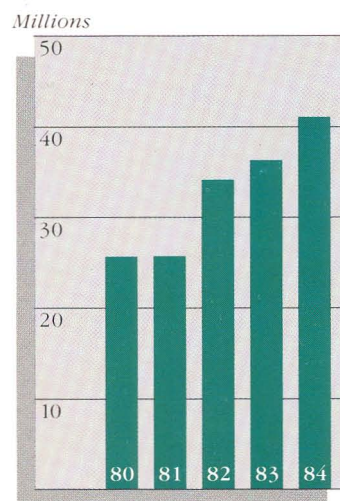
For the five years ended June 30, 1984

In thousands except per share amounts

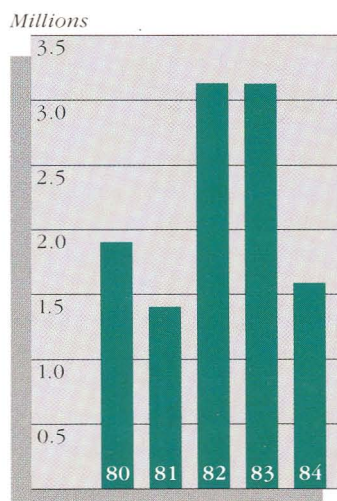
	1980	1981	1982	1983	1984
Operations					
Net sales	\$25,449	\$25,620	\$34,124	\$36,227	\$40,956
Gross margin	11,389	11,169	16,116	18,036	19,006
Income (loss) before income tax	3,437	2,572	5,750	4,869	(1,216)
Net income	1,902	1,412	3,125	3,120	1,580
Per Share Data*					
Net income per share	\$.38	\$.27	\$.59	\$.56	\$.28
Stockholders' equity per share	2.07	2.24	2.70	3.33	3.54
Dividends per share03	.03	.04	none	none
Average common and common equivalent shares outstanding	5,034,688	5,148,072	5,315,992	5,528,560	5,718,918
Other Financial Statistics					
Working capital	\$ 6,100	\$ 7,712	\$10,431	\$12,485	\$13,436
Property, plant and equipment, net	5,737	5,384	5,479	7,359	12,556
Total assets	16,197	17,661	22,143	28,256	35,975
Long term obligations	2,431	2,382	2,726	3,774	6,899
Stockholders' equity	9,539	10,897	13,750	17,941	20,256
Other Statistics					
Current ratio	2.4 to 1	2.8 to 1	2.8 to 1	2.9 to 1	2.5 to 1
Long-term debt to equity3 to 1	.2 to 1	.2 to 1	.2 to 1	.3 to 1
Number of employees at end of year	495	426	445	463	548

*Reflects an eight-for-one stock split effective September 9, 1983

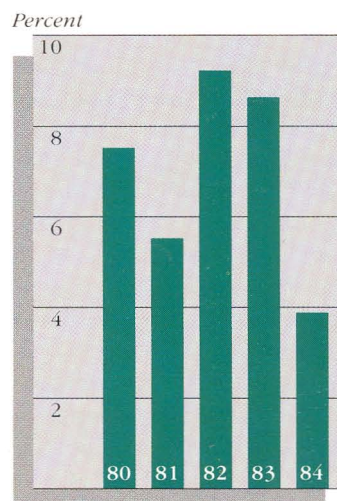
Net Sales



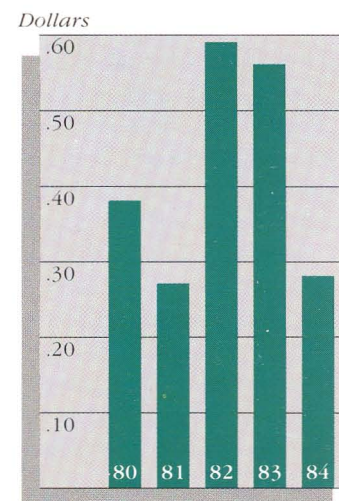
Net Income



Return on Sales



Income per Share



To the Shareholders

September 5, 1984

We have somewhat altered the format of this year's annual report, and have included more information about the Company in the body of the report, and less information in the letter to the shareholders. I hope you will find the report to be both informative and complete.

Net sales for the fourth fiscal quarter were \$11,379,000, and while we showed a net loss after taxes of \$16,100, we lost \$312,800 on an operating basis, the second consecutive quarter of operating losses. This brought to a close our fiscal 1984 with an operating loss of \$33,800, the first time we have had such a loss since our fiscal 1971, which was during the startup of our Company. While much of the poor financial performance can be attributed to expenditures targeted at accelerating future growth, nevertheless the performance was unacceptable, and we are striving diligently to return to profitability at the earliest possible time.

We are still in the throes of completing major projects and introducing them to the marketplace. Early deliveries of the Cascade 30 Digital Key Telephone System have been made, and customer reception appears to be very good. Since this is a product that was developed on contract and is being produced in Taiwan, the margins are not up to historic standards, and it will be some time before that product achieves adequate levels of profitability. The first installation of the Cascade 400 Digital Private Branch Exchange has been in our own plant, and after fairly extensive debugging, the system is operating well. Two more trial installations are scheduled for September. Bringing the CallData System to market is dependent on the in-house completion of hardware, software, and systems integration aspects of that major product. Substantial progress has been made, but much remains to be accomplished.

Until recently our Local Area Communications Business Unit, headed by Dale Johnson, had encompassed both our voice products (Cascade 30, Cascade 400, and key system enhancements) and our data products (Data Carrier System and associated products). Each of these segments of local area communications has significant growth potential in its own right, and even though we expect some integration of voice and data applications to occur in the coming years, as of now the product lines are separate and each segment has its own sales force. Therefore, in order to more fully capitalize on the total potential, on July 5th a new business unit was formed to handle the data segment. It is headed by John Foulkes, who joined the Company in 1977 and was the original architect of the Data Carrier System, which is currently the heart of the data product line.

The year just ended was full of challenge and change, some of it quite unsettling. I greatly appreciate the support and understanding of all our employees, and of our outside shareholders.



Charles L. Anderson
Chairman

The Year in Review

Teltone Corporation was founded 16 years ago to capitalize on changes taking place in telecommunications: the advent of tone dialing and the regulatory decisions which created the interconnect industry. The historic strategy of the Company was to pursue market niches which were not likely to attract competition from larger concerns with significantly greater resources, a strategy which allowed the Company to grow rapidly using internally generated funds. Beginning with key system intercoms, service observation equipment, and tone-to-rotary dial pulse converters, the Company has continued to develop products which enhance existing switching equipment, and at the same time has begun to seek other avenues for long-term growth.

The Company's older products, tone-to-pulse converters, key system enhancements, and service observation equipment, are single circuit boards and small systems. Their competitiveness has been maintained through cost reduction programs, high volume manufacturing, and/or continual feature enhancement. Though still significant contributors of revenue, these have, for the most part, reached maturity through saturation of the market and, in some cases, obsolescence of the devices which they are designed to enhance. In parallel with this process, a few product lines have emerged from the old, and the company has invested significant resources in new product development.

Given the market niche strategy, a large portion of the Company's history has been a series of overlapping birth to maturity cycles for a relatively large number of products.

The remainder of the Company's history, the developments of the last four years, are a strategic effort to leverage the Company's resources and expertise to develop larger systems in pursuit of larger markets.

Data Products

Transmission of data over the telephone network was pioneered by the telephone companies, and in recent years the distinction between the voice and data markets has diminished. This is due to advances in microprocessor technology, the accompanying increase in software based products, and the tremendous market for products which process and transmit information.

In 1980 Teltone introduced its Data Carrier System (DCS), which allows the intrabuilding telephone wiring, and wiring between buildings up to a mile radius, to be used for data transmission at the same time that wiring is carrying normal voice traffic. This can provide significant savings over dedicated cabling for data and allows terminals to be added and relocated with the same speed as telephone sets.

In the last fiscal year the Company began to move from a distributor network for sales of this product family to a dedicated sales force. The Company's commitment to this market was demonstrated by the tripling of the sales force during 1983.

The product line has been steadily expanded. Teltone T1 compatible multiplexers utilize four-wire telephone lines for dedicated intersite communications, and, via a cross marketing agreement with Tellabs Incorporated, Teltone offers their statistical multiplexers which make efficient use of transmission lines at high speeds. This year Teltone introduced the Tellabs switching multiplexer, which networks together both the statistical multiplexers and the DCS equipment without limitations of distance. Also, Teltone introduced a synchronous version of the DCS product, thereby expanding the potential market for that line.

In fiscal 1983, through a loan agreement with Peripheral Technology, Incorporated, Teltone introduced asynchronous to binary synchronous protocol converters and IBM 3278 look-alike, asynchronous terminals. These products, combined with the Company's DCS equipment, were expected to provide a cost-effective alternative to the IBM 3278 in certain applications. However, the low baud rate of the terminal and price reductions of competitive products resulted in these products not being successful, and they were discontinued.

Built under license from British Telecom and enhanced by Telton, the Cascade 400 provides up to 400 ports for small to medium-sized businesses. British Telecom has purchased a test and validation system from Telton in a return of technology.



In promoting its unique PBX and key system equipment Teltone has adopted the theme "The new natural resource for voice and data communications." The photograph of Mt. Shuksan has been used in trade advertising to symbolize the theme. Advertising in support of sales to direct customers will be undertaken as a joint venture between Teltone and its dealers for the Cascade systems.



Amost everywhere you turn these days, someone is announcing another "breakthrough" in office integration. Meanwhile, disputes about different media and protocols go unresolved. And with more than 150 companies offering local area networking equipment, it's getting hard to see the forest for the trees.

When it comes to integrating voice and data at the lowest possible cost per channel, however, there is one clear and simple solution. It's Teltone's Data Carrier System, which has become the industry standard for cost-effectiveness in local area networks.

After the success of Data Carrier—and 15 years as a respected supplier of telecommunications equipment—expanding our line with complementary networking products seemed perfectly natural.

Take our new switching systems, for example. The Cascade 30® Digital Key Telephone System makes voice/data integration affordable in groups of less than 30 ports.

Our Cascade 400® System is a fully-featured digital PBX that is based on advanced but proven technology.

Add to these our packet switch, statistical and time division multiplexers, protocol converters and IBM look-alike terminals, and you'll discover that Teltone provides a powerful array of networking tools.

What's more, all of them are available now.

At Teltone, we're concentrating on what we know best: integrated voice and data switching, in small to medium-sized local networks, for users who want a reliable system today with room to grow tomorrow. And we're ready to share our resources with you. Feel

free to call us at 1-800-227-3800 (Ext. 1122) or write Teltone Corporation, PO Box 657, Kirkland, WA 98033.

TEL TONE

A new natural resource for voice and data communications.

Switching Products

The development of a full scale PBX requires large resources in marketing, engineering, and sales. Teltone has entered this market via a license agreement with British Telecom for their Monarch System. The Cascade 400 is a version of this switch which has been enhanced to comply with United States Federal Communication Commission rules, to include certain features required in the United States market, and to have an expanded capacity of 400 ports. It is presently undergoing beta field trial at Teltone. Follow-on releases of software and hardware are scheduled through the end of fiscal 1986, including a feature phone and the ability to transmit and switch data directly through the PBX.

The Company intends to market this product and its Cascade 30 Electronic Key System through a number of dealers who employ their own direct sales forces. The Company presently has tentative agreements with a group of six dealers, The Consortium, who will market the products under the Data-Tel name. Agreements are also in process with nine other independent dealers. Combined, these 15 companies have a direct sales force of approximately 90 people. Additional dealerships will be negotiated in fiscal 1985.

Over the past two years Solstar (previously American Sun Moon Star) has developed the Cascade 30 Digital Electronic Key System to Teltone specifications for the North American market. Manufactured in Taiwan, this product serves up to 20 telephone lines and ten trunks. Hardware and software enhancements are also scheduled for this product through fiscal 1986. An available option provides a DCS station unit integrated in the base of the Cascade 30 phone set. The Cascade 30 is expected to assist sales of the DCS and Cascade 400. The first billable shipments of the Cascade 30 occurred in June of this year.

Customer Premises Products

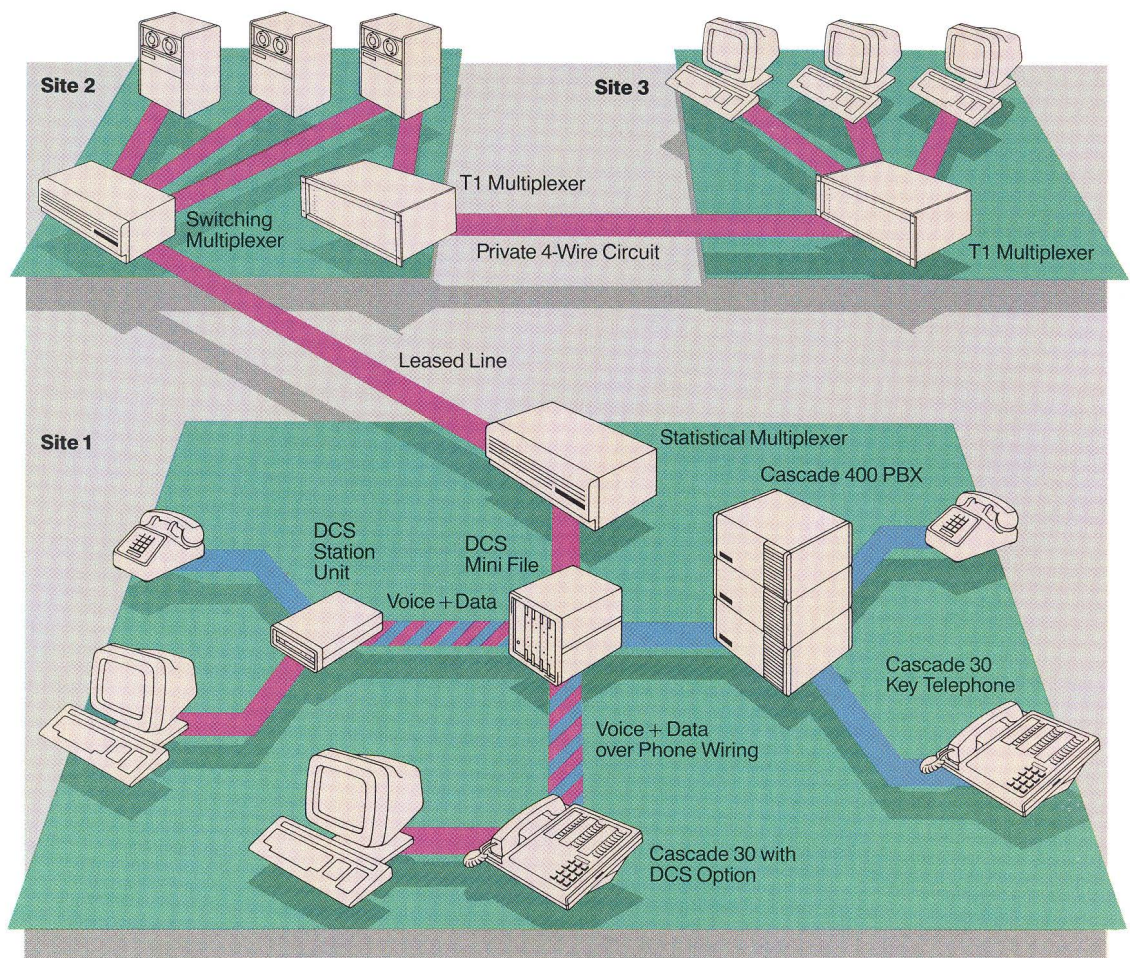
In this product line the Company's mature products include key system intercoms, remote supervision equipment for off-premises extensions of key systems, and remote access equipment for PBX's. Due to uncertainties created by the AT&T divestiture, sales of these

The Year in Review

The Cascade 30 is available with a DCS station unit built into the phone set, or the DCS module can be ordered as a snap-in component. Integration of voice and data capabilities in the same housing enhances both products.



Teltone voice and data products work together to form a complete network, eliminating integration problems that can occur when system components are purchased from multiple manufacturers.



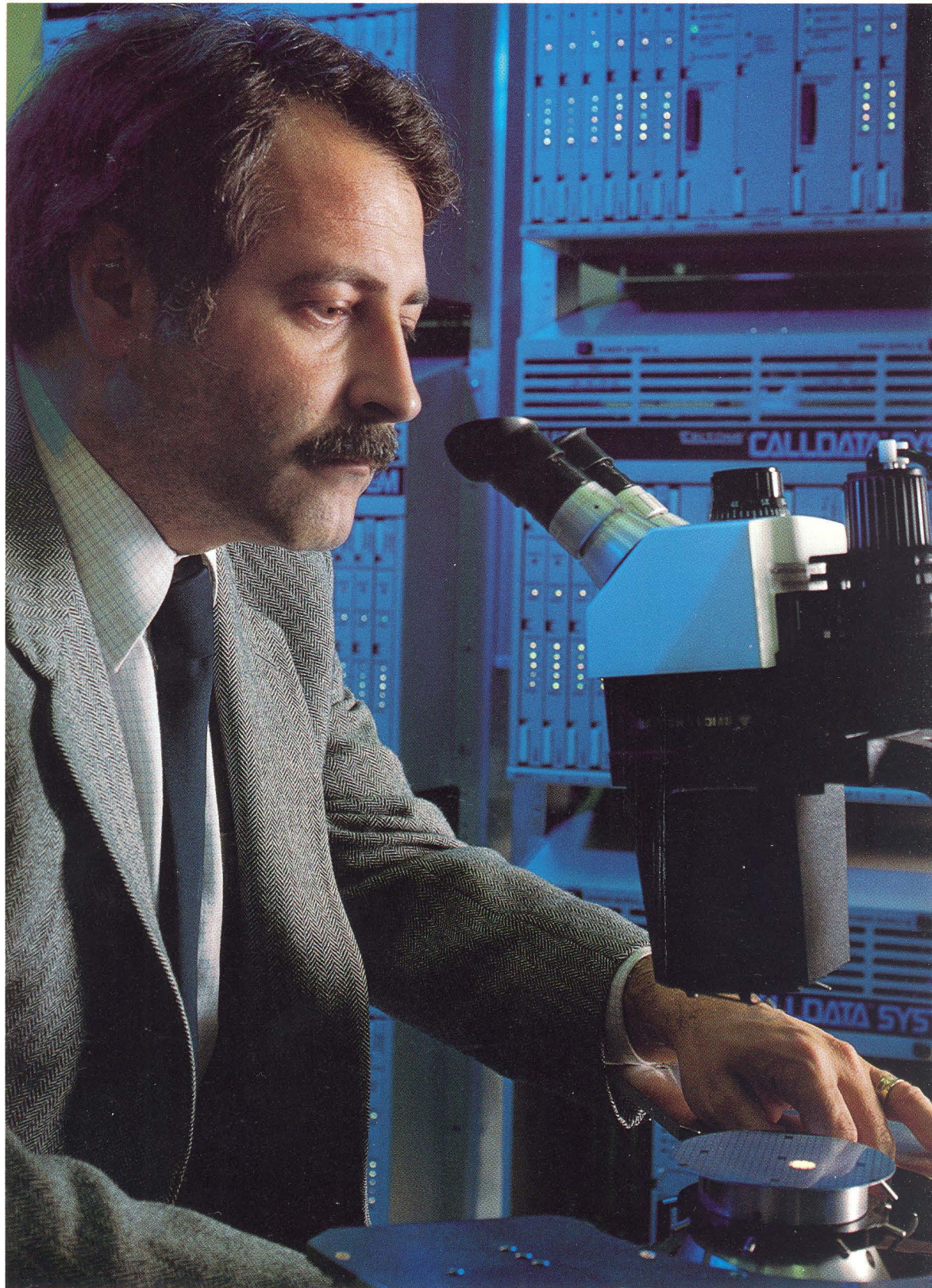
products were delayed while the Bell Operating Companies and AT&T developed their strategies for the key system market. Sales resumed but at lower than historic levels during fiscal 1984. In the process of seeking new revenue sources, the Bell Operating Companies have purchased Teltone M-106 Remote Access Units for use in central offices to resell WATS services and to provide tariffed Centrex features. The contribution to sales by these customer premises products is expected to continue its decline.

Component Products

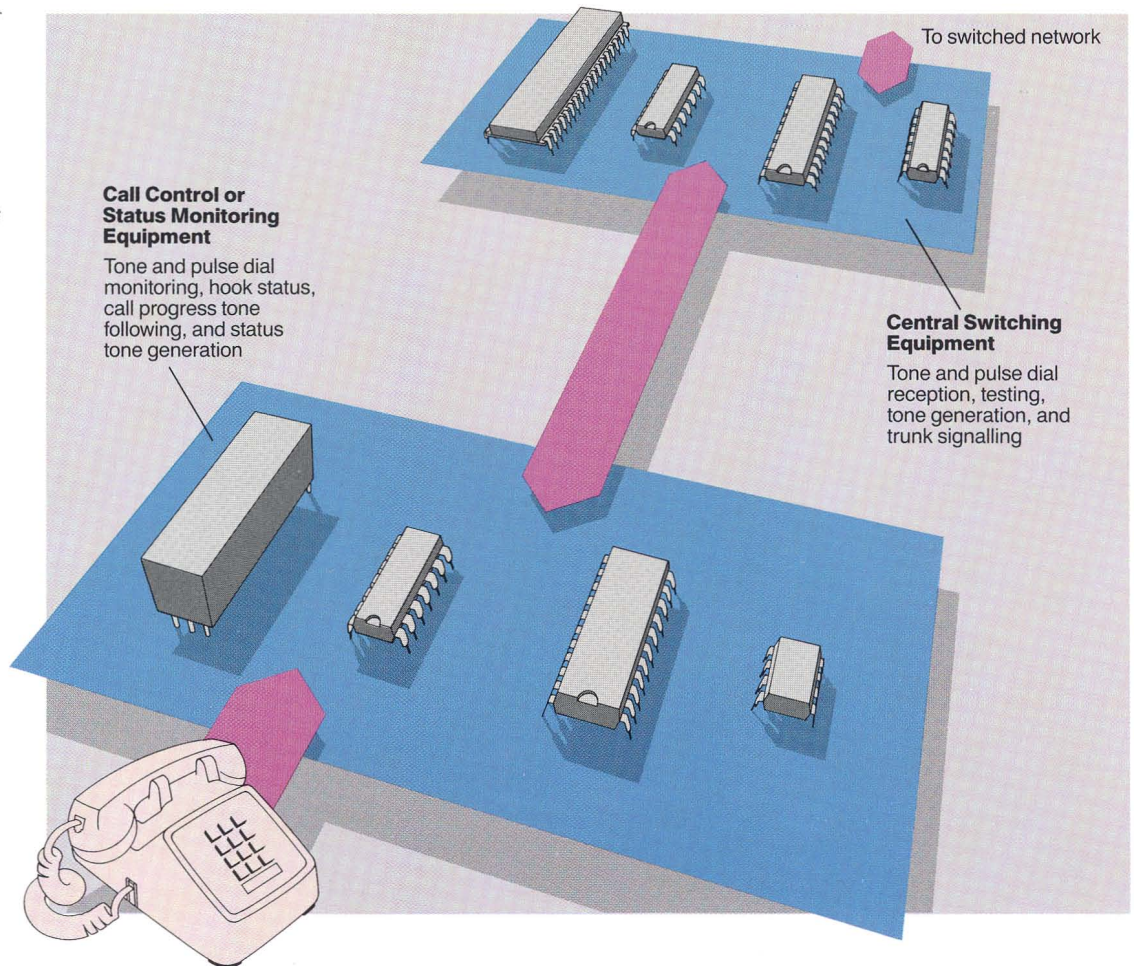
In the process of developing tone conversion equipment and key system intercoms with tone dialing recognition, Teltone gained expertise in LSI technology, specifically, LSI tone receiver technology. When, in fiscal 1978, Teltone began marketing modules and chips to other manufacturers, the company benefitted from the direct revenues obtained as well as from volume related cost reductions of its own products.

This product line has been very successful. In fiscal 1983 seven new products were brought to market. During fiscal 1984, an additional seven were introduced. These include call progress tone detectors, call progress tone generators, PCM (Pulse Code Modulation) tone receivers, and a rotary dial pulse counter/switchhook status monitor. These telecommunication devices are products which inject technology and cost saving back into the Company as well as generating revenue in their own right.

Telcom components built for sale to other manufacturers are also used in Telton products. The M-957 DTMF Receiver detects tone dialed numbers in the CallData System and performs the same function in the Cascade 400.



Teltone markets a number of electronic signalling devices for the telecommunications OEM market. These telcom components use LSI circuit techniques to provide complex signalling functions in small, low power packages, enhancing our competitive position and generating revenue from external use.



In fiscal 1984 the M-927 single-package, hybrid receiver and the M-957 fully integrated CMOS receiver were the flagships. The nonreceiver devices contributed significantly less and their potential sales are not as well understood.

Telephone Company Products

The equipment which connects subscribers to the numbers they dial is located in "central offices." Products which upgrade older central office equipment to modern services have been significant in Teltone's history. Tone-to-pulse conversion (which adds tone dialing), coin-free and credit card dialing, redirection of dialed numbers in a manner transparent to the subscriber, toll restriction, and live quality-of-service observation are capabilities Teltone equipment has made possible for "non-intelligent," electromechanical central offices. In general, these products have consisted of microprocessor based, single circuit boards, whose cost has been much less than the replacement cost of the central office. The marketplace for these products is easily defined, as is the theoretical saturation level. However, interest rates, regulatory policies, legislation, and other non-foreseeable factors are significant variables.

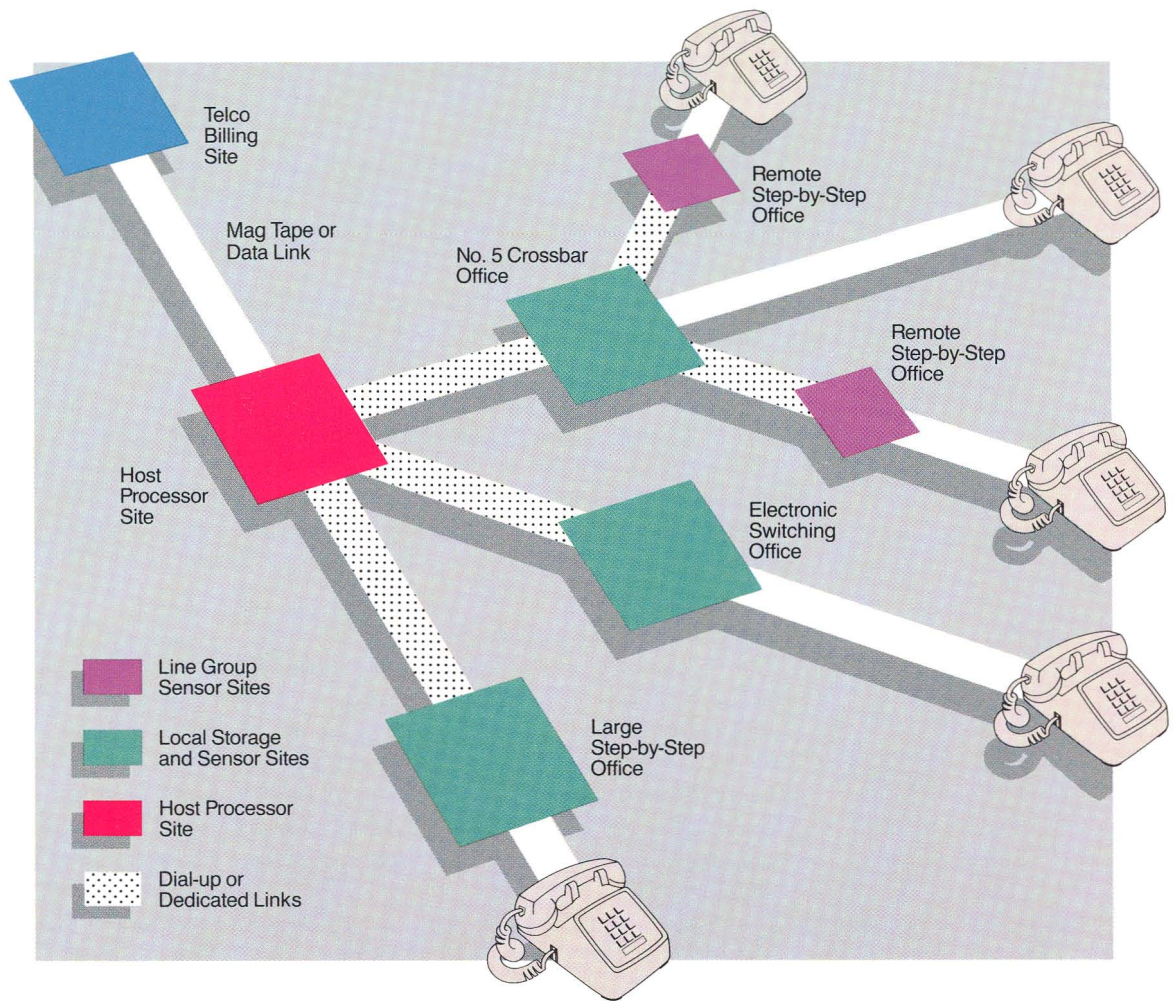
Tone-to-pulse converter sales have greatly declined in the United States. Remaining sales are due to large operating companies completing upgrade programs and small independent phone companies who are just now adding tone dialing service. Most of Europe has not converted to tone service and this has been an important source of revenue for

The Year in Review

Due to the function of the CallData System within the architecture of the telephone company central office, reliability is critical. Test and validation efforts are a significant part of the development.



The CallData System is integrated into the telephone company switching and billing systems. The sensor-local storage module-host computer architecture is such that the system can be configured efficiently for varying sizes and central office/billing center arrangements.



Teltone in recent years. However, due to the type of central offices, less tone-to-pulse equipment is required per subscriber than in the United States and Great Britain.

Teltone's service observation equipment allows telephone companies to perform live quality-of-service observation and fully automated collection of call disposition records from remote locations. This assists the operating companies in maintaining and improving service levels and complying with the requirements of the regulatory bodies. The Company's toll recording (TRS) and Fast Automatic Number Identification (FANI) systems increase the call processing speed of central offices. These products have assisted Teltone in competing for universal measured service equipment contracts by demonstrating the Company's ability to develop large systems with adequate reliability for critical billing and common control functions.

In order to increase revenues and satisfy regulatory requirements for equal access to other common carriers (like Sprint and MCI), the telephone operating companies are expected to install universal measured service equipment that will record billing information on every local call. The Teltone CallData System consists of three parts: sensors which collect call data, local storage modules which process and store the data, and host computers which poll the storage modules from a remote location and generate billing data on magnetic tapes. The sensors relate directly to the Company's experience in designing and manufacturing tone-to-pulse, FANI, and TRS equipment. They are higher volume products

similar in size to the Company's tone-to-pulse converters. The storage modules and the host computers (DEC 11/750's) are lower volume products whose primary value added is proprietary software.

The Bell Operating Companies are the major market for the CallData System. The Company presently has equipment under field trial and evaluation at several telephone companies, and contract negotiation is in process with the Southwestern Bell and Southern New England Telephone Companies.

Teltone International, Inc. and Teltone Limited

Due to worldwide economic conditions and the strength of the dollar, Teltone International, Inc. sales, excluding Canada, were below the previous year. Telcom components and tone-to-pulse converters are the highest revenue sources from this portion of the business.

Canadian sales, in contrast, increased 148 percent and produced net after tax profits on plan. A contract with Bell Canada was an important contributor and full manufacturing operations in Canada began on July 1st of 1983.

During the year, Teltone Limited added a direct data sales force of five, including technical support personnel, and the first Canadian sale of DCS equipment occurred in the third quarter of fiscal 1984.

People and Philosophy

The CallData System and the Cascade 400 differ from the Company's previous products in size and complexity, and many changes resulted from this in recent fiscal years. In 1982 Teltone employed three software engineers, but at the end of 1984, Teltone employed 31 software engineers and over 100 engineers in total. In 1984 78.5% of the work force was indirect labor compared to 64.5% in 1982. In support of this change in work force, the company more than doubled its computing resources in 1982 and 1983, and in July, 1984 installed two newly designed computers to increase computing resources by four to eight times.

Increased computing power and a larger development work force are necessary, but management believes that the most important factor in the past and future success of the corporation has been and will be the individual efforts of the employees in all positions. In evidence of this, management remains firmly committed to a philosophy of treating all employees with fairness and respect and providing them with opportunity to share in the Company's growth and profits.

1983 Follow Up

Looking back on the previous annual report and detailed corporate plans, fiscal 1984 brought both disappointments and successes. The Cascade 400 and Cascade 30 were introduced on target at the November, 1983 North American Telephone Association show, but development of the Cascade 400 as a shippable product has not been completed. The CallData System, likewise, is significantly behind schedule.

Among the fulfilled plans for the year were the completion of the 50,000 square-foot addition to the corporate headquarters on schedule, over \$3,000,000 in anticipated M-106 revenues, the highly successful introduction of the Tellabs switching multiplexer, and strong sales of the Tellabs statistical multiplexer and Teltone DCS equipment.

Financial Review

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Consolidated Statements of Income

For the three years ended June 30, 1984

	1984	1983	1982
Net Sales	\$40,955,837	\$36,227,126	\$34,123,973
Cost of Goods Sold	21,949,784	18,190,742	18,008,256
Gross Margin on Sales	19,006,053	18,036,384	16,115,717
Operating Expenses:			
Selling, general, and administrative	11,343,913	8,238,651	6,851,095
Engineering and development	7,552,661	4,971,461	3,029,924
Profit sharing	143,274	330,124	780,000
	19,039,848	13,540,236	10,661,019
Income (Loss) From Operations	(33,795)	4,496,148	5,454,698
Other (Income) Expense:			
Interest expense	383,901	189,576	164,882
Interest and dividend income	(292,722)	(590,061)	(429,202)
Other	1,090,656	27,953	(30,770)
	1,181,835	(372,532)	(295,090)
Income (Loss) Before Federal Income Tax	(1,215,630)	4,868,680	5,749,788
Provision (Benefit) for Federal Income Tax	(2,795,500)	1,749,000	2,625,000
Net Income	\$ 1,579,870	\$ 3,119,680	\$ 3,124,788
Net Income per Common and Common Equivalent Share	\$.28	\$.56	\$.59

The Notes on pages 21 to 26 are an integral part of these Financial Statements.

Management's Discussion

Results of Operations

Net Sales

Net sales increased 13 percent during fiscal 1984. The increase was comprised of increases in Domestic and Canadian sales, offset by a decrease in International sales. Domestically, sales increased 21 percent (\$5,569,000), primarily as the result of increases in data and component product lines.

Canadian sales increased 148 percent (\$2,029,000) as a result of orders to provide central office equipment to a Canadian operating telephone company. To support this increase, in July of 1983 Teltone Limited, the Company's Canadian subsidiary, began local manufacturing. During the last quarter of fiscal 1984, 45 percent of Teltone Limited's sales were manufactured at its facility in Markham, Ontario, Canada.

International sales decreased 33 percent (\$2,869,000). The central office and component product lines were impacted by both the high value of the dollar and increased competition.

Fiscal 1983 sales increased 6 percent over fiscal 1982. While sales were flat domestically, combined Canadian and International sales grew 34 percent with most of the growth occurring in the central office and component lines.

Cost of Goods Sold

As a percent of sales, cost of goods sold was 54 percent, 50 percent, and 53 percent, respectively, for the fiscal years 1984, 1983, and 1982. The relative changes from year to year are related to shifts in product mix.

Operating Expenses

Beginning in fiscal 1983 and continuing through fiscal 1984, the Company has been developing two major products—the CallData System and the Cascade 400. At the same time the data end user sales force and supporting facilities have been put in place. These efforts are the primary reasons for the significant increase in selling, general, and administrative expenses and engineering and development expenses, both in dollar amounts and as a percentage of sales, from 1982 to 1984. These expenditures, which are targeted at accelerating future growth, resulted in an operating loss for fiscal 1984.

Other Expenses

Other expenses for fiscal 1984 include a 103 percent increase in interest expense to \$383,900, due to increased debt. Also included is the write-off of a loan to Peripheral Technology, Incorporated, a privately owned Washington corporation (PTI). On March 30, 1983, the Company agreed to provide PTI with interim financing of up to \$1,000,000 on a revolving basis. The agreement gave the Company an option to convert, prior to September 30, 1984, its loan for shares of common stock in such an amount as to give the Company 50 percent ownership of PTI.

After a reevaluation of the market it became obvious that the expected synergy between the product lines of the two companies would not materialize. Based upon this review the Company elected not to convert its loan to 50 percent ownership. Because of PTI's inability to repay the amounts due, the loan has been determined to be uncollectible. Therefore, during the third quarter, the loan balance of \$1,000,000 and accrued interest of \$84,000 were written off to Other Expense.

Net Income

The Company's pretax earnings for 1984 were affected by the high operating expenses described above plus the write-off of the uncollectible loan, and reflect a pretax loss of \$1,215,600 compared to pretax income of \$4,868,700 for fiscal 1983. Income before taxes declined 15 percent from 1982 to 1983.

Consolidated Balance Sheets

At June 30, 1984 and 1983

<i>Assets</i>	1984	1983
Current Assets		
Cash and short term cash investments		\$ 4,032,870
Marketable securities		1,500,000
Accounts receivable	\$ 7,600,894	4,936,581
Inventories		
Raw materials	4,285,019	1,685,562
Work in process	2,683,816	1,895,021
Finished goods	4,747,610	4,637,115
Total inventories	11,716,445	8,217,698
Federal income tax receivable	1,702,465	
Other current assets	1,236,043	340,236
Total current assets	22,255,847	19,027,385
Property, Plant, and Equipment—at Cost		
Land	519,388	519,388
Buildings and improvements	6,259,731	3,073,792
Engineering, manufacturing, and office equipment	11,179,313	7,888,591
Total	17,958,432	11,481,771
Less accumulated depreciation and amortization	5,402,784	4,122,478
Property, plant, and equipment—net	12,555,648	7,359,293
Other Assets	1,163,319	1,869,854
Total	\$35,974,814	\$28,256,532
<i>Liabilities and Stockholders' Equity</i>		
Current Liabilities		
Accounts payable—trade	\$ 2,799,412	\$ 3,578,045
Notes payable to bank	3,065,000	65,600
Current portion of long-term liabilities	432,446	274,489
Federal income tax		457,729
Accrued payroll costs	619,478	447,581
Accrued vacation	519,472	404,301
Accrued profit sharing		75,684
Accrued warranty expense	412,352	352,141
Other accrued expenses	971,381	886,245
Total current liabilities	8,819,541	6,541,815
Long-term Liabilities, Less Current Portion	6,112,352	2,075,932
Deferred Federal Income Tax	786,779	1,698,100
Stockholders' Equity		
Common stock—no par value; authorized 20,000,000 shares; issued, 1984—5,739,443 shares; 1983—5,532,208 shares	3,556,845	2,508,632
Retained earnings	17,750,254	16,170,384
Total	21,307,099	18,679,016
Less: 199,592 shares of treasury stock—at cost	976,331	738,331
Foreign currency translation adjustment	74,626	
Stockholders' equity	20,256,142	17,940,685
Total	\$35,974,814	\$28,256,532

The Notes on pages 21 to 26 are an integral part of these Financial Statements

Net income for fiscal 1984 was \$1,579,900 compared to \$3,119,700 for fiscal 1983, a decline of 49 percent. This net income is primarily a result of the expected refund of previously paid income tax due to the carryback of a domestic operating loss and current year tax credits for research and development and capital equipment purchases, and the reversal of accrued Federal income taxes on the undistributed earnings of the Company's DISC.

Since the inception of Teltone International, Inc., a wholly owned Domestic International Sales Corporation (DISC), international sales have grown substantially. Management expects international sales to remain a significant contributor to sales and effective in the third quarter of 1984 determined that the tax deferred earnings of the DISC would be permanently invested and that under statutes effective at that date no tax on those earnings would thus be payable. As a result of this change in estimate, deferred income taxes previously recorded on DISC earnings have been reversed to income. This appears on the income statement as a reduction of income tax expense in 1984, and increased net income by \$1,295,200 or \$0.23 per share. \$1,110,000 of this reversal relates to DISC earnings prior to 1984.

On July 18, 1984, Congress enacted legislation which will replace DISC provisions with regulations pertaining to Foreign Sales Corporations (FSC), effective January 1, 1985. As a transitional feature of the new legislation, deferred DISC income earned through December 31, 1984 will be treated as "previously taxed income." So long as the DISC retains its status through December 31, 1984, it can distribute its entire deferred income to the parent company subsequent to that date without tax consequence.

Net income was flat in fiscal 1983 and fiscal 1982. Federal income tax declined 33 percent from 1982 to 1983 due to the benefit from tax credits for research and development and for capital equipment purchases.

Liquidity and Capital Resources

The Company's need for cash depends primarily upon the growth in sales and the related need to invest in accounts receivable, inventories, equipment, and facilities. The primary sources of liquidity are funds provided by operations, sales of common stock to employees, and debt. Working capital increased during fiscal 1984 primarily from the proceeds of long-term financing described below.

Cash balances at June 30, 1984 were zero as the Company makes use of zero-balance concentration accounts offsetting available cash against outstanding short-term credit lines. This compares to cash and marketable securities of \$5,532,900 at June 30, 1983, which were used during fiscal 1984 to fund the growth in accounts receivable and inventories.

Accounts receivable and inventories increased \$2,664,300 and \$3,498,700 respectively at June 30, 1984 compared to June 30, 1983. Accounts receivable were affected by the increased level of sales and by terms extending beyond historic patterns. Inventory increases are attributable to purchases made for new products yet to be shipped and for volumes and mix of product that did not occur as projected.

The combination of significant tax credits, a domestic operating loss, and the determination that a promissory note was uncollectible has resulted in an estimated Federal income tax receivable of \$1,702,500 for the year ended June 30, 1984. A claim for refund will be filed for the year ended June 30, 1984, and funds received will be used to reduce the Company's short-term debt.

Consolidated Statements of Changes in Financial Position

For the three years ended June 30, 1984

	1984	1983	1982
Funds Were Provided By:			
Operations:			
Net income	\$ 1,579,870	\$3,119,680	\$3,124,788
Add (deduct) charges (credits) to income not requiring working capital:			
Depreciation and amortization	1,505,189	1,038,997	859,291
Deferred Federal income tax	(911,321)	480,423	560,055
Write off of loan to Peripheral Technology, Inc.	1,000,000		
Amortization of unearned compensation	191,625	109,500	54,750
Total funds provided by operations	3,365,363	4,748,600	4,598,884
Proceeds from long-term liabilities	4,560,379	886,230	337,448
Sale of common stock to employees	712,402	821,404	278,223
Tax benefit from options exercised	27,811	140,025	130,328
Other	493,901	137,267	29,164
	<u>9,159,856</u>	<u>6,733,526</u>	<u>5,374,047</u>
Funds Were Applied To:			
Acquisition of property, plant, and equipment:			
Building and improvements	3,387,164	276,263	144,968
Engineering, manufacturing, and office equipment	3,395,259	2,711,654	885,978
Reduction of long-term liabilities	523,959	318,239	553,776
Purchase of treasury stock	238,000		513,856
Dividend paid			220,990
Loan to Peripheral Technology, Inc.	225,000	775,000	
Foreign currency translation adjustment	74,626		
Other	365,112	597,922	335,470
	<u>8,209,120</u>	<u>4,679,078</u>	<u>2,655,038</u>
Increase in Working Capital	<u>\$ 950,736</u>	<u>\$2,054,448</u>	<u>\$2,719,009</u>
Increase (Decrease) in Components of Working Capital:			
Cash and short-term cash investments	\$(4,032,870)	\$ (315,423)	\$2,466,865
Marketable securities	(1,500,000)	1,500,000	
Accounts receivable	2,664,313	786,809	70,090
Inventories	3,498,747	723,481	1,571,974
Federal income tax receivable	1,702,465		
Other current assets	895,807	234,484	(105,007)
Accounts payable	778,633	(1,513,979)	(566,411)
Note payable to bank	(2,999,400)	(65,600)	
Current portion of long-term liabilities	(157,957)	198,777	234,141
Federal income tax	457,729	278,879	(213,822)
Accrued expenses	(356,731)	227,020	(738,821)
Increase in Working Capital	<u>\$ 950,736</u>	<u>\$2,054,448</u>	<u>\$2,719,009</u>

The Notes on pages 21 to 26 are an integral part of these Financial Statements.

Management's Discussion

On August 9, 1983, the Company began construction of a new 50,000 square-foot facility adjacent to its Kirkland, Washington site to house manufacturing and office space. Construction was completed, and the building was occupied in March 1984. Cost to complete, including furnishings, was \$3,850,000. This expansion was financed with a revolving note and term loan for \$3,700,000, with terms based on prime, LIBOR, or certificate of deposit rates, at the option of the Company.

During June 1984 the Company opened a customer service office in Redmond, Washington. The leased space houses headquarters field service personnel, customer equipment repair services, and a new training center, all occupying 15,000 square feet. During fiscal 1984 data sales offices opened in California, Colorado, and New York. Both sales and field service are provided through the New York and California offices.

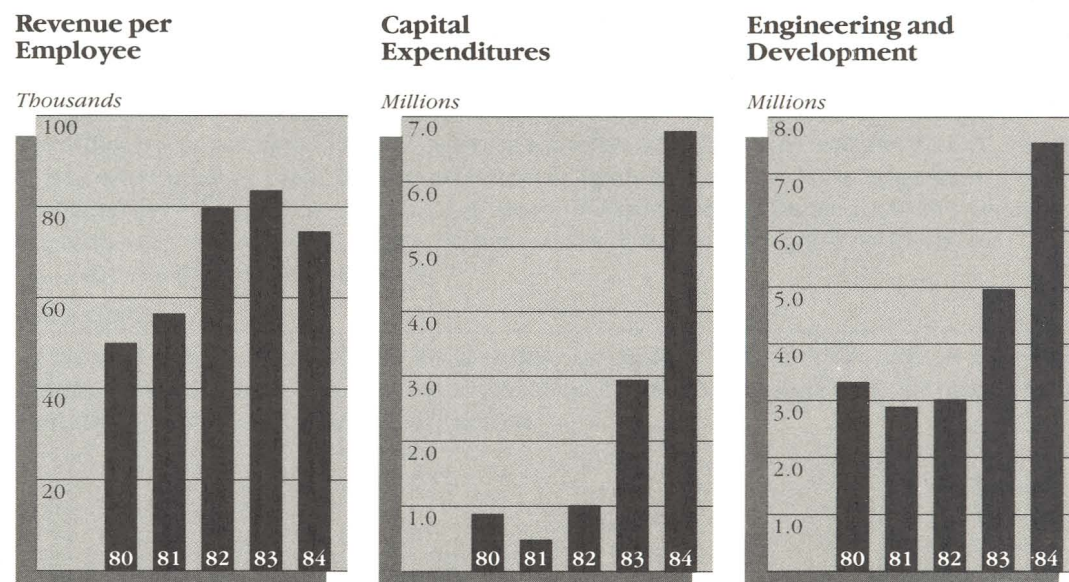
Engineering, manufacturing, and office equipment purchases were \$3,395,300 and \$2,711,700 for fiscal 1984 and 1983, respectively. Furnishings for the new building totaled \$707,300 and the remaining \$2,688,000 were purchases for engineering, information systems and manufacturing equipment. Of the \$2,688,000 of equipment, \$540,600 was financed on a five year lease line. At June 30, 1984, additional equipment valued at \$848,300 was on order to be financed on the same lease line. These leases are classified as capital leases.

Sales of common stock totaled \$712,400 during the year ended June 30, 1984, and were related to exercises by employees of shares granted under the Stock Option and Employees' Stock Purchase Plans.

The Company expects that its lines of credit, including a \$2,000,000 lease line for capital equipment purchases approved September 4, 1984, together with cash flow from operations, will be sufficient to meet the Company's cash requirements for the next twelve months for inventory, receivables, and capital assets.

Effect of Inflation

The Company believes that the effect of inflation on labor rates has been offset by increases in productivity and decreases in material costs. Price increases of the Company's product lines have not had a material effect on the increase in sales.



Consolidated Statements of Stockholders' Equity

For the three years ended June 30, 1984

	Common Stock Issued		Retained Earnings	Other	Total
	Shares	Amount			
Balance, June 30, 1981	613,820	\$ 974,402	\$10,146,906	\$ (224,475)	\$10,896,833
Options exercised	19,102	255,035			255,035
Issued under employees' purchase plan . .	620	23,188			23,188
Issued under restricted stock agreement, net of unearned compensation of \$492,750 and receivable of \$332,500	20,000	54,750			54,750
Income tax benefit arising from options exercised.		130,328			130,328
Dividend paid—\$.35 per share.			(220,990)		(220,990)
Purchase of treasury stock— 12,024 shares				(513,856)	(513,856)
Net income.			3,124,788		3,124,788
Balance, June 30, 1982	653,542	1,437,703	13,050,704	(738,331)	13,750,076
Options exercised	28,843	460,531			460,531
Issued under employees' purchase plan . .	9,141	360,873			360,873
Amortization of unearned compensation .		109,500			109,500
Income tax benefit arising from options exercised.		140,025			140,025
Eight-for-one stock split	4,840,682				
Net income.			3,119,680		3,119,680
Balance, June 30, 1983	5,532,208	2,508,632	16,170,384	(738,331)	17,940,685
Options exercised	154,240	397,875			397,875
Issued under employees' purchase plan . .	52,995	314,527			314,527
Amortization of unearned compensation .		191,625			191,625
Cancellation of receivable due to forfeiture of restricted stock		116,375			116,375
Purchase of treasury stock— 56,000 shares				(238,000)	(238,000)
Income tax benefit arising from options exercised.		27,811			27,811
Foreign currency translation adjustment. .				(74,626)	(74,626)
Net income.			1,579,870		1,579,870
Balance, June 30, 1984	5,739,443	\$3,556,845	\$17,750,254	\$(1,050,957)	\$20,256,142

The Notes on pages 21 to 26 are an integral part of these Financial Statements.

Summary of Significant Accounting Policies

Basis of Reporting

The consolidated financial statements include Teltone Corporation and its wholly-owned subsidiaries, Teltone International, Incorporated, a Domestic International Sales Corporation (DISC), and Teltone Limited, a Canadian corporation. All significant intercompany accounts and transactions have been eliminated. The Company accounts for its investment in 35% of the common stock of Dees Communications Engineering Limited, a Canadian corporation, on the equity method.

Marketable Securities

Marketable securities are carried at the lower of aggregate cost or market.

Inventories

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

Depreciation and Amortization

Depreciation and amortization are provided using the straight-line method over estimated useful lives as follows:

Buildings and improvements: 20-35 Years

Engineering, manufacturing, and office equipment: 4-8 Years

Capitalization of Interest

Interest is capitalized during the period an asset is being constructed. Interest capitalized in 1984 was \$77,928. There was no interest capitalized in 1983 or 1982.

Engineering and Development Costs

Engineering and development costs are charged to expense as incurred.

Warranty Costs

Estimated warranty costs are accrued at the time products are sold.

Federal Income Tax

The Company uses the flow-through method of accounting for investment tax credits. Accordingly, the provision for Federal income tax is reduced each year by the net investment credit applicable to qualified property additions and disposals.

Foreign Currency Translation

The Company determined during the fourth quarter of 1984 that operations of its foreign subsidiary were self-contained and integrated within the country of operation as described in the Statement of Financial Accounting Standards No. 52—Foreign Currency Translation. Accordingly, the net assets of the Company's foreign subsidiary are translated to U.S. dollars at year-end exchange rates. Income and expense items are translated at average rates of exchange prevailing during the year. Translation Adjustments are accumulated in a separate component of shareholders' equity. Foreign currency transaction gains and losses are included in non-operating expenses.

Stock Options

At the time options are exercised, the proceeds are credited to Common Stock, as is any tax benefit from employee's taxable compensation attributable to the excess of fair market value over the option price on the date of exercise.

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