

ADVANCED PHOTONIX INC
Form 10-Q
August 16, 2010

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 July 2, 2010
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

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)

Registrants' telephone number, including area code
(734) 864-5600

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 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 11, 2010, there were 25,537,032 of Class A Common Stock, \$.001 par value.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Advanced Photonix, Inc.
Form 10-Q
For the Quarter Ended July 2, 2010

Table of Contents

	Page
PART I FINANCIAL INFORMATION	
Item 1. Financial Statements Condensed Consolidated Balance Sheets at July 2, 2010 and March 31, 2010	3
Condensed Consolidated Statements of Operations for the three-month periods ended July 2, 2010 and June 26, 2009 (unaudited)	4
Condensed Consolidated Statements of Cash Flows for the three-month periods ended July 2, 2010 and June 26, 2009 (unaudited)	5
Notes to Condensed Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3. Quantitative and Qualitative Disclosures About Market Risk	25
Item 4. Controls and Procedures	25
PART II OTHER INFORMATION	
Item 1. Legal Proceedings	26
Item 1A. Risk Factors	26
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	26
Item 3. Defaults Upon Senior Securities	26
Item 5. Other Information	26
Item 6. Exhibits	27-33
Exhibit 3.1.3 Amended Certificate of Incorporation of Advanced Photonix, Inc., dated August 22, 2008	
Exhibit 31.1 Section 302 Certification of Chief Executive Officer	
Exhibit 31.2 Section 302 Certification of Chief Financial Officer	
Exhibit 32.1 Section 906 Certification of Chief Executive Officer	
Exhibit 32.2 Section 906 Certification of Chief Financial Officer	

PART I -- FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

Advanced Photonix, Inc.
Condensed Consolidated Balance Sheets

	July 2, 2010 (Unaudited)	March 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,431,000	\$ 1,762,
Accounts receivable, net	3,407,000	2,679,
Inventories	3,805,000	3,656,
Prepaid expenses and other current assets	201,000	200,
Total current assets	8,844,000	8,297,
Equipment and leasehold improvements, net	3,222,000	3,284,
Goodwill	4,579,000	4,579,
Intangibles and patents, net	6,801,000	7,096,
Restricted cash	500,000	500,
Other assets	276,000	99,
Total Assets	\$ 24,222,000	\$ 23,855,
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,787,000	\$ 1,006,
Accrued compensation	539,000	530,
Accrued interest	66,000	640,
Other accrued expenses	1,170,000	1,182,
Current portion of long-term debt - related parties	1,401,000	1,401,
Current portion of long-term debt - bank term loan	434,000	434,
Current portion of long-term debt - MEDC	422,000	254,
Total current liabilities	5,819,000	5,447,
Long-term debt, less current portion - MEDC	1,802,000	1,970,
Long-term debt, less current portion - bank line of credit	1,394,000	1,394,
Long-term debt, less current portion - bank term loan	542,000	687,
Total liabilities	9,557,000	9,498,
Commitments and contingencies		
Shareholders' equity:		
Class A redeemable convertible preferred stock, \$.001 par value; 780,000 shares authorized; 40,000 shares outstanding		--
Class A Common Stock, \$.001 par value, 100,000,000 authorized; July 2, 2010 – 25,537,032 shares issued and outstanding, March 31, 2010 – 24,495,669 shares issued and outstanding		24,
Additional paid-in capital	50,743,000	50,164,
Accumulated deficit	(36,104,000)	(35,831,
Total shareholders' equity	14,665,000	14,357,
Total Liabilities and Shareholders' Equity	\$ 24,222,000	\$ 23,855,

See notes to condensed consolidated financial statements.

Advanced Photonix, Inc.
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ended	
	July 2, 2010	June 26, 2009
Sales, net	\$ 6,253,000	\$ 5,934,000
Cost of products sold	3,335,000	2,937,000
Gross profit	2,918,000	2,997,000
Operating expenses:		
Research, development and engineering	1,288,000	1,063,000
Sales and marketing	473,000	451,000
General and administrative	1,012,000	1,173,000
Amortization expense	406,000	515,000
Wafer fabrication relocation expenses	--	40,000
Total operating expenses	3,179,000	3,242,000
Loss from operations	(261,000)	(245,000)
Other income (expense):		
Interest income	1,000	1,000
Interest expense	(50,000)	(67,000)
Interest expense, related parties	(15,000)	(14,000)
Change in fair value of warrant liability	54,000	39,000
Other expense	(2,000)	(10,000)
Net loss	\$ (273,000)	\$ (296,000)
Basic and diluted loss per share	\$ (0.01)	\$ (0.01)
Weighted average common shares outstanding		
Basic and diluted	24,675,000	24,135,000

See notes to condensed consolidated financial statements.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Advanced Photonix, Inc.
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Three Months Ended July 2, 2010	June 26, 2009
Cash flows from operating activities:		
Net loss	\$ (273,000)	\$ (296,000)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Depreciation	244,000	294,000
Amortization	406,000	515,000
Stock based compensation expense	18,000	95,000
Change in fair value of warrant liability	(54,000)	(39,000)
Changes in operating assets and liabilities:		
Accounts receivable - net	(728,000)	(597,000)
Inventories	(149,000)	(165,000)
Prepaid expenses and other assets	(178,000)	(218,000)
Accounts payable and accrued expenses	820,000	263,000
Net cash provided by (used in) operating activities	106,000	(48,000)
Cash flows from investing activities:		
Capital expenditures	(182,000)	(81,000)
Patent expenditures	(111,000)	(75,000)
Net cash used in investing activities	(293,000)	(156,000)
Cash flows from financing activities:		
Payments on bank term loan	(145,000)	(108,000)
Proceeds from exercise of restricted stock	1,000	--
Net cash used in financing activities	(144,000)	(108,000)
Net decrease in cash and cash equivalents	(331,000)	(312,000)
Cash and cash equivalents at beginning of period	1,762,000	2,072,000
Cash and cash equivalents at end of period	\$ 1,431,000	\$ 1,760,000
Supplemental disclosure of cash flow information:		
	July 2, 2010	June 26, 2009
Cash paid for income taxes	--	\$ --
Cash paid for interest	\$ 76,000	\$ 46,000
Non-cash financing activities:		
	July 2, 2010	June 26, 2009
Conversion of accrued MEDC loan interest to common stock	\$ 562,000	\$ --

See notes to condensed consolidated financial statements.

Advanced Photonix, Inc.
Notes to Condensed Consolidated Financial Statements
July 2, 2010

Note 1. Basis of Presentation

Business Description

General – Advanced Photonix, Inc. ® (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. Operating results for the three-month period ended July 2, 2010 are not necessarily indicative of the results that may be expected for the balance of the fiscal year ending March 31, 2011.

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, 2010, filed with the U.S. Securities and Exchange Commission ("SEC") on June 29, 2010.

Note 2. Recent Pronouncements and Accounting Changes

In April 2010, the FASB issued new guidance concerning revenue recognition related to research and development projects. It clarifies that revenue can be recognized when a milestone is achieved if the milestone meets all criteria to be considered substantive. This guidance is effective for fiscal years beginning on or after June 15, 2010. The guidance will be reviewed to determine if this change will have a material impact on the Company's future financial statements.

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 July 2, 2010, under all of our plans, there were 7,200,000 shares authorized for issuance, with 1,665,610 shares remaining available for future grant.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Non-director 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, 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.

The following table summarizes information regarding options outstanding and options exercisable at June 26, 2009 and July 2, 2010 and the changes during the periods then ended:

	Number of Options Outstanding (000's)	Weighted Average Exercise Price per Share	Number of Shares Exercisable (000's)	Weighted Average Exercise Price per Share
Balance of March 31, 2009	2,746	\$ 1.92	2,374	\$ 1.93
Granted	78	\$ 0.63		
Exercised	--	--		
Expired	(20)	\$ 1.80		
Balance of June 26, 2009	2,804	\$ 1.92	2,493	\$ 1.92

	Number of Options Outstanding (000's)	Weighted Average Exercise Price per Share	Number of Shares Exercisable (000's)	Weighted Average Exercise Price per Share
Balance of March 31, 2010	2,604	\$ 1.86	2,402	\$ 1.89
Granted	156	\$ 0.44		
Exercised	--	--		
Expired	(27)	\$ 1.61		
Balance of July 2, 2010	2,733	\$ 1.78	2,438	\$ 1.89

Information regarding stock options outstanding as of July 2, 2010 is as follows:

Price Range	Shares (in 000s)	Options Outstanding	
		Weighted Average Exercise Price	Weighted Average Remaining Life
\$0.44 - \$1.25	901	\$0.69	8.92
\$1.50 - \$2.50	1,169	\$1.91	5.68
\$2.68 - \$5.34	663	\$3.03	4.49

Price Range	Shares (in 000s)	Options Exercisable	
		Weighted Average Exercise Price	Weighted Average Remaining Life
\$0.44 - \$1.25	703	\$0.75	3.60
\$1.50 - \$2.50	1,080	\$1.93	5.45
\$2.68 - \$5.34	655	\$3.03	4.49

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

The intrinsic value of options exercised in quarters ending July 2, 2010 and June 26, 2009 was zero in each quarter since no stock options were exercised.

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

	Shares (000's)	Weighted Average Grant Date Fair Value
Unvested, March 31, 2009	29	\$ 1.50
Granted	195	\$ 0.65
Vested	(29)	\$ 1.50
Expired	--	--
Unvested, June 26, 2009	195	\$ 0.65

	Shares (000's)	Weighted Average Grant Date Fair Value
Unvested, March 31, 2010	25	\$ 0.63
Granted	70	\$ 0.44
Vested	(25)	\$ 0.63
Expired	--	--
Unvested, July 2, 2010	70	\$ 0.44

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 July 2, 2010 and June 26, 2009 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 July 2, 2010 and June 26, 2009 averaged 68% and 42%, 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 July 2, 2010 and June 26, 2009, 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 July 2, 2010 and June 26, 2009 on the implied yield available on U.S. Treasury issues with an equivalent expected term, which averaged 2.2% and 2.2% during the respective periods.
- The forfeiture rate, for awards issued during the three month periods ended July 2, 2010 and June 26, 2009, were approximately 20.0% and 20.4%, respectively, and was based on the Company's actual historical forfeiture trend.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

The Company recorded \$18,000 and \$95,000 of stock-based compensation expense (as classified in table below) in our consolidated statements of operations for the three month periods ended July 2, 2010 and June 26, 2009, respectively

	Three months ended	
	July 2, 2010	June 26, 2009
Cost of Products Sold	\$ 3,000	\$ 3,000
Research and Development expense	4,000	23,000
General and Administrative expense	8,000	64,000
Sales and Marketing expense	3,000	5,000
Total Stock Based Compensation	\$ 18,000	\$ 95,000

At July 2, 2010, 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 \$135,000. This expense will be amortized on a straight-line basis over a weighted-average period of approximately 1.9 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 four financial institutions that are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. As of July 2, 2010, the Company had cash at one financial institution 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 July 2, 2010, cash deposits held at financial institutions in excess of FDIC insured amounts of \$250,000 were approximately \$1.4 million. As of March 31, 2010, cash deposits held at financial institutions in excess of FDIC insured amounts of \$250,000 were approximately \$1.8 million.

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 July 2, 2010, no customer comprised 10% or more of accounts receivable. As of March 31, 2010, 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.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Compensating Cash Balance - The Company's credit facility with The PrivateBank and Trust Company has 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 July 2, 2010 and March 31, 2010 was \$51,000.

Inventories - Inventories, which include material, labor and manufacturing overhead, are stated at the lower of cost (on a first in, first out method) or market. Inventories consist of the following at July 2, 2010 and March 31, 2010:

	July 2, 2010	March 31, 2010
Raw material	\$ 2,505,000	\$ 2,375,000
Work-in-process	975,000	867,000
Finished products	325,000	414,000
Inventories, net	\$ 3,805,000	\$ 3,656,000

Slow moving and obsolete inventories are reviewed throughout the year to assess whether a cost adjustment is required. Our review of slow moving and obsolete inventory begins with a listing of all inventory items which have not moved regularly within the past 12 months. In addition, any residual inventory, which is customer specific and remaining on hand at the time of contract completion, is included in the list. 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 further assessed and a write down is recorded when warranted. Additionally, non-cancelable open purchase orders for parts we are obligated to purchase where demand has been reduced may also be written down. Impairments for open purchase orders where the market price is lower than the purchase order price are also recorded. The impairments established for excess, slow moving, and obsolete inventory create a new cost basis for those items. The cost basis of these parts is not subsequently increased if the circumstances which led to the impairment change in the future. If a product that had previously been impaired is subsequently sold, the amount of reduced cost basis is reflected as cost of goods sold.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

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

	Weighted Average Lives in Years	July 2, 2010 Amortization Method	Carrying Value	Accumulated Amortization	Intangibles Net
Non-Compete agreement	3	Cash Flow	\$ 130	\$ 130	--
Customer list	15	Straight Line	475	350	125
Trademarks	15	Cash Flow	2,270	689	1,581
Customer relationships	5	Cash Flow	1,380	1,380	--
Technology	10	Cash Flow	10,950	6,817	4,133
Patents pending			637	--	637
Patents	10	Straight Line	463	138	325
Total Intangibles			\$ 16,305	\$ 9,504	6,801

	Weighted Average Lives in Years	March 31, 2010 Amortization Method	Carrying Value	Accumulated Amortization	Intangibles Net
Non-Compete agreement	3	Cash Flow	\$ 130	\$ 130	--
Customer list	15	Straight Line	475	347	128
Trademarks	15	Cash Flow	2,270	653	1,617
Customer relationships	5	Cash Flow	1,380	1,380	--
Technology	10	Cash Flow	10,950	6,460	4,490
Patents pending			535	--	535
Patents	10	Straight Line	454	128	326
Total Intangibles			\$ 16,194	\$ 9,098	7,096

Amortization expense for the three-month periods ended July 2, 2010 and June 26, 2009 was approximately \$406,000 and \$515,000, 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 and Patents (000's)	
Remainder of 2011	\$ 1,217
2012	1,345
2013	1,128
2014	941
2015	597
2016 & after	936
Total	\$ 6,164

- a) Patent pending costs of \$637,000 are not included in the chart above. These costs will be amortized beginning the month the patents are granted.

Note 6. Debt

Total outstanding debt of the Company as of July 2, 2010 and March 31, 2010 consisted of the following (dollars in thousands):

	July 2, 2010	March 31, 2010
Bank term loan	\$ 976	\$ 1,121
Bank line of credit	1,394	1,394
MEDC loans	2,224	2,224
Debt to Related Parties	1,401	1,401
Total	\$ 5,995	\$ 6,140

Bank Debt –The Company has a credit facility with The PrivateBank and Trust Company. As part of this credit facility, the Company has a term loan and a \$3.0 million line of credit. The term loan is to be repaid in monthly principal payments of \$36,161, plus interest at prime plus 2%, until maturity on September 25, 2011, provided that if the existing loans to the Company by the Michigan Economic Development Corporation (MEDC) or Michigan Strategic Fund (MSF) have not converted to equity on or before August 31, 2011, the outstanding principal shall be due on August 31, 2011. The interest rate on the term loan on July 2, 2010 was 5.25%. The line of credit bears interest at prime plus 2% and any outstanding borrowings are due on December 25, 2011, provided that if the existing loans to the Company by the MEDC or MSF have not been converted to equity on or before August 31, 2011, the outstanding principal will be due on August 31, 2011. The availability under the line of credit is determined by a calculation of a borrowing base that includes a percentage of accounts receivable and inventory.

The line of credit is guaranteed by each of API's wholly-owned subsidiaries and the term 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.

The Company's credit facility contains financial covenants including minimum Debt Service Coverage ratio, Adjusted EBITDA level, and Net Worth requirements. The minimum Debt Service Coverage ratio is 1.0 to 1.0 for the first three quarters of fiscal 2011 and 1.2 to 1.0 thereafter. The minimum Adjusted EBITDA level is measured on a trailing three month basis for the July 2, 2010 (\$190,000), September 30, 2010 (\$190,000), December 31, 2010 (\$260,000) and March 31, 2011 (\$400,000) test dates and thereafter on a trailing twelve month basis (\$1,160,000). The minimum Net Worth requirement is \$13.0 million for the first quarter of FY 2011, \$12.5 million for the second quarter of FY 2011, \$12.1 million for the third quarter of FY 2011 and \$11.8 million for the fourth quarter of FY 2011. The Company was in compliance with its financial covenants in Q1 2011.

In addition to the financial covenants, the Company is required to amend the secured promissory notes issued to our CFO and CTO (Related Parties Debt) to defer the December 1, 2010 and March 1, 2011 installment payments owed under the related party notes. Failure to amend the related party notes by August 25, 2010 will constitute an event of default under the agreement.

Interest payments made to the Lender during the three-month periods ended July 2, 2010 and June 26, 2009 were approximately \$39,000 and \$32,000, respectively.

MEDC Loans - The Michigan Economic Development Corporation (MEDC) entered into two loan agreements with Picometrix LLC, one in fiscal 2005 (MEDC-loan 1) and one in fiscal 2006 (MEDC-loan 2). Both loans are unsecured.

The MEDC-loan 1 was issued in the original principal amount of \$1,025,000. Under the original terms of the MEDC – loan 1, the interest rate was 7% and interest accrued but unpaid through October 2008 would be added to then outstanding principal balance of the promissory note issued pursuant to the MEDC-loan 1 and the restated principal would be amortized over the remaining four years (September 15, 2012). Effective September 23, 2008, the MEDC-loan 1 was amended and restated to change the start date of repayment of principal and interest from October 2008 to October 2009.

During the fourth quarter of fiscal 2010, the Company began negotiations with the MEDC to further amend the MEDC-loan 1 promissory note. The Company and the MEDC agreed that the payment of restated principal and accrued interest was to be suspended until the negotiations were completed. In May 2010, the Company entered into a debt conversion agreement with the MEDC whereby the MEDC would convert the accrued and unpaid interest as of November 30, 2009 totaling \$324,669 into 601,239 unregistered shares of the Class A Common Stock of the Company at a price per share of \$0.54 (market value of the stock on the day of conversion). In addition, the Company granted the MEDC a put option to sell back to the Company the shares received pursuant to the debt conversion agreement in the event of a trigger event as defined in the debt conversion agreement. In conjunction with the debt conversion agreement, the Company amended the MEDC-loan 1 promissory note to retroactively change the interest rate from 7% to 4% beginning in December 2009, and to change the repayment terms of the outstanding principal and interest such that beginning in October 2010, the Company is to repay the remaining principal and accrued interest on a monthly basis through maturity in November 2014.

MEDC-loan 2, which was assigned to the Michigan Strategic Fund (MSF) in June 2010, was issued in the original principal amount of \$1.2 million. Under the original terms of the MEDC – loan 2, the interest rate was 7% and interest accrued, but unpaid in the first two years of this agreement was added to the then outstanding principal of the promissory note issued pursuant to the MEDC-loan 2. During the third year of this agreement, the Company was to pay interest on the restated principal of the promissory 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 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.

During the fourth quarter of fiscal 2010, the Company began negotiations with the MEDC to further amend the MEDC-loan 2 promissory note. The Company and the MEDC agreed that the payment of restated principal and accrued interest was to be suspended until the negotiations were completed. In May 2010, the Company entered into a debt conversion agreement with the MEDC whereby the MEDC would transfer the MEDC-loan 2 promissory note to the MSF which would convert the accrued and unpaid interest as of October 31, 2009 totaling \$237,667 into 440,124 unregistered shares of the Class A Common Stock of the Company at a price per share of \$0.54 (market value of the stock on the day of conversion). In addition, the Company granted the MSF a put option to sell back to the Company the shares received pursuant to the debt conversion agreement in the event of a trigger event as defined in the debt conversion agreement. In conjunction with the debt conversion agreement, the Company amended the MEDC-loan 2 promissory note to retroactively change the interest rate from 7% to 4% beginning in November 2009, and to change the repayment terms of the outstanding principal and interest such that beginning in July 2010, the Company is to repay the remaining principal and accrued interest on a monthly basis through maturity in September 2014.

The Company performed an assessment of the amendments made to the MEDC and MSF loans during Q1 fiscal 2011 to determine whether or not the amendments constituted a “troubled debt restructuring” or a “substantial modification” in accordance with FASB guidance and concluded that the amendments did not constitute either a troubled debt restructuring or a substantial modification. Furthermore, the Company performed an assessment of the balance sheet classification of the common shares issued as part of the debt conversion agreements in light of the put options granted and determined that equity classification of the shares is appropriate since the trigger event related to the put option is considered to be in the control of the Company.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Related Parties Debt - As a result of the acquisition of Picotronic, Inc., the Company issued four-year promissory notes in the aggregate principal amount of \$2.9 million to the stockholders of Picometrix. The notes bear interest at a rate of prime plus 1.0% and are secured by all of the intellectual property of Picometrix. The interest rate at July 2, 2010 was 4.25%. API has the option of prepaying the notes without penalty. Note holders include Robin Risser and Steve Williamson, the Company's CFO and CTO, respectively.

On November 30, 2009, the Company and the note holders entered into the fourth 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, 2011 payable in two installments as follows:

December 1, 2010	\$ 450,000
March 1, 2011	\$ 950,500

Interest payments made to Related Parties during the three-month periods ended July 2, 2010 and June 26, 2009 were approximately \$15,000 and \$15,000, respectively.

As described in the Bank Debt section of Note 6 to the condensed consolidated financial statements, the Company's credit agreement with The PrivateBank and Trust Company requires that the Company defer the December 1, 2010 and March 1, 2011 installments by August 25, 2010. The Company anticipates the amendments to defer these installments will be completed by the deadline.

Note 7. Stockholders' Equity

At March 31, 2010, the Company had the following warrants outstanding and exercisable:

	Shares (000's)	Exercise Price
Convertible Note – 1st Franche *	695	\$ 1.7444
Convertible Note – 2nd Franche	695	\$ 1.7444
Private Placement	741	\$ 1.8500

At July 2, 2010, the Company had the following warrants outstanding and exercisable:

	Shares (000's)	Exercise Price
Convertible Note – 2nd Franche	713	\$ 1.7000
Private Placement	765	\$ 1.7900

*Expired on April 18, 2010

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. The exercise price was reduced to \$1.70 in June 2010 as a result of the issuance of Class A Common Stock to the MEDC and MSF at a price of \$0.54 per share. Future 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. The exercise price was reduced to \$1.79 in June 2010 as a result of the issuance of Class A Common Stock to the MEDC and MSF at a price of \$0.54 per share. Future adjustments cannot reduce the exercise price below \$1.79 without obtaining shareholder approval.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

As a result of adopting the FASB's guidance, effective April 1, 2009, on how an entity should evaluate whether an instrument is indexed to its own stock, the above mentioned warrants, which previously were treated as equity, are no longer afforded equity treatment because of their exercise price reset features. At the effective date the Company was required to adjust its balance sheet to reflect the incremental impact of treating the warrants as liabilities since their original issuance date. On April 1, 2009, the Company reclassified \$2,619,000 of previously recorded debt discount from additional paid-in-capital, as a cumulative effect adjustment, and recorded the initial recognition of a \$294,000 warrant liability, to reflect the fair value of the warrants on that date. These adjustments resulted in a \$2,325,000 decrease to the accumulated deficit. The fair value liability of these warrants decreased to approximately \$58,000 as of July 2, 2010. As a result, the Company recorded other income of \$54,000, from the change in the fair value of these warrants for the three-month period ended July 2, 2010. The Company recorded other income of \$39,000, from the change in the fair value of these warrants for the three-month period ended June 26, 2009.

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

	July 2, 2010	June 26, 2009
Expected term (in years)	1.2 - 2.2	0.8 - 3.2
Volatility	59.09% - 80.29%	76.01% - 104.13%
Expected dividend	--	--
Risk-free interest rate	0.83% - 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 Level 3 inputs. Management classified these as Level 3 measurements as they are based on unobservable inputs and involve management judgment.

Note 8. Earnings Per Share

The Company's net earnings per share calculations are in accordance with FASB ASC 260-10. 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:

	Three months ended	
	July 2, 2010	June 26, 2009
Basic and Diluted		
Weighted Average Basic Shares Outstanding	24,675,000	24,135,000
Dilutive effect of Stock Options and Warrants	--	--
Weighted Average Diluted Shares Outstanding	24,675,000	24,135,000
Net loss	\$ (273,000)	\$ (296,000)
Basic & diluted loss per share	\$ (0.01)	\$ (0.01)

The dilutive effect of stock options for the periods presented was not included in the calculation of diluted loss per share because to do so would have had an anti-dilutive effect as the Company had a net loss for these periods. As of July 2, 2010, the number of anti-dilutive shares excluded from diluted earnings per share totaled approximately 4.2 million shares, which includes 1.5 million anti-dilutive warrants.

On April 1, 2009, the Company adopted the FASB's guidance on determining whether instruments granted in share-based payment transactions are participating securities 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. This guidance did not have a material impact on our reported earnings per share amounts.

Note 9. 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.

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." 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.

Certain prior year balances have been reclassified in the consolidated financial statements to conform to the current year presentation.

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 SEC 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 6% 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 July 2, 2010 and March 31, 2010, 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.

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. This guidance 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. The Company has selected March 31 as the date for its annual impairment test.

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, 2010 indicated there was no impairment. As of March 31, 2010, our market capitalization calculated as described as above, was \$14.2 million and our carrying value, including goodwill, was \$14.4 million. We applied a 25% control premium to market capitalization to determine a fair value of \$17.8 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, our carrying value would have exceeded fair value, requiring a step two analysis which may have resulted in an impairment of goodwill.

As evidenced above, our stock price and control premium are significant factors in assessing our fair value for purposes of the goodwill impairment assessment. Our stock price can be affected by, among other things, changes in industry or market conditions, changes in our results of operations, and changes in our forecasts or market expectations relating to future results. Significant turmoil in the financial markets and weakness in macroeconomic conditions globally have recently contributed to volatility in our stock price and a significant decline in our stock price during the first quarter of FY 2011. Our stock price had fluctuated from a high of \$0.59 to a low of \$0.42 during the first quarter of FY 2011. After updating our control premium analysis to include recent transaction data, the control premium averaged 62%. Absent the inclusion of a control premium greater than 18% for FY 2011, our carrying value would have exceeded fair value, requiring a step two analysis which may have resulted in an impairment of goodwill. The current macroeconomic environment, however, 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 2011 would be necessary and an impairment of goodwill may be recorded. A non-cash goodwill impairment charge would have the affect of decreasing our earnings or increasing our losses in such period. If we are required to take a substantial impairment charge, our operating results would be materially adversely affected in such period.

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, 2010 indicated there were no impairments. There were no events or changes in circumstances that indicated a potential impairment has occurred during the three-months ended July 2, 2010.

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 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, 2010 10-K, the Company has a full valuation allowance on its net Deferred Tax Assets as of July 2, 2010.

Inventories

The Company's inventories are stated at the lower of 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

In anticipation of the economic slowdown, the Company instituted company-wide cost reduction measures to mitigate the impact of the revenue shortfall. These included headcount reductions, benefit reductions and wage freezes. In addition, the Company deferred all non-essential capital expenditures. These measures, combined with prior cost savings through facility consolidations over the past few years, have significantly lowered the Company's breakeven cash flow during this fiscal year.

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):

Revenues	Three months ended			
	July 2, 2010		June 26, 2009	
Telecommunications	\$ 1,799	29%	\$ 1,701	29%
Industrial Sensing/NDT	3,456	55%	2,126	36%
Military/Aerospace	943	15%	1,937	32%
Medical	55	1%	122	2%
Homeland Security	--	--	48	1%
Total Revenues	\$ 6,253	100%	\$ 5,934	100%

The Company's revenues for the quarter ended July 2, 2010 were \$6.3 million, an increase of 5% (or \$319,000) from revenues of \$5.9 million for the quarter ended June 26, 2009. Revenues increased 22% from the quarter ended March 31, 2010. The Company experienced increases in two of our five markets for the quarter ending July 2, 2010 compared to the prior year period.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Industrial Sensing/NDT market revenue was \$3.5 million in Q1 2011, an increase of 63% (or \$1.3 million) from the comparable prior year period and an increase of 32% from the Q4 2010. Growth in our comparative and consecutive quarters reflect a strengthening in our industrial markets as the economy continues to recover from the economic recession and additional revenue from our Terahertz NDT application development contracts to inspect the F-35 Joint Strike Fighter. The Company expects substantial growth in the industrial/NDT market for fiscal year 2011.

Telecommunications revenue in the first quarter of FY 2011 was \$1.8 million, an increase of approximately 6% (\$98,000) over the prior year first quarter and an increase of 33% compared to Q4 2010. This increase in the Company's telecommunications revenue is an indication that our customers are recovering from the prior year economic recession. The Company expects telecommunication revenue to have accelerating growth during the remainder of fiscal year 2011.

Medical market revenues in the first quarter of FY 2011 decreased \$67,000 or 55% from the prior year first quarter of \$122,000. 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 grow for the fiscal year 2011.

Military/Aerospace market revenue was \$943,000, a decrease of 51% (or \$1.0 million) from the comparable prior year revenues of \$1.9 million. This decrease was attributable primarily to the timing of customer order releases. The Company's expects military revenues to result in moderate growth in fiscal year 2011.

During the first quarter of FY 2011, the Company had zero Homeland security revenue, a decrease of \$48,000 from the comparable prior year period. This decrease was the result of the completion of the Terahertz development contract from the Department of Homeland Security for the Nuclear Gauge feasibility demonstration completed in September 2009. The Company expects Homeland Security revenues for balance of fiscal year 2011 to remain at the current level, absent a significant new development contract.

Gross Profit

Gross profit for Q1 2011 was \$2.9 million compared to Q1 2010 of \$3.0 million, or a slight decrease of \$79,000 on an increase in revenue volume of 5% (or \$319,000). Gross profit margins decreased 8% to 47% for Q1 2011 compared to 51% of sales for the comparable prior year. The lower gross profit margin for Q1 2011 was due primarily to product mix, 100G HSOR Telcordia qualification costs and low hybrid assembly manufacturing yields on 40G and new 100G line side products.

Operating Expenses

Total operating expenses were \$3.2 million during Q1 2011, approximately \$63,000 lower than Q1 2010. This decrease was primarily driven by G&A cost savings initiatives and lower amortization expense on intangible assets, combined with the completion of the Wafer Fabrication consolidation in Q1 2010. These decreases were partially offset by an increase in R&D expenses and higher sales and marketing expenses related to the increase in revenue.

Research, development and engineering (RD&E) expenses of \$1.3 million increased by \$225,000 in Q1 2011 compared to Q1 2010, primarily due to higher spending on product development in our high speed optical receiver (HSOR) product platform and our THz application development for the F-35 Joint Strike Fighter. The Company expects to increase investment in the next generation 40G/100G HSOR products and THz application and market development in fiscal year 2011 in order to gain HSOR market share and move THz from the laboratory to the factory floor.

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Sales and marketing expenses increased \$22,000 (or 5%) to \$473,000 in Q1 2011, as compared to \$451,000 for Q1 2010. This increase was primarily attributable to advertising expense increase and Terahertz sales force increase. As the economy rebounds and revenues improve, the Company will continue to focus its sales and marketing activities in our growth markets. As a result, we expect increases in sales and marketing expenses in fiscal year 2011.

Total general and administrative expenses (G&A) decreased \$161,000 (14%), to approximately \$1.0 million (16% of sales) in Q1 2011 as compared to \$1.2 million (20% of sales) in Q1 2010. The decrease was primarily attributable to the Company's cost savings initiatives resulting in labor and other spending reductions. The Company expects an increase in G&A expenses for fiscal year 2011 compared to 2010, primarily driven by the reinstatement of wage increases and the Company 401(K) matching benefit in the second half of the fiscal year.

Amortization expense of \$406,000 in Q1 2011 was \$109,000 lower compared to Q1 2010. The Company's utilizes 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 operating expenses was \$15,000 for the three month period ended July 2, 2010 compared to \$92,000 for the three months ended June 26, 2009, a decrease of \$77,000.

Other operating expense incurred, related to the previously announced wafer fabrication consolidation to the Company's Ann Arbor facility, was zero in Q1 2011 compared to \$40,000 in Q1 2010. Wafer fabrication consolidation was completed in the first quarter of FY 2010.

Other Income (Expense), net

Interest income for Q1 2011 was \$1,000, the same as Q1 2010.

Interest expense in Q1 2011 was \$65,000 compared to \$81,000 in Q1 2010, a decrease of \$16,000 (or 20%). This decrease was primarily due to the combination of reduced debt obligations and lower interest rates.

As discussed in Note 7 to the Condensed Consolidated Financial Statements, FASB guidance on determining whether instruments granted in share-based payment transactions are participating securities requires our outstanding warrants to 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, the Company records an expense or income in our statements of operations. The income of \$54,000 on the change in fair value of the warrant liability in the first quarter of FY 2011 is primarily due to the change in the stock price, expected volatility, interest rates and contractual life of the warrants which are the primary assumptions applied to the Black-Scholes model used to calculate the fair value of the warrants.

The Company incurred a net loss for Q1 2011 of approximately \$273,000 (\$0.01 per share), as compared to a net loss of \$296,000 (\$0.01 per share) in Q1 2010, a decrease in loss of approximately \$23,000.

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.

Liquidity and Capital Resources

At July 2, 2010, the Company had cash and cash equivalents of \$1.4 million, a decrease of \$331,000 from the March 31, 2010 balance of \$1.8 million. The lower balance is attributable to an increase of cash from operating activities of \$106,000, offset by a decrease from investing activities of \$293,000 and a decrease of \$144,000 from financing activities.

Operating Activities

The increase of \$106,000 in cash resulting from operating activities was primarily attributable to net cash provided by operations of \$341,000, offset by net cash used for operating assets and liabilities of \$235,000. This net cash decrease from operating assets and liabilities was primarily the result of an increase in net accounts receivable of \$728,000, an increase in inventories of \$149,000, an increase in prepaid and other assets of \$178,000, offset by an increase in accounts payable and accrued expenses of \$820,000. Cash provided by operations of \$341,000 included a loss from operations of \$273,000, offset by \$614,000 in depreciation, amortization, change in warrant liability fair value and stock-based compensation expenses.

Investing Activities

The Company used \$293,000 in investing activities including capital expenditures of \$182,000 and patent expenditures of \$111,000.

Financing Activities

For the three-months ended July 2, 2010, \$144,000 was used in financing activities, comprised primarily of payments on our bank term loan.

On June 25, 2010, the Company and The PrivateBank and Trust Company entered into a second amendment to the credit agreement. The amendment increased the interest rate from prime plus 1% to prime plus 2%. Furthermore, financial covenants were amended. According to the terms of the amended agreement, the minimum Debt Service Coverage ratio is 1.0 to 1.0 for the first three quarters of fiscal 2011 and 1.2 to 1.0 thereafter. The minimum Adjusted EBITDA level is measured on a trailing three month basis for the July 2, 2010 (\$190,000), September 30, 2010 (\$190,000), December 31, 2010 (\$260,000) and March 31, 2011 (\$400,000) test dates and thereafter on a trailing twelve month basis (\$1,160,000). The minimum Net Worth requirement is \$13.0 million for the first quarter of FY 2011, \$12.5 million for the second quarter of FY 2011, \$12.1 million for the third quarter of FY 2011 and \$11.8 million for the fourth quarter of FY 2011. The Company was in compliance with its financial covenants in Q1 2011.

In addition to the financial covenants, the Company is required to amend the secured promissory notes issued to our CFO and CTO (Related Parties Debt) to defer the December 1, 2010 and March 1, 2011 installment payments owed under the related party notes. Failure to amend the related party notes by August 25, 2010 will constitute an event of default under the agreement.

In May 2010, the Company entered into a debt conversion agreement with the MEDC whereby the MEDC converted the accrued and unpaid interest under MEDC-loan 1 as of November 30, 2009 totaling \$324,669 into 601,239 unregistered shares of the Class A Common Stock of the Company at a price per share of \$0.54 (market value of the stock on the day of conversion). In addition, the Company granted the MEDC a put option to sell back to the Company the shares received pursuant to the debt conversion agreement in the event of a trigger event as defined in the agreement. In conjunction with the debt conversion agreement, the Company amended the MEDC-loan 1 promissory note to retroactively change the interest rate from 7% to 4% beginning in December 2009, and to change the repayment terms of the outstanding principal and interest such that beginning in October 2010, the Company is to repay the remaining principal and accrued interest on a monthly basis through maturity in November 2014.

In May 2010, the Company also entered into a debt conversion agreement with the MEDC related to MEDC-loan 2 whereby the MEDC transferred the MEDC-loan 2 promissory note to the MSF which converted the accrued and unpaid interest as of October 31, 2009 totaling \$237,667 into 440,124 unregistered shares of the Class A Common Stock of the Company at a price per share of \$0.54 (market value of the stock on the day of conversion). In addition, the Company granted the MSF a put option to sell back to the Company the shares received pursuant to the debt conversion agreement in the event of a trigger event as defined in the debt conversion agreement. In conjunction with the debt conversion agreement, the Company amended the MEDC-loan 2 promissory note to retroactively change the interest rate from 7% to 4% beginning in November 2009, and to change the repayment terms of the outstanding principal and interest such that beginning in July 2010, the Company is to repay the remaining principal and accrued interest on a monthly basis through maturity in September 2014.

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.

The Company believes that existing cash and cash equivalents and cash flow from future operations, in conjunction with the current amended credit facility, or a similar new credit facility arrangement that is entered into, 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” in the Condensed Consolidated Financial Statements regarding the effect of certain recent accounting pronouncements on our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

At July 2, 2010, most of the Company’s interest rate exposure is linked to the prime rate, subject to certain limitations, offset by cash investments 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 July 2, 2010 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, 2010 is incorporated herein by reference.

Item 1A. Risk Factors

The Company's Annual Report on Form 10K for the fiscal year ended March 31, 2010 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 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.

3.1.3	Amendment to Certificate of Incorporation of Advanced Photonix, Inc., dated August 22, 2008
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

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 16, 2010

/s/ Richard Kurtz
Richard Kurtz
Chairman, Chief Executive Officer, President
and Director

/s/ Robin Risser
Robin Risser
Chief Financial Officer
and Director