

ADVANCED PHOTONIX INC  
Form 10-Q  
August 10, 2009

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

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

For the quarterly period ended June 26, 2009

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR  
15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-11056

**ADVANCED PHOTONIX, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation  
or organization)

**33-0325826**

(I.R.S. Employer Identification Number)

**2925 Boardwalk, Ann Arbor, Michigan 48104**

(Address of principal executive offices) (Zip Code)

**(734) 864-5600**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days:

YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller

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reporting company  in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer      Accelerated filer      Non-accelerated filer      Smaller reporting company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
YES  NO

As of August 5, 2009, there were 24,284,726 of Class A Common Stock, \$.001 par value, and 31,691 shares of Class B Common Stock, \$.001 par value outstanding.

**Advanced Photonix, Inc.**  
**Form 10-Q**  
**For the Quarter Ended June 26, 2009**

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**PART I -- FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements**

**ADVANCED PHOTONIX, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | June 26, 2009<br>(Unaudited) | March 31, 2009 |
|---|------------------------------|----------------|
| <b>ASSETS</b>   |                              |                |
| Current assets:   |                              |                |
| Cash and cash equivalents   | \$ 1,760,000                 | \$ 2,072,000   |
| Restricted cash   | 500,000                      | 500,000        |
| Accounts receivable, net  | 3,881,000                    | 3,284,000      |
| Inventories, net  | 3,834,000                    | 3,669,000      |
| Prepaid expenses and other current assets   | 370,000                      | 252,000        |
| Total current assets  | 10,345,000                   | 9,777,000      |
| Equipment and leasehold improvements, net   | 4,109,000                    | 4,322,000      |
| Goodwill  | 4,579,000                    | 4,579,000      |
| Intangibles and patents, net  | 8,535,000                    | 8,975,000      |
| Other assets  | 388,000                      | 388,000        |
| Total Assets  | \$ 27,956,000                | \$ 28,041,000  |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                              |                |
| Current liabilities:  |                              |                |
| Accounts payable  | \$ 1,215,000                 | \$ 1,356,000   |
| Accrued compensation  | 1,378,000                    | 1,037,000      |
| Current portion of fair value warrant liability   | 46,000                       | 46,000         |
| Accrued interest  | 548,000                      | 513,000        |
| Other accrued expenses  | 643,000                      | 615,000        |
| Current portion of long-term debt - related parties   | 1,401,000                    | 1,401,000      |
| Current portion of long term debt - bank term loan  | 434,000                      | 434,000        |
| Current portion of long-term debt - MEDC  | 570,000                      | 353,000        |
| Total current liabilities   | 6,235,000                    | 5,709,000      |
| Long-term debt, less current portion - MEDC   | 1,654,000                    | 1,871,000      |
| Long-term debt - bank line of credit  | 1,394,000                    | 1,394,000      |
| Long-term fair value warrant liability less current portion   | 209,000                      | 209,000        |
| Long-term debt, less current portion - bank term loan   | 1,013,000                    | 1,121,000      |
| Total liabilities   | 10,505,000                   | 10,095,000     |
| Commitments and contingencies   |                              |                |
| Shareholders' equity:   |                              |                |
| Class A redeemable convertible preferred stock, \$.001 par value; 780,000 shares authorized; 40,000 outstanding | --                           | --             |

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Class A Common Stock, \$.001 par value, 100,000,000 authorized; June 26, 2009 □  
 24,284,726 shares issued and outstanding, March 31, 2009 □ 24,089,726 shares issued  
 and outstanding

|  |               |           |
|--|---------------|-----------|
|  | 24,000        | 24        |
| Class B Common Stock, \$.001 par value; 4,420,113 shares authorized; June 26, 2009<br>and March 31, 2009 - 31,691 issued and outstanding | --            |           |
| Additional paid-in capital   | 49,875,000    | 52,400    |
| Accumulated deficit  | (32,448,000)  | (34,478)  |
| Total shareholders' equity   | 17,451,000    | 17,946    |
| Total Liabilities and Shareholders' Equity   | \$ 27,956,000 | \$ 28,041 |

See notes to condensed consolidated financial statements.

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**ADVANCED PHOTONIX, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

|   | <b>Three Months Ended</b> |                      |
|---|---------------------------|----------------------|
|   | <b>June 26, 2009</b>      | <b>June 27, 2008</b> |
| Sales, net  | \$ 5,934,000              | \$ 7,770,000         |
| Cost of products sold                               | 2,937,000                 | 4,014,000            |
| Gross profit  | 2,997,000                 | 3,756,000            |
| <b>Operating expenses:</b>                          |                           |                      |
| Research, development and engineering               | 1,063,000                 | 1,128,000            |
| Sales and marketing                                 | 451,000                   | 620,000              |
| General and administrative                          | 1,173,000                 | 1,083,000            |
| Amortization expense                                | 515,000                   | 526,000              |
| Wafer fabrication relocation expenses               | 40,000                    | 160,000              |
| Total operating expenses                            | 3,242,000                 | 3,517,000            |
| Income (loss) from operations                       | (245,000)                 | 239,000              |
| <b>Other income (expense):</b>                      |                           |                      |
| Interest income                                     | 1,000                     | 16,000               |
| Interest expense                                    | (67,000)                  | (81,000)             |
| Interest expense, related parties                   | (14,000)                  | (27,000)             |
| Income on change in fair value of warrant liability | 39,000                    | --                   |
| Other income/(expense)                              | (10,000)                  | --                   |
| Net income (loss)                                   | \$ (296,000)              | \$ 147,000           |
| Net income (loss) per share                         |                           |                      |
| Basic   | \$ (0.01)                 | \$ 0.01              |
| Diluted   | \$ (0.01)                 | \$ 0.01              |
| Weighted average common shares outstanding          |                           |                      |
| Basic   | 24,135,000                | 24,010,000           |
| Diluted   | 24,135,000                | 24,370,000           |

See notes to condensed consolidated financial statements.

**ADVANCED PHOTONIX, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

|  | <b>Three Months Ended</b> |                      |
|--|---------------------------|----------------------|
|  | <b>June 26,<br/>2009</b>  | <b>June 27, 2008</b> |
| <b>OPERATING ACTIVITIES:</b>   |                           |                      |
| Net income (loss)  | \$ (296,000)              | \$ 147,000           |
| Adjustment to reconcile net income (loss) to net cash provided by (used in) operating activities |                           |                      |
| Depreciation   | 294,000                   | 268,000              |
| Amortization   | 515,000                   | 526,000              |
| Stock-based compensation expense   | 95,000                    | 34,000               |
| Change in fair value of warrant liability  | (39,000)                  | --                   |
| Changes in operating assets and liabilities:   |                           |                      |
| Accounts receivable  | (597,000)                 | (1,146,000)          |
| Inventories  | (165,000)                 | (270,000)            |
| Prepaid expenses and other assets  | (118,000)                 | (109,000)            |
| Accounts payable and accrued expenses  | 263,000                   | 1,294,000            |
| Net cash provided by (used in) operating activities  | (48,000)                  | 744,000              |
| <b>INVESTING ACTIVITIES:</b>   |                           |                      |
| Capital expenditures   | (81,000)                  | (206,000)            |
| Change in restricted cash  | --                        | 1,000,000            |
| Patent expenditures  | (75,000)                  | (32,000)             |
| Net cash provided by (used in) investing activities  | (156,000)                 | 762,000              |
| <b>FINANCING ACTIVITIES:</b>   |                           |                      |
| Payments on capital lease financing  | --                        | (115,000)            |
| Payment on bank term loan  | (108,000)                 | --                   |
| Net cash (used in) financing activities  | (108,000)                 | (115,000)            |
| Net increase (decrease) in cash and cash equivalents   | (312,000)                 | 1,391,000            |
| Cash and cash equivalents at beginning of quarter  | 2,072,000                 | 82,000               |
| Cash and cash equivalents at end of quarter  | \$ 1,760,000              | \$ 1,473,000         |
| <b>Supplemental disclosure of cash flow information:</b>   |                           |                      |
|  | <b>June 26,<br/>2009</b>  | <b>June 27, 2008</b> |
| Cash paid for income taxes   | \$ --                     | \$ --                |
| Cash paid for interest   | \$ 46,000                 | \$ 70,000            |

*See notes to condensed consolidated financial statements.*

**Advanced Photonix, Inc.**  
**Notes to Condensed Consolidated Financial Statements**  
**June 26, 2009**

**Note 1. Basis of Presentation**

## Business Description

**General** Advanced Photonix, Inc.<sup>®</sup> (the Company, we or API), was incorporated under the laws of the State of Delaware in June 1988. The Company is engaged in the development and manufacture of optoelectronic devices and value-added sub-systems and systems. The Company serves a variety of global Original Equipment Manufacturers (OEMs), in a variety of industries. The Company supports the customers from the initial concept and design phase of the product, through testing to full-scale production. The Company has two manufacturing facilities located in Camarillo, California and Ann Arbor, Michigan.

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and the Company's wholly owned subsidiaries, Silicon Sensors Inc. (SSI) and Picometrix, LLC (Picometrix). The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. All material inter-company accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all adjustments, consisting of normal and recurring adjustments, necessary for a fair presentation of the financial position and the results of operations for the periods presented have been included. The Company evaluates subsequent events through the date the accompanying financial statements were issued, which was August 10, 2009. Operating results for the three month period ended June 26, 2009 are not necessarily indicative of the results that may be expected for the balance of the fiscal year ending March 31, 2010.

These unaudited condensed consolidated financial statements should be read in conjunction with Management's Discussion and Analysis and the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2009.

### Note 2. Recent Pronouncements and Accounting Changes

In June 2008, the FASB ratified the consensus reached by the Emerging Issues Task Force, EITF Issue No. 07-5, *Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock* (EITF 07-5). EITF 07-5 addresses how an entity should evaluate whether an instrument is indexed to its own stock. The consensus is effective for fiscal years (and interim periods) beginning after December 15, 2008. The consensus must be applied to outstanding instruments as of the beginning of the fiscal year in which the consensus is adopted and should be treated as a cumulative-effect adjustment to the opening balance of retained earnings. Early adoption is not permitted. The Company adopted the provisions of EITF 07-5 on April 1, 2009. See Note 7 for a discussion on the impact that the adoption of EITF 07-5 had on the Company's financial statements.

In April 2009, the FASB issued FASB Staff Position (FSP) SFAS No. 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. FSP SFAS No. 107-1 and APB 28-1 enhances consistency in financial reporting by increasing the frequency of fair value disclosures. The FSP requires these disclosures on a quarterly basis, providing qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value. FSP No. 107-1 is effective for interim and annual periods ending after June 15, 2009. The adoption of FSP SFAS No. 107-1 and APB 28-1 in the first quarter of FY 2010 is included in Note 10 to the condensed consolidated financial statements.

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In May 2009, the FASB issued SFAS No. 165, *Subsequent Events*, (SFAS No. 165). SFAS No. 165 is intended to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date—that is, whether that date represents the date the financial statements were issued or were available to be issued. SFAS No. 165 is effective for interim and annual periods ending after June 15, 2009 and shall be applied prospectively. The Company has adopted SFAS No. 165 effective with the Q1 2010 financial statements. The adoption of SFAS No. 165 has no impact on our condensed consolidated financial statements.

On July 1, 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – A Replacement of FASB Statement No. 162* (SFAS No. 168). SFAS

No. 168 replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* and establishes the *Accounting Standards Codification* (Codification) as the single official source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Once effective, all other non-grandfathered, non-SEC accounting literature not included in the Codification becomes non-authoritative. SFAS No. 168 supersedes all existing, non-SEC accounting and reporting standards applied by non-governmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). SFAS No. 168 is effective for interim and annual periods ending after September 15, 2009. As the Codification does not change GAAP, the Company does not expect SFAS 168 to have a material impact on its financial statements. Previous references to applicable literature via our disclosures will be updated with references to the new Codification sections.

The Company adopted the following accounting standards in the first quarter of FY 2010, none of which had a material effect on the Company's results of operations, financial position, or liquidity.

- FASB Staff Position (FSP) SFAS No. 157-2, *Effective Date of FASB Statement No. 157*
- SFAS No. 141 (Revised 2007), *Business Combinations*
- SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements*
- FSP No. 142-3, *Determining the Useful Life of Intangible Assets*
- FSP No. ABP 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion*
- FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities*
- FSP SFAS No. 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*

### Note 3. Share-Based Compensation

The Company has five stock equity plans: The 1990 Incentive Stock Option and Non-Qualified Stock Option Plan, the 1991 Directors' Stock Option Plan (The Directors' Plan), the 1997 Employee Stock Option Plan, the 2000 Stock Option Plan and the 2007 Equity Incentive Plan. As of June 26, 2009, under all of our plans, there were 7,200,000 shares authorized for issuance, with 1,986,510 shares remaining available for future grant.

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Options typically vest at the rate of 25% per year over four years and are exercisable up to ten years from the date of issuance. Options granted under the Directors' Plan typically vests at the rate of 50% per year over two years. Under these plans, the option exercise price equals the stock's market price on the date of grant. Options and restricted stock awards may be granted to employees, officers, directors and consultants. Under the 2007 Equity Incentive Plan, stock options typically vest within four years from grant date and restricted stock awards typically vest within one year.

Restricted shares are granted with a per share or unit purchase price at 100% of fair market value on the date of grant. The shares of restricted stock vest after either three, six or twelve months, and are not transferable for one year after the grant date. Stock-based compensation will be recognized over the expected vesting period of the stock options and restricted stock.

During the three month period ended June 26, 2009, there were 78,000 stock options and 195,000 restricted shares granted by the Company at an estimated grant-date fair value of \$21,978 for the stock options and \$126,150 for the restricted shares.

The following table summarizes information regarding options outstanding and options exercisable at June 26, 2009 and June 27, 2008 and the changes during the three months then ended:

|                                  | <b>Number of<br/>Options<br/>Outstanding<br/>(000's)</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price<br/>per Share</b> | <b>Number of<br/>Shares<br/>Exercisable<br/>(000's)</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price<br/>per Share</b> |
|----------------------------------|--|--|---|--|
| <b>Balance of March 31, 2008</b> | <b>2,619</b>   | <b>\$ 1.92</b>   | <b>2,198</b>  | <b>\$ 1.87</b>   |

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|                                  |              |           |             |              |                |
|----------------------------------|--------------|-----------|-------------|--------------|----------------|
| Granted                          | 264          | \$        | 1.50        |              |                |
| Exercised                        | --           |           | --          |              |                |
| Expired                          | (38)         | \$        | 1.25        |              |                |
| <b>Balance of June 27, 2008</b>  | <b>2,845</b> | <b>\$</b> | <b>1.89</b> | <b>2,312</b> | <b>\$ 1.90</b> |
| <b>Balance of March 31, 2009</b> | <b>2,746</b> | <b>\$</b> | <b>1.92</b> | <b>2,374</b> | <b>\$ 1.93</b> |
| Granted                          | 78           | \$        | 0.63        |              |                |
| Exercised                        | --           |           | --          |              |                |
| Expired                          | (20)         | \$        | 1.80        |              |                |
| <b>Balance of June 26, 2009</b>  | <b>2,804</b> | <b>\$</b> | <b>1.92</b> | <b>2,493</b> | <b>\$ 1.92</b> |

Information regarding stock options outstanding as of June 26, 2009 is as follows:

| Price Range                | (in 000s)<br>Shares | Weighted Average<br>Exercise Price | Options Outstanding                |  |
|----------------------------|---------------------|------------------------------------|------------------------------------|--|
|                            |                     |                                    | Weighted Average<br>Remaining Life |  |
| <b>Options Outstanding</b> |                     |                                    |                                    |  |
| \$0.50 - \$1.25            | 834                 | \$0.74                             | 5.04                               |  |
| \$1.50 - \$2.50            | 1,265               | \$1.96                             | 6.50                               |  |
| \$2.68 - \$5.34            | 705                 | \$3.19                             | 4.51                               |  |
| <b>Options Exercisable</b> |                     |                                    |                                    |  |
| \$0.50 - \$1.25            | 755                 | \$0.75                             | 1.19                               |  |
| \$1.50 - \$2.50            | 1,072               | \$1.96                             | 6.03                               |  |
| \$2.68 - \$5.34            | 666                 | \$3.21                             | 4.39                               |  |

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The intrinsic value of options exercised in quarters ending June 26, 2009 and June 27, 2008 was zero in each quarter since no options were exercised.

During FY 2009 and FY 2010, restricted shares were issued to certain individuals. The restricted share transactions are summarized below.

|                                 | Shares<br>(000) | Weighted<br>Average Grant<br>Date Fair Value |
|---------------------------------|-----------------|--|
| <b>Unvested, March 31, 2008</b> | --              | --   |
| Granted                         | 29              | \$ 1.50                                      |
| Vested                          | --              | --   |
| Expired                         | --              | --   |
| <b>Unvested, June 27, 2008</b>  | 29              | \$ 1.50                                      |
|                                 | Shares<br>(000) | Weighted<br>Average Grant<br>Date Fair Value |
| <b>Unvested, March 31, 2009</b> | 29              | \$ 1.50                                      |
| Granted                         | 195             | \$ 0.65                                      |
| Vested                          | (29)            | \$ 1.50                                      |
| Expired                         | --              | --   |
| <b>Unvested, June 26, 2009</b>  | 195             | \$ 0.65                                      |



The total fair value of restricted shares vesting during the first quarter of FY 2010 was \$20,300. Share price on the date of vesting was \$0.70.

The Company accounts for stock-based incentives plans, in accordance with Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment* (SFAS No. 123(R)). The Company estimates the fair value of stock-based awards utilizing the Black-Scholes pricing model for stock options and the intrinsic value for restricted stock. The fair value of the awards is amortized as compensation expense on a straight-line basis over the requisite service period of the award, which is generally the vesting period. The Black-Scholes fair value calculations involve significant judgments, assumptions, estimates and complexities that impact the amount of compensation expense to be recorded in current and future periods. The factors include:

- The time period that stock-based awards are expected to remain outstanding has been determined based on the average of the original award period and the remaining vesting period in accordance with the SEC's short-cut approach pursuant to SAB No. 107, *Disclosure About Fair Value of Financial Statements*. The expected term assumption for awards issued during the three month periods ended June 26, 2009 and June 27, 2008 was 6.3 years. As additional evidence develops from the employee's stock trading history, the expected term assumption will be refined to capture the relevant trends.
- The future volatility of the Company's stock has been estimated based on the weekly stock price from the acquisition date of Picometrix LLC (May 2, 2005) to the date of the latest stock grant. The expected volatility assumption for awards issued during the three month periods ending June 26, 2009 and June 27, 2008 averaged 42% and 41%, respectively. As additional evidence develops, the future volatility estimate will be refined to capture the relevant trends.
- A dividend yield of zero has been assumed for awards issued during the three month periods ended June 26, 2009 and June 27, 2008, based on the Company's actual past experience and the fact that Company does not anticipate paying a dividend on its shares in the near future.
- The Company has based its risk-free interest rate assumption for awards issued during the three month periods ended June 26, 2009 and June 27, 2008 on the implied yield available on U.S. Treasury issues with an equivalent expected term, which averaged 2.2% and 3.5% during the respective periods.
- The forfeiture rate, for awards issued during the three month periods ended June 26, 2009 and June 27, 2008, were approximately 20.4% and 18.7%, respectively, and was based on the Company's actual historical forfeiture trend.

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Under the provisions of SFAS No. 123(R), the Company recorded \$95,000 and \$34,000 of stock-based compensation expense (as classified in table below) in our consolidated statements of operations for the three month periods ended June 26, 2009 and June 27, 2008, respectively.

|                                       | <b>Three months ended</b> |                      |
|---------------------------------------|---------------------------|----------------------|
|                                       | <b>June 26, 2009</b>      | <b>June 27, 2008</b> |
| Cost of Products Sold                 | \$ 3,000                  | \$ 2,000             |
| Research and Development expense      | 23,000                    | 7,000                |
| General and Administrative expense    | 64,000                    | 19,000               |
| Sales and Marketing expense           | 5,000                     | 6,000                |
| <b>Total Stock Based Compensation</b> | <b>\$ 95,000</b>          | <b>\$ 34,000</b>     |

At June 26, 2009, the total stock-based compensation expense related to unvested stock options and restricted shares granted to employees under the Company's stock option plans but not yet recognized was approximately \$232,000. This expense will be amortized on a straight-line basis over a weighted-average period of approximately 1.8 years and will be adjusted for subsequent changes in estimated forfeitures.

#### **Note 4. Credit Risk**

**Pervasiveness of Estimates and Risk** - The preparation of condensed 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 and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses

during the reporting period. Actual results could differ from those estimates. Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash equivalents and trade accounts receivable.

The Company maintains cash balances at five financial institutions that are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. As of June 26, 2009, the Company had cash at three financial institutions in excess of federally insured amounts. As excess cash is available, the Company invests in short-term and long-term investments, primarily consisting of Government Securities Money Market instruments, and Repurchase agreements. As of June 26, 2009, cash deposits held at financial institutions in excess of FDIC insured amounts of \$250,000 were \$1.7 million. As of March 31, 2009, cash deposits held at financial institutions in excess of FDIC insured amounts of \$250,000 were \$2.0 million.

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Accounts receivable are unsecured and the Company is at risk to the extent such amount becomes uncollectible. The Company performs periodic credit evaluations of its customers' financial condition and generally does not require collateral. At June 26, 2009, one customer comprised 10% or more of accounts receivable. As of March 31, 2009, one customer comprised 10% or more of accounts receivable.

#### Note 5. Detail of Certain Asset Accounts

**Cash and Cash Equivalents** - The Company considers all highly liquid investments, with an original maturity of three months or less when purchased, to be cash equivalents.

**Compensating Cash Balance** - During FY 2009, the Company established a Line of Credit Agreement with The PrivateBank and Trust Company with a minimum compensating balance requirement of \$500,000. This amount has been separately disclosed on the accompanying balance sheets as restricted cash.

**Accounts Receivable** - Receivables are stated at amounts estimated by management to be the net realizable value. The allowance for doubtful accounts is based on specific identification. Accounts receivable are charged off when it becomes apparent, based upon age or customer circumstances, that such amounts will not be collected.

Accounts receivable are unsecured and the Company is at risk to the extent such amount becomes uncollectible. The Company performs periodic credit evaluations of its customers' financial condition and generally does not require collateral. Any unanticipated change in the customers' credit worthiness or other matters affecting the collectability of amounts due from such customers could have a material effect on the results of operations in the period in which such changes or events occur. The allowance for doubtful accounts on both June 26, 2009 and March 31, 2009 was \$62,000.

**Inventories** - Inventories, which include material, labor and manufacturing overhead, are stated at the lower of standard cost (which approximates the first in, first out method) or market. Inventories consist of the following at June 26, 2009 and March 31, 2009.

|                   | June 26, 2009       | March 31, 2009      |
|-------------------|---------------------|---------------------|
| Raw material      | \$ 3,387,000        | \$ 3,316,000        |
| Work-in-process   | 944,000             | 808,000             |
| Finished products | 443,000             | 392,000             |
| Total inventories | 4,774,000           | 4,516,000           |
| Less reserve      | (940,000)           | (847,000)           |
| Inventories, net  | <b>\$ 3,834,000</b> | <b>\$ 3,669,000</b> |

Slow moving and obsolete inventories are reviewed throughout the year. To calculate a reserve for obsolescence, the Company begins with a review of its slow moving inventory. Any inventory, which has been slow moving within the past 12 months, is evaluated and reserved if deemed appropriate. In addition, any residual inventory, which is customer specific and remaining on hand at the time of contract completion, is reserved for at the standard unit cost. The complete list of slow moving and obsolete inventory is then reviewed by the production,

engineering and/or purchasing departments to identify items that can be utilized in the near future. Items identified as useable in the near future are then excluded from slow moving and obsolete inventory and the remaining amount is then reserved as slow moving and obsolete. Additionally, non-cancelable open purchase orders for parts the Company is obligated to purchase where demand has been reduced may be reserved. Reserves for open purchase orders where the market price is lower than the purchase order price are also established. If a product that had previously been reserved for is subsequently sold, the amount of reserve specific to that item is then reversed.

**Goodwill and Intangible Assets** - Intangible assets that have definite lives consist of the following (in thousands):

|                            | Weighted<br>Average<br>Lives | Amortization<br>Method | June 26, 2009     |                             |                    | March 31, 2009    |                             |                    |
|----------------------------|------------------------------|------------------------|-------------------|-----------------------------|--------------------|-------------------|-----------------------------|--------------------|
|                            |                              |                        | Carrying<br>Value | Accumulated<br>Amortization | Intangibles<br>Net | Carrying<br>Value | Accumulated<br>Amortization | Intangibles<br>Net |
| Non-Compete agreement      | 3                            | Cash Flow              | \$ 130            | \$ 130                      | \$ --              | \$ 130            | \$ 130                      | \$ --              |
| Customer list              | 15                           | Straight Line          | 475               | 337                         | 138                | 475               | 334                         | 141                |
| Trademarks                 | 15                           | Cash Flow              | 2,270             | 548                         | 1,722              | 2,270             | 514                         | 1,756              |
| Customer relationships     | 5                            | Cash Flow              | 1,380             | 795                         | 585                | 1,380             | 726                         | 654                |
| Technology Patents pending | 10                           | Cash Flow              | 10,950            | 5,633                       | 5,317              | 10,950            | 5,231                       | 5,719              |
| Patents                    |                              | Straight Line          | 570               | --                          | 570                | 502               | --                          | 502                |
|                            |                              |                        | 302               | 99                          | 203                | 295               | 92                          | 203                |
| <b>Total Intangibles</b>   |                              |                        | <b>\$16,077</b>   | <b>\$7,542</b>              | <b>8,535</b>       | <b>\$16,002</b>   | <b>\$7,027</b>              | <b>\$ 8,975</b>    |

Amortization expense for the three month periods ended June 26, 2009 and June 27, 2008 was approximately \$508,000 and \$526,000, respectively. Patent amortization expense, for the three month periods ended June 26, 2009 and June 27, 2008 was approximately \$7,000 and \$2,000, respectively. The current patents held by the Company have remaining useful lives ranging from 2 years to 20 years.

Assuming no impairment to the intangible value, future amortization expense for intangible assets and patents are as follows:

| Intangible Assets (000's) |                | Patents (a) (000's) |              |
|---------------------------|----------------|---------------------|--------------|
| 2010 (9 months)           | \$ 1,527       | 2010 (9 months)     | \$ 18        |
| 2011                      | 1,584          | 2011                | 24           |
| 2012                      | 1,305          | 2012                | 24           |
| 2013                      | 1,088          | 2013                | 24           |
| 2014                      | 901            | 2014                | 24           |
| 2015 & after              | 1,357          | 2015 & after        | 89           |
| <b>Total</b>              | <b>\$7,762</b> | <b>Total</b>        | <b>\$203</b> |

a) Patent pending costs of \$570,000 are not included in the chart above. These costs will be amortized beginning the month the patents are granted.

#### Note 6. Debt

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Total outstanding debt of the Company as of June 26, 2009 and March 31, 2009 consisted of the following (dollars in thousands):

|                         | <b>June 26, 2009</b> | <b>As of<br/>March 31,<br/>2009</b> |
|-------------------------|----------------------|-------------------------------------|
| Bank term loan          | \$ 1,447             | \$ 1,555                            |
| Bank line of credit     | 1,394                | 1,394                               |
| MEDC loans              | 2,224                | 2,224                               |
| Debt to Related Parties | 1,401                | 1,401                               |
| <b>Total</b>            | <b>\$ 6,466</b>      | <b>\$ 6,574</b>                     |

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**Line of Credit** □ During FY 2009, the Company established a Line of Credit agreement with The PrivateBank and Trust Company. As part of this banking relationship, the Company established a three year Line of Credit of \$3.0 million at an interest rate of prime plus 1%, adjusted quarterly. The prime rate at June 26, 2009 was 3.25%. The facility contains customary representations, warranties and financial covenants including minimum debt service coverage ratio, Adjusted EBITDA level, and Net Worth requirements (as defined in the agreement). The principal loan amount is due on September 25, 2011, provided that if existing loans to the Company by the Michigan Economic Development Corporation have not converted to equity on or before August 31, 2011, the outstanding principal shall be due on August 31, 2011. The availability under the facility will be determined by the calculation of a borrowing base that includes a percentage of accounts receivable and inventory.

On May 29, 2009, the Company amended its Line of Credit loan agreement effective March 31, 2009. According to the terms of the amended loan agreement, the Adjusted EBITDA level is measured on a year to date basis for the June 26, 2009, September 25, 2009, December 25, 2009 and March 31, 2010 test dates and thereafter on a trailing four quarter basis. In addition, the Debt Service Coverage ratio and the Net Worth covenants were amended. The amended minimum Debt Service Coverage ratio is 1.0 to 1.0 for the first quarter, 1.25 to 1.0 for the second quarter and 1.5 to 1.0 thereafter. The amended minimum Net Worth covenant is \$15.5 million and will increase by 10% of Net Income for each fiscal year that the Company reports net income.

The line of credit Agreement is guaranteed by each of API's wholly-owned subsidiaries and the loan is secured by a Security Agreement among API, its subsidiaries and The PrivateBank, pursuant to which API and its subsidiaries granted to The PrivateBank a first-priority security interest in certain described assets. At June 26, 2009, the Company was in compliance with the Debt Service Coverage ratio, Net Worth requirements and with the Adjusted EBITDA level. The outstanding line of credit balance as of June 26, 2009 is \$1.4 million.

**MEDC Loans** - The Michigan Economic Development Corporation (MEDC) entered into two loan agreements with Picometrix LLC, one in fiscal 2004 (MEDC-loan 1) and one in fiscal 2005 (MEDC-loan 2). Both loans are unsecured.

The MEDC-loan 1 is for \$1.025 million with an interest rate of 7%. Under the original terms of the promissory note, interest accrued but unpaid through October 2008 would be added to then outstanding principal balance of the note and the restated principal would be amortized over the remaining four years (September 15, 2012). Effective September 23, 2008, the MEDC-loan 1 of \$1,025,000 was amended and restated to change the start date of repayment of principal and interest from October 2008 to October 2009. Commencing in October 2009, the Company will pay MEDC the restated principal and accrued interest on any unpaid balance over the remaining three years.

MEDC-loan 2 is for \$1.2 million with an interest rate of 7%. Under the original terms of the promissory notes, interest accrued, but unpaid in the first two years of this agreement was added to the then outstanding principal of this promissory note. During the third year of this agreement, the Company was to pay interest on the restated principal of the Note until October 2008, at which time the Company was to repay the restated principal over the remaining three years (September 15, 2011). Effective January 26, 2009, the MEDC-loan 2 of \$1.2 million was amended and restated to change the start date of repayment of principal and interest from October 2008 to November 2009 and to extend the repayment period to October 2012.

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Included in Accrued interest on the condensed consolidated balance sheet at June 26, 2009 and March 31, 2009 is approximately \$525,000 and \$488,000, respectively, of accrued interest that will be rolled into the principal of the MEDC loans when the repayment periods begin as described above.

**Related Party Debt** - As a result of the acquisition of Picotronix, Inc. (dba Picometrix) in May 2005, the stockholders of Picometrix received four-year API promissory notes in the aggregate principal amount of \$2.9 million ("Debt to Related Parties"). The notes bear an interest rate of prime plus 1.0% and are secured by all of the intellectual property of Picometrix. The interest rate at June 26, 2009 was 4.25%. API has the option of prepaying the debt to related parties without penalty. Note holders include Robin Risser and Steve Williamson, the Company's CFO and CTO, respectively.

The Company's only significant related party transactions relate to the payment of principal and interest on the Related Party Debt. The Company and the note holders entered into amendments to the Notes to extend the due date for the remaining principal balance of the Notes (in the aggregate amount of \$1,400,500) to March 1, 2010 payable in two installments as follows:

|                  |            |
|------------------|------------|
| December 1, 2009 | \$ 450,000 |
| March 1, 2010    | \$ 950,500 |

On June 26, 2009, the remaining balance on the notes was \$1.4 million. Robin Risser and Steve Williamson, the Company's CFO and CTO, respectively, are the note holders.

Interest payments made to Related Parties during the quarters ending June 26, 2009 and June 27, 2008 were \$14,676 and \$33,296, respectively.

**Note 7. Stockholders' Equity**

At March 31, 2009, the Company had the following warrants outstanding and exercisable:

|  | <b>Shares (000's)</b> | <b>Exercise Price</b> |
|--|-----------------------|-----------------------|
| Convertible Note - 1 <sup>st</sup> Tranche | 695                   | \$ 1.7444             |
| Convertible Note - 2 <sup>nd</sup> Tranche | 695                   | \$ 1.7444             |
| Private Placement                          | 741                   | \$ 1.8500             |

The exercise price for the Convertible Note warrants are subject to adjustment, based on a formula contained in the Convertible Note agreement, if common stock is issued in the future below the \$1.7444 exercise price. Such adjustments cannot reduce the exercise price below \$1.70 without obtaining shareholder approval. The exercise price for the Private Placement warrants are subject to adjustment based on a formula contained in the Private Placement agreement, if common stock is issued in the future below the \$1.85 exercise price. Such adjustments cannot reduce the exercise price below \$1.79 without obtaining shareholder approval.

As a result of adopting EITF 07-5 on April 1, 2009 as discussed in Note 2, the above mentioned warrants, which previously were treated as equity, are no longer afforded equity treatment because of their exercise price reset features. On April 1, 2009, the Company reclassified from Additional paid-in-capital, as a cumulative effect adjustment, a \$2,326,000 decrease in accumulated deficit and the initial recognition of a \$294,000 warrant liability, to reflect the fair value of the warrants on that date. The fair value liability of these warrants decreased to approximately \$255,000 as of June 26, 2009 and as such, the Company recorded \$39,000 as other income from the change in the fair value of these warrants for the three months ended June 26, 2009.

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The fair value of the warrants was estimated using the Black-Scholes option pricing model using the following assumptions:

|                          | <b>June 26, 2009</b> | <b>April 1, 2009</b> |
|--------------------------|----------------------|----------------------|
| Expected term (in years) | .8 - 3.3             | 1.1 - 3.5            |
| Volatility               | 76.01% - 104.13%     | 72.09% - 97.99%      |
| Expected dividend        | --                   | --                   |
| Risk-free interest rate  | 0.58% - 1.16%        | 0.58% - 1.16%        |

Expected volatility is based primarily on historical volatility. Historical volatility is based on the weekly stock price for the most recent period equivalent to the term of the warrants. A dividend yield of zero has been assumed based on the Company's actual past experience and the fact that the Company does not anticipate paying a dividend on its shares in the future. The Company has based its risk-free interest on the implied yield available on U.S. Treasury issues with equivalent expected term.

The inputs used to determine the fair value of the warrants are classified as a Level 2 input in accordance with SFAS No. 157 *[Fair Value Measurements]*.

### Note 8. Consolidation Activities

**Wafer Fabrication consolidation** - The Company completed the consolidation and modernization of its wafer fabrication facilities during Q1 2010. Prior to this consolidation, the Company had excess wafer fabrication capacity at its three locations (including Dodgeville, WI), with the Ann Arbor, MI facility having the most modern infrastructure. The wafer fabrication facilities and equipment in its Wisconsin and California facilities had similar capabilities and both required substantial upgrade and improvement in order to maintain production capabilities. Since the Ann Arbor facility, when equipped, would have the physical capacity to produce all of the Company's current and foreseeable wafer requirements and would not significantly impact current production requirements during any upgrade process, management decided to consolidate all optoelectronic wafer fabrication into the Ann Arbor facility.

The Company spent approximately \$2.3 million wafer fabrication consolidation expense to complete the consolidation. The costs incurred consisted of labor and associated expense of \$1.1 million, travel and relocation costs of \$169,000, accelerated depreciation expense on de-commissioned assets of \$150,000 and supplies, consulting and other related costs of \$854,000 and \$40,000 to re-provision the California clean room into a hybrid assembly area. In accordance with SFAS No. 146, *[Accounting for Cost Activities Associated with Exit or Disposal Activities]*, all costs associated with the consolidation were recorded as expenses when incurred. With the completion of the wafer fabrication consolidation, the Company expects to realize cost reductions through elimination of duplicate expenditures and yield improvements as well as an increase in new product development capability. Related costs incurred in Q1 FY 2010 were \$40,000.

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### Note 9. Earnings Per Share

The Company's net earnings per share calculations are in accordance with SFAS No. 128, *[Earnings per Share]*. Accordingly, basic earnings (loss) per share are computed by dividing net earnings (loss) by the weighted average number of shares outstanding for each year. The calculation of earnings (loss) per share is as follows:

|   | <b>Three months ended</b> |                          |
|---|---------------------------|--------------------------|
|   | <b>June 26,<br/>2009</b>  | <b>June 27,<br/>2008</b> |
| <b><u>Basic and Diluted</u></b>               |                           |                          |
| Weighted Average Basic Shares Outstanding     | 24,135,000                | 24,010,000               |
| Dilutive effect of Stock Options and Warrants | --                        | 360,000                  |
| Weighted Average Diluted Shares Outstanding   | 24,135,000                | 24,370,000               |
| Net income (loss)                             | \$ (296,000)              | \$ 147,000               |
| Basic earnings (loss) per share               | \$ (0.01)                 | \$ 0.01                  |
| Diluted earnings (loss) per share             | \$ (0.01)                 | \$ 0.01                  |

The dilutive effect of stock options outstanding at June 26, 2009 was not included in the calculation of diluted loss per share for the three month period because to do so would have had an anti-dilutive effect as the Company had a net loss for this period. As of June 26, 2009, the number of anti-dilutive shares excluded from diluted earnings per share totaled approximately 4.6 million shares, which includes 2.1 million anti-dilutive warrants.

On April 1, 2009, the Company adopted FASB FSP EITF 03-6-1, *“Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities”* (FSP EITF 03-6-1), which requires that unvested restricted stock with a non-forfeitable right to receive dividends be included in the two-class method of computing earnings per share. FSP EITF 03-6-1 did not have a material impact on our reported earnings per share amounts.

#### **Note 10. Fair Value of Financial Instruments**

The carrying value of all financial instruments potentially subject to valuation risk (principally consisting of cash equivalents, accounts receivable, accounts payable, and debt) approximates the fair value based upon the short-term nature of these instruments, and in the case of debt, the prevailing interest rates available to the Company.

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

### **Forward-Looking Statements**

*Certain statements contained in this Management’s Discussion and Analysis (MD&A), including, without limitation, statements containing the words “may,” “will,” “can,” “anticipate,” “believe,” “plan,” “estimate,” “continue,” and similar expressions constitute “forward-looking statements.” These forward-looking statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including risks described in the Risk Factors sections and elsewhere in this filing. Except for our ongoing obligation to disclose material information as required by federal securities laws, we do not intend to update you concerning any future revisions to any forward-looking statements to reflect events or circumstances occurring after the date of this report. The following discussion should be read in conjunction with the Risk Factors as well as our financial statements and the related notes.*

### **Critical Accounting Policies and Estimates**

The discussion and analysis of Company’s financial condition and results of operations is based on its condensed consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these condensed consolidated financial statements requires us to make judgments and estimates that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statement and the reported amount of revenues and expenses during the reporting period. The Company bases its estimates on historical experience and on various other assumptions that it believes are reasonable under the circumstances. Actual results may differ from such estimates under different assumptions or conditions.

### **Application of Critical Accounting Policies**

Application of the Company’s accounting policies requires management to make certain judgments and estimates about the amounts reflected in the financial statements. Management uses historical experience and all available information to make these estimates and judgments, although differing amounts could be reported if there are changes in the assumptions and estimates. Estimates are used for, but not limited to, the accounting for the allowance for doubtful accounts, inventory allowances, valuation of intangible assets and goodwill, depreciation and amortization, warranty costs, taxes and contingencies. Management has identified the following accounting policies as critical to an understanding of its financial statements and/or as areas most dependent on management’s judgment and estimates.

### **Global Economic Conditions**

The credit markets and the financial services industry continue to experience a period of significant disruption characterized by the bankruptcy, failure, collapse or sale of various financial institutions, increased volatility in securities prices, severely diminished liquidity and credit availability and a significant level of intervention from the United States and other governments. Continued concerns about the systemic impact of potential long-term

or widespread recession, energy costs, geopolitical issues, the availability and cost of credit, the global commercial and residential real estate markets and related mortgage markets and reduced consumer confidence have contributed to increased market volatility and diminished expectations for most developed and emerging economies continuing into 2010. As a result of these market conditions, the cost and availability of credit has been and may continue to be adversely affected by illiquid credit markets and wider credit spreads. Continued turbulence in the United States and international markets and economies could restrict our ability to refinance our existing indebtedness, increase our costs of borrowing, limit our access to capital necessary to meet our liquidity needs and materially harm our operations or our ability to implement our business strategy.

### **Revenue Recognition**

Revenue is derived principally from the sales of the Company's products. The Company recognizes revenue when the basic criteria of Staff Accounting Bulletin No. 104 are met. Specifically, the Company recognizes revenue when persuasive evidence of an arrangement exists, usually in the form of a purchase order, when shipment has occurred since its terms are FOB source, or when services have been rendered, title and risk of loss have passed to the customer, the price is fixed or determinable and collection is reasonably assured in terms of both credit worthiness of the customer and there are no post shipment obligations or uncertainties with respect to customer acceptance.

The Company sells certain of its products to customers with a product warranty that provides warranty repairs at no cost. The length of the warranty term is one year from date of shipment. The Company accrues the estimated exposure to warranty claims based upon historical claim costs. The Company's management reviews these estimates on a regular basis and adjusts the warranty provisions as actual experience differs from historical estimates or as other information becomes available.

The Company does not provide price protection or general right of return. The Company's return policy only permits product returns for warranty and non-warranty repair or replacement and requires pre-authorization by the Company prior to the return. Credit or discounts, which have been historically insignificant, may be given at the discretion of the Company and are recorded when and if determined.

The Company predominantly sells directly to original equipment manufacturers with a direct sales force. The Company sells in limited circumstances through distributors. Sales through distributors represent approximately 5% of total revenue. Significant terms and conditions of distributor agreements include FOB source, net 30 days payment terms, with no return or exchange rights, and no price protection. Since the product transfers title to the distributor at the time of shipment by the Company, the products are not considered inventory on consignment.

Revenue is also derived from technology research and development contracts. We recognize revenue from these contracts as services and/or materials are provided.

### **Impairment of Long-Lived Assets**

As of June 26, 2009 and March 31, 2009, our consolidated balance sheet included \$4.6 million in goodwill. Goodwill represents the excess purchase price over amounts assigned to tangible or identifiable intangible assets acquired and liabilities assumed from our business acquisitions.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill and intangible assets that are not subject to amortization shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test shall consist of a comparison of the fair value of the asset with its carrying amount, as defined. SFAS 142 requires a two-step method for determining goodwill impairment. Step one is to compare the fair value of the reporting unit with the unit's carrying amount, including goodwill. If this test indicates that the fair value is less than the carrying value, then step two is required to compare the implied fair value of the reporting unit's goodwill with the carrying amount of the reporting unit's goodwill. If the carrying amount of the asset exceeds its fair value, an impairment loss shall be recognized in an amount equal to that excess.



We determine the fair value of our single reporting unit to be equal to our market capitalization plus a control premium. Market capitalization is determined by multiplying the shares outstanding on the assessment date by the average market price of our common stock over a 10-day period before and a 10-day period after each assessment date. We use this 20-day duration to consider inherent market fluctuations that may affect any individual closing price. We believe that our market capitalization alone does not fully capture the fair value of our business as a whole, or the substantial value that an acquirer would obtain from its ability to obtain control of our business. As such, in determining fair value, we add a control premium which seeks to give effect to the increased consideration a potential acquirer would be required to pay in order to gain sufficient ownership to set policies, direct operations and make decisions related to our company to our market capitalization.

The Company's evaluation as of March 31, 2009 indicated there were no impairments. As of March 31, 2009, our market capitalization calculated as described as above, had fallen to \$17.1 million and our carrying value, including goodwill, had decreased to \$17.9 million. We applied a 25% control premium to market capitalization to determine a fair value of \$21.4 million. We believe that including a control premium at this level is supported by recent transaction data in our industry. Absent the inclusion of a control premium greater than 4% for FY 2009, our carrying value would have exceeded fair value, requiring a step two analysis which may have resulted in an impairment of goodwill.

We determined in the first quarter 2010 that there were no events or changes in circumstances since the end of fiscal year 2009 requiring an impairment test. Our stock price has fluctuated from a high of \$0.73 to a low of \$0.59 during the first quarter of FY 2010. The current macroeconomic environment continues to be challenging and we cannot be certain of the duration of these conditions and their potential impact on our stock price performance. If our recent stock price decline persists and our market capitalization remains below our carrying value for a sustained period, it is reasonably likely that a goodwill impairment assessment prior to the next annual review in the fourth quarter of fiscal 2010 would be necessary and an impairment of goodwill may be recorded.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, the carrying value of long-lived assets, including amortizable intangibles and property and equipment, are evaluated whenever events or changes in circumstances indicate that a potential impairment has occurred relative to a given asset or assets. Impairment is deemed to have occurred if projected undiscounted cash flows associated with an asset are less than the carrying value of the asset. The estimated cash flows include management's assumptions of cash inflows and outflows directly resulting from the use of that asset in operations. The amount of the impairment loss recognized is equal to the excess of the carrying value of the asset over its then estimated fair value. The Company's evaluation for the fiscal year ended March 31, 2009, indicated there were no impairments.

#### **Deferred Tax Asset Valuation Allowance**

The Company records deferred income taxes for the future tax consequences of events that were recognized in the Company's financial statements or tax returns. The Company records a valuation allowance against deferred tax assets in accordance with SFAS 109, *Accounting for Income Taxes*, when, in management's judgment, it is more likely than not that the deferred income tax assets will not be realized in the foreseeable future. Consistent with the March 31, 2009 10K, the Company has a full valuation allowance on its net Deferred Tax Assets as of June 26, 2009.

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#### **Inventories**

The Company's inventories are stated at the lower of standard cost (which approximates actual cost under the first-in, first-out method) or market. Slow moving and obsolete inventories are reviewed throughout the year. To calculate a reserve for obsolescence, we begin with a review of our slow moving inventory. Any inventory, which has been slow moving within the past 12 months, is evaluated and reserved if deemed appropriate. In addition, any residual inventory, which is customer specific and remaining on hand at the time of contract completion, is reserved for at the standard unit cost. The complete list of slow moving and obsolete inventory is then reviewed by the production, engineering and/or purchasing departments to identify items that can be utilized in the near future. These items are then excluded from the analysis and the remaining amount of slow-moving and obsolete inventory is then reserved for. Additionally, non-cancelable open purchase orders for parts we are obligated to purchase where demand has been reduced may be reserved. Reserves for open purchase orders where the market price is lower than the purchase order price are also established. If a product that had previously been reserved for is subsequently sold, the amount of reserve specific to that item is then reversed.

**RESULTS OF OPERATIONS****Revenues**

The Company predominantly operates in one industry segment, consisting of light and radiation detection devices. The Company sells its products to multiple markets including telecommunications, industrial sensing/non destructive testing (NDT), military-aerospace, medical, and homeland security.

Revenues by market consisted of the following (dollars in thousands):

| <b>Revenues</b>        | <b>Three months ended</b> |             |                      |             |
|------------------------|---------------------------|-------------|----------------------|-------------|
|                        | <b>June 26, 2009</b>      |             | <b>June 27, 2008</b> |             |
| Telecommunications     | \$ 1,701                  | 29%         | \$ 2,199             | 28%         |
| Industrial Sensing/NDT | 2,126                     | 36%         | 3,211                | 41%         |
| Military/Aerospace     | 1,937                     | 32%         | 1,763                | 23%         |
| Medical                | 122                       | 2%          | 500                  | 7%          |
| Homeland Security      | 48                        | 1%          | 97                   | 1%          |
| <b>Total Revenues</b>  | <b>\$ 5,934</b>           | <b>100%</b> | <b>\$ 7,770</b>      | <b>100%</b> |

The Company's revenues for the quarter ended June 26, 2009 were \$5.9 million, a decrease of 24% (or \$1.8 million) over revenues of \$7.8 million for the quarter ended June 27, 2008. The Company had growth in only one of the five markets for the quarter ending June 26, 2009.

Military/Aerospace market revenues in Q1 2010 were \$1.9 million, an increase of 10% (or \$174,000) from the comparable prior period revenues of \$1.8 million. The increases were attributable primarily to an increase in Terahertz contracts. The Company expects military revenues to be up for the year compared to the prior year.

Industrial Sensing/NDT market revenues decreased to \$2.1 million in Q1 2010, a decrease of 34% (or \$1.1 million) from the comparable prior year period. The Company's Industrial Sensing/NDT revenue in the first quarter continued to experience a slow down as our customers responded to reduced demand as the result of the recession and our customers delayed capital expenditures which delayed purchases of our terahertz products. The Company expects Industrial Sensing/NDT revenues to improve in the second half of the year as the economy begins its anticipated climb out of the recession; however, we expect an overall decline in the Industrial Sensing/NDT market for fiscal year compared to the prior year.

Homeland Security revenues in Q1 2010 were \$48,000 compared to \$97,000 in the same quarter of the prior year. The sales in the current fiscal year are attributable to a THz development contract for the nuclear gauge replacement from the Department of Homeland Security. The Company expects Homeland Security revenues for the remainder of the year to be down significantly as compared to the prior year as a result of the terahertz development contract ending in September 2009.

Telecommunications market revenues of \$1.7 million for Q1 2010 were approximately 23% lower (or \$498,000) than the same quarter of the prior year. The Company's telecommunications revenues for the first half of the first quarter continued to experience a slow down as our customers responded to the recession by implementing inventory reduction programs and delaying second source initiatives for the 40G line side products. Based on customer guidance, the reduced demand was not the result of changing underlying market demand for 40G infrastructure capacity expansion. Consistent with this guidance, most of their inventory reduction programs were completed in the first quarter of FY 2010 as evidenced by a 147% growth in our Telecommunications market revenues in Q1 2010 compared to Q4 2009. We expect a return to more normal growth for the balance of the fiscal year.

Medical market revenues for Q1 2010 were \$122,000, a decrease of 76% (or \$378,000) from Q1 2009. This decrease was primarily a result of the Company's decision to eliminate business at a customer that did not meet its profitability criteria. The Company expects Medical market revenues to be slightly lower for the year as compared the prior year.

### **Gross Profit**

Gross Profit for Q1 2010 was \$3.0 million compared to Q1 2009 of \$3.8 million, or a decrease of \$759,000 on lower revenue volume of \$1.8 million. Gross profit margins increased slightly to 51% for Q1 2010 compared to 48% of sales for the comparable prior year. The improvement in gross profit margin was due primarily to favorable product mix and cost reductions now being realized through our prior years' facilities consolidation activities.

### **Operating Expenses**

Total operating expenses were \$3.2 million during Q1 2010 as compared to \$3.5 million in Q1 2009. This decrease was primarily driven by lower sales and marketing expenses of \$169,000 related to the decrease in revenue and our cost reduction program, decreased R&D expenses of \$65,000 and lower spending on the Wafer Fabrication consolidation of \$120,000 as a result of the completion of this consolidation during Q1 2010. These decreases were partially offset by an increase in G&A expenses of \$90,000.

Research, development and engineering (RD&E) expenses decreased by \$65,000 in Q1 2010 compared to Q1 2009, primarily due to lower spending on development programs in our high speed optical receiver (HSOR) product platform, offset by increased spending in our Terahertz product platform. The Company expects to continue to increase investment in the next generation 40G/100G HSOR products and THz applications in FY 2010 in order to gain HSOR market share and move THz from the laboratory to the factory floor.

Sales and marketing expenses decreased \$169,000 (or 27%) to \$451,000 in Q1 2010, as compared to \$620,000 for Q1 2009. The decrease was primarily attributable to lower compensation expenses driven by the Company's cost saving measures implemented in response to the recession and lower sales volume.

The Company has and will continue to focus its sales and marketing activity for the growing Telecom and Industrial/NDT markets. However, sales and marketing expenses are expected to decrease during the balance of FY 2010.

Total general and administrative expenses (G&A) increased by \$90,000 (8%), to approximately \$1.2 million (20% of sales) in Q1 2010 as compared to Q1 2009. This increase was primarily attributable to increased depreciation associated with the implementation of the company wide Enterprise Resource Planning system and increased cost associated with Section 404 Sarbanes-Oxley Act compliance.

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The Company expects G&A expenses to remain relatively constant for the balance of the year with planned cost reductions offset by increased expenses relating to Section 404 of the Sarbanes-Oxley Act. Currently, the Company is required to be compliant with the external reporting requirements of Section 404 by the end of fiscal year 2010. External costs required to be in compliance will materially increase in fiscal year 2010.

Amortization expense decreased by 2% to \$515,000 in Q1 2010 compared to \$528,000 in Q1 2009 due to the Company's utilization of the cash flow amortization method on the majority of its intangible assets.

The non-cash expensing of stock option and restricted stock grants included in cost of products sold and operating expenses was \$95,000 for the three months period ended June 26, 2009 compared to \$34,000 for the three months ended June 27, 2008, an increase of \$61,000.

Other operating expense incurred was related to the previously announced wafer fabrication consolidation to the Company's Ann Arbor facility, which amounted to \$40,000 in Q1 2010, compared to \$160,000 in Q1 2009. Wafer fabrication consolidation was completed in the first quarter of 2010.

### **Other Income (Expense), net**

Interest income decreased in Q1 2010 by \$15,000 from Q1 2009, due primarily to lower interest rates and lower bank balances for short term investments.

Interest expense in Q1 2010 was \$81,000 compared to \$108,000 in Q1 2009, a decrease of \$27,000. The Company incurred lower interest expense to banks and related parties primarily due to the combination of lower debt obligations and lower interest rates.

As discussed in Note 7 to the Condensed Consolidated Financial Statements, the adoption of EITF 07-5 on April 1, 2009 requires our standing warrants be recorded as a liability at fair value with subsequent changes in fair value recorded in earnings. The fair value of the warrant is determined using a Black-Scholes option pricing model, and is affected by changes in inputs to that model including our stock price, expected stock price volatility and contractual term. To the extent that the fair value of the warrant liability increases or decreases, we record a loss or income in our statements of income. The income of \$39,000 on change in fair value of the warrant liability in the first quarter of FY 2010 is primarily due to the change in the current expected stock price, volatility, interest rates and contractual life of the warrants which are the primary assumptions applied to the Black-Scholes model which we have used to calculate the fair value of the warrants.

The Company incurred a net loss for Q1 2010 of \$296,000 (\$0.01 per share), as compared to a net profit of \$147,000 (\$0.01 per share) in Q1 2009, for an increase in losses of approximately \$443,000.

### **Fluctuation in Operating Results**

The Company's operating results may fluctuate from period to period and will depend on numerous factors, including, but not limited to, customer demand and market acceptance of the Company's products, new product introductions, product obsolescence, component price fluctuation, varying product mix, and other factors. If demand does not meet the Company's expectations in any given quarter, the sales shortfall may result in an increased impact on operating results due to the Company's inability to adjust operating expenditures quickly enough to compensate for such shortfall. The Company's results of operations could be materially adversely affected by changes in economic conditions, governmental or customer spending patterns for the markets it serves. The current turbulence in the global financial markets and its potential impact on global demand for our customers' products and their ability to finance capital expenditures could materially affect the Company's operating results. In addition, any significant reduction in defense spending as a result of a change in governmental spending patterns could reduce demand for the Company's product sold into the military market.

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### **Liquidity and Capital Resources**

At June 26, 2009, the Company had cash and cash equivalents of \$1.8 million, a decrease of \$312,000 from the March 31, 2009 balance of \$2.1 million. The lower balance is attributable to a decrease of cash from operating activities of \$48,000, a decrease in investing activities of \$156,000, and a decrease in cash of \$108,000 from financing activities.

### **Operating Activities**

The decrease of \$48,000 in cash resulting from operating activities was primarily attributable to net cash generated from operations of \$569,000 offset by net reduction in operating assets and liabilities of \$617,000. This net reduction was primarily the result of an increase in accounts receivable of \$597,000, inventory of \$165,000 and prepaid/other assets of \$118,000 offset by an increase in accounts payable and other accruals of \$263,000. Cash generated from operations of \$569,000 included a loss from operations of \$296,000, income of \$39,000 to record a change in fair value of warrants and \$904,000 in non-cash depreciation, amortization, and stock-based compensation expenses.

### **Investing Activities**

The Company used \$156,000 in investing activities for capital expenditures of \$81,000 (which includes \$40,000 to complete the conversion of the California clean room to hybrid assembly manufacturing space) and patent expenditures of \$75,000.

### **Financing Activities**

For the quarter ended June 26, 2009, the Company used \$108,000 in net cash from financing activities to pay down on the bank term loan.

On May 29, 2009, the Company amended its credit facility with The PrivateBank and Trust Company, headquartered in Chicago, IL effective March 31, 2009. As part of this amendment, the Company continued its three year Line of Credit of \$3.0 million, with a minimum compensating balance requirement of \$500,000. The borrowings are based on 80% of the Company's eligible accounts receivable and 50% of the Company's eligible inventory, subject to certain limitations as defined by the agreement. The line of credit is guaranteed by each of API's wholly-owned subsidiaries and the loan is secured by a Security Agreement among API, its subsidiaries and The PrivateBank, pursuant to which API and its subsidiaries granted to The PrivateBank a first-priority security interest in certain described assets. All business assets of the Company secure the line other than the intellectual

property of the Company's Picometrix subsidiary. The amended loan agreement contains customary representations, warranties and financial covenants including minimum debt service coverage ratio, Adjusted EBITDA level, and Net Worth Requirements (as defined in the agreement). According to the terms of the amended loan agreement, the Adjusted EBITDA level is measured on a year to date basis for the June 26, 2009, September 25, 2009, December 25, 2009 and March 31, 2010 test dates and thereafter on a trailing four quarter basis. In addition, the Debt Service Coverage ratio and the Net Worth covenants were amended. The amended minimum Debt Service Coverage ratio is 1.0 to 1.0 for the first quarter, 1.25 to 1.0 for the second quarter and 1.5 to 1.0 thereafter. The amended minimum Net Worth covenant is \$15.5 million and will increase by 10% of Net Income for each fiscal year that the Company reports net income.

At June 26, 2009, the Company was in compliance with the financial covenants. The interest rate is variable at a prime rate plus 1.0% and is adjusted quarterly. Interest is payable monthly, with principal due at maturity date on September 25, 2011. The prime interest rate was 3.25% at June 26, 2009. At June 26, 2009, the outstanding balance on the line was \$1.4 million.

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The Company identifies and discloses all significant off balance sheet arrangements and related party transactions. API does not utilize special purpose entities or have any known financial relationships with other companies' special purpose entities.

#### **Operating Leases**

The Company enters into operating leases where the economic climate is favorable. The liquidity impact of operating leases is not material.

#### **Purchase Commitments**

The Company has purchase commitments for materials, supplies, services, and property, plant and equipment as part of the normal course of business. Commitments to purchase inventory at above-market prices have been reserved. Certain supply contracts may contain penalty provisions for early termination. Based on current expectations, API does not believe that it is reasonably likely to incur any material amount of penalties under these contracts.

#### **Other Contractual Obligations**

The Company does not have material financial guarantees that are reasonably likely to affect liquidity.

We believe that existing cash and cash equivalents and cash flow from future operations in conjunction with the available credit facility will be sufficient to fund our anticipated cash needs at least for the next twelve months. However, we may require additional financing to fund our operations in the future and there can be no assurance that additional funds will be available, especially if we experience operating results below expectations, or, if financing is available, there can be no assurance as to the terms on which funds might be available. If adequate financing is not available as required, or is not available on favorable terms, our business, financial position and results of operations will be adversely affected.

#### **Recent Pronouncements and Accounting Changes**

See Note 2. Recent Pronouncements and Accounting Changes regarding the effect of certain recent accounting pronouncements on our consolidated financial statements.

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

At June 26, 2009, most of the Company's interest rate exposure is linked to the prime rate, subject to certain limitations, offset by cash investment indexed to the prime rate. As such, the Company is at risk to the extent of changes in the prime rate and does not believe that moderate changes in the prime rate will materially affect our operating results or financial condition.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

Our Chief Executive Officer and Chief Financial Officers (the "Certifying Officers") are responsible for establishing and maintaining disclosure controls and procedures for the Company. The Certifying Officers have designed such

disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which this report was prepared. The Certifying Officers have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Exchange Act Rule 13a-15(e) and 15d-15(e) (the Rules) under the Securities Exchange Act of 1934 (or Exchange Act)) as of the end of the period covered by this quarterly report and believe that the Company's disclosure controls and procedures are effective based on the required evaluation.

There was no change in the Company's internal control over financial reporting that occurred during the quarter ended June 26, 2009 that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

**Part II □ OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information regarding litigation proceedings described in our Annual Report on Form 10K for the year ended March 31, 2009 is incorporated herein by reference.

**Item 1A. Risk Factors**

The Company's Annual Report on Form 10K for the fiscal year ended March 31, 2009 includes a detailed discussion of its risk factors. This 10-Q should be read in conjunction with the risk factors and information disclosed in the Company's Annual Report on Form 10K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults upon Senior Securities**

None

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

None

**Item 5. Other Information**

None

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

The following documents are filed as Exhibits to this report:

| Exhibit No. |   |
|-------------|---|
| 31.1        | Certificate of the Registrant's Chairman, Chief Executive Officer, and Director pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2        | Certificate of the Registrant's Chief Financial Officer, and Secretary pursuant to Section 302 of the Sarbanes-Oxley Act of 2002          |
| 32.1        | Certificate pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                      |

32.2

Certificate pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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### SIGNATURES

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.

**Advanced Photonix, Inc.**

(Registrant)

August 10, 2009

**/s/ Richard Kurtz**

Richard Kurtz  
Chairman, Chief Executive Officer  
and Director

**/s/ Robin Risser**

Robin Risser  
Chief Financial Officer  
and Director

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