

APA Enterprises, Inc.  
Form 10-Q  
November 14, 2005

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

**FORM 10-Q**

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

For the quarterly period ended September 30, 2005

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

Commission File Number 0-16106

**APA Enterprises, Inc.**

(Exact name of Registrant as specified in its charter)

**Minnesota**

(State or other jurisdiction of incorporation or organization)

**41-1347235**

(I.R.S. Employer Identification No.)

**2950 N.E. 84<sup>th</sup> Lane, Blaine, Minnesota 55449**

(Address of principal executive offices and zip code)

**(763) 784-4995**

(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 the filing requirement for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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

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date:

Class:  
Common stock, par value \$.01

Outstanding at November 4, 2005  
11,872,331

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**APA ENTERPRISES, INC.**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
**(Unaudited)**

	September 30, 2005	March 31, 2005
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 8,880,807	\$ 10,813,492
Accounts receivable, net of allowance for uncollectible accounts of \$76,677 at September 30, 2005 and \$57,107 at March 31, 2005	1,716,797	1,446,248
Inventories	1,650,994	1,270,653
Prepaid expenses and other	398,120	395,920
<b>Total current assets</b>	<b>12,646,718</b>	<b>13,926,313</b>
Property, plant and equipment, net	3,571,453	3,946,998
Other assets:		
Bond reserve funds	338,140	337,091
Goodwill	3,422,511	3,422,511
Other	371,190	441,101
	4,131,841	4,200,703
<b>Total assets</b>	<b>\$ 20,350,012</b>	<b>\$ 22,074,014</b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Current portion of long-term debt	\$ 1,364,920	\$ 1,471,036
Accounts payable	1,079,043	814,005
Accrued compensation	762,377	568,950
Accrued expenses	147,622	190,062
<b>Total current liabilities</b>	<b>3,353,962</b>	<b>3,044,053</b>
Long-term debt, net of current maturities	25,833	107,800
Shareholders' equity:		
Undesignated shares, 4,999,500 authorized shares; no shares issued and outstanding	-	-
Preferred stock, \$.01 par value; 500 authorized shares; no shares issued and outstanding	-	-
Common stock, \$.01 par value; 50,000,000 authorized shares; 11,872,331 shares issued and outstanding at September 30, 2005 and March 31, 2005	118,723	118,723
Additional paid-in capital	51,962,774	51,960,084
Accumulated deficit	(35,111,280)	(33,156,646)
<b>Total shareholders' equity</b>	<b>16,970,217</b>	<b>18,922,161</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 20,350,012</b>	<b>\$ 22,074,014</b>

SEE ACCOMPANYING NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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**APA ENTERPRISES, INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	Three Months Ended September 30,		Six Months Ended September 30,	
	2005	2004	2005	2004
Revenues	\$ 4,069,367	\$ 3,668,068	\$ 7,581,930	\$ 7,355,786
Cost of sales	3,165,297	2,885,804	5,952,750	5,972,647
Gross profit	904,070	782,264	1,629,180	1,383,139
Operating expenses				
Research and development	346,707	220,595	670,305	411,803
Selling, general and administrative	1,677,031	1,474,208	3,147,439	2,825,115
	2,023,738	1,694,803	3,817,744	3,236,918
Loss from operations	(1,119,668)	(912,539)	(2,188,564)	(1,853,779)
Other income	79,437	55,221	281,159	320,827
Other expense	(22,647)	(24,979)	(45,529)	(50,231)
	56,790	30,242	235,630	270,596
Loss before income taxes	(1,062,878)	(882,297)	(1,952,934)	(1,583,183)
Income taxes	750	750	1,700	2,700
Net loss	\$ (1,063,628)	\$ (883,047)	\$ (1,954,634)	\$ (1,585,883)
Net loss per share:				
Basic and diluted	(\$0.09)	(\$0.07)	(\$0.16)	(\$0.13)
Weighted average shares outstanding:				
Basic and diluted	11,872,331	11,872,331	11,872,331	11,872,331

SEE ACCOMPANYING NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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**APA ENTERPRISES, INC.**  
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	Six Months Ended September 30,	
	2005	2004
<b>Cash Flow from operating activities</b>		
Net loss	\$ (1,954,634)	\$ (1,585,883)
Adjustments to reconcile net loss to net cash used in operating activities, net of acquisition:		
Depreciation and amortization	544,573	476,303
Gain on sale of assets	(93,126)	(208,314)
Compensation expense, net	2,690	(28,908)
Changes in operating assets and liabilities:		
Accounts receivable, net	(270,549)	246,651
Inventories	(380,341)	(3,083)
Prepaid expenses and other	(51,775)	24,455
Accounts payable and accrued expenses	416,025	133,199
Net cash used in operating activities	(1,787,137)	(945,590)
<b>Cash flow from investing activities</b>		
Purchases of property and equipment	(234,793)	(293,909)
Proceeds from sale of assets	111,680	220,000
Net cash used in investing activities	(123,113)	(73,909)
<b>Cash flow from financing activities</b>		
Repayment of long-term debt	(68,083)	(205,648)
Decrease in bond reserve funds	45,648	43,692
Net cash used in financing activities	(22,435)	(161,956)
Decrease in cash and cash equivalents	(1,932,685)	(1,181,455)
Cash and cash equivalents at beginning of period	10,813,492	13,544,910
Cash and cash equivalents at end of period	\$ 8,880,807	\$ 12,363,455
<b>Noncash investing and financing activities</b>		
Capital expenditure included in accounts payable	\$ -	\$ (225,000)

SEE ACCOMPANYING NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

Table of Contents**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS****Note 1. Basis of Presentation**

The accompanying consolidated condensed financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended March 31, 2005.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain reclassifications of previously reported amounts have been made to conform that presentation to the current period presentation.

**Note 2. Net Loss Per Share**

The following table sets forth the computation of basic and diluted net loss per share:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2005	2004	2005	2004
Numerator for basic and diluted net loss	\$ (1,063,628)	\$ (883,047)	\$ (1,954,634)	\$ (1,585,883)
Denominator for basic and diluted net loss per share - weighted average shares outstanding	11,872,331	11,872,331	11,872,331	11,872,331
Basic and diluted net loss per share	(\$0.09)	(\$0.07)	(\$0.16)	(\$0.13)

Common stock options and warrants to purchase 647,195 and 873,742 shares of common stock with a weighted average exercise price of \$2.96 and \$6.65 were outstanding at September 30, 2005 and 2004, respectively, but were excluded from calculating diluted net loss per share because they were antidilutive.

**Note 3. Segment Reporting**

The Company has identified two reportable segments based on its internal organizational structure, management of operations, and performance evaluation. These segments are (1) Optronics and (2) Cables and Networks (APACN). Optronics' revenue is generated in the design, manufacture and marketing of ultraviolet (UV) detection and measurement devices and optical components. Cables & Network's revenue is derived primarily from standard and custom fiber optic cable assemblies, copper cable assemblies, value added fiber optics frames, panels and modules. Expenses are allocated between the companies based on detailed information contained in invoices. In addition, corporate overhead costs for management's time and other expenses are allocated to each segment.



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Segment detail is summarized as follows (unaudited, in thousands):

	Optronics	Cables & Networks	Eliminations	Consolidated
<b>Three months ended September 30, 2005</b>				
External sales	\$ 109	\$ 4,058	\$ (98)	\$ 4,069
Gross profit (loss)	(192)	1,097	(1)	904
Operating income (loss)	(1,127)	7	-	(1,120)
Depreciation and amortization	217	58	-	275
Capital expenditures	52	62	-	114
Assets	20,257	7,440	(7,347)	20,350
<b>Three months ended September 30, 2004</b>				
External sales	\$ 149	\$ 3,623	(104)	\$ 3,668
Gross profit (loss)	(240)	1,022	-	782
Operating income (loss)	(1,026)	113	-	(913)
Depreciation and amortization	179	58	-	237
Capital expenditures	2	30	-	32
Assets	24,056	7,506	(7,391)	24,171
<b>Six months ended September 30, 2005</b>				
External sales	\$ 213	\$ 7,566	\$ (197)	\$ 7,582
Gross profit (loss)	(378)	2,009	(2)	1,629
Operating loss	(2,128)	(61)	-	(2,189)
Depreciation and amortization	427	118	-	545
Capital expenditures	139	96	-	235
Assets	20,257	7,440	(7,347)	20,350
<b>Six months ended September, 2004</b>				
External sales	\$ 292	\$ 7,295	(231)	\$ 7,356
Gross profit (loss)	(669)	2,052	-	1,383
Operating income (loss)	(2,061)	207	-	(1,854)
Depreciation and amortization	364	112	-	476
Capital expenditures	236	58	-	294
Assets	24,056	7,506	(7,391)	24,171

**Note 4. Sale of Optics Manufacturing Operations**

In January, 2004 the Company announced the cessation of optics manufacturing at its Blaine, Minnesota facility. The closure was the result of aggressive off-shore pricing and continued lower demand for this product line. This resulted in a charge of \$171,000 taken in the 4<sup>th</sup> quarter ended March 31, 2004. The Company sold its optics manufacturing operations on April 14, 2004 for \$220,000. The terms of the sale required the Company to restructure a loan with the Aberdeen Development Corporation (ADC), which included an upfront loan payment of \$89,305 and payment of the remaining \$140,000 loan amount in seven annual installments of \$20,000 each beginning June 30, 2004. The Company recorded a gain of approximately \$208,000 on the sale in the first quarter of fiscal 2005.

**Note 5. Sale of Land**

In June 2005 the Company sold approximately 2 acres of its land in Aberdeen, South Dakota to the Aberdeen Development Corporation (ADC) in exchange for the retirement of its remaining \$120,000 debt on its loan with ADC. The land was granted to APA in conjunction with building a facility in Aberdeen and was part of a single parcel of approximately 12 acres on which the Company has constructed and operates its manufacturing facility. The Company recognized a gain of approximately \$109,000 on the sale of the land in the first quarter of fiscal 2006.

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The Company has various incentive and non-qualified stock option plans which are used as an incentive for directors, officers, and other employees. The Company uses the intrinsic value method to value stock options issued to employees. Under this method, compensation expense is recognized for the amount by which the market price of the common stock on the date of grant exceeds the exercise price. The Company's stock based compensation expense also reflects the benefit of the cancellation of previously unvested expensed options. The Company recognized compensation income of \$1,851 and expense of \$2,690 for the three and six months ended September 30, 2005, versus recognizing compensation income of \$15,446 and \$28,908 for the three and six months ended September 30, 2004. For those stock options granted where the exercise price was equal to the market value of the underlying common stock on the date of grant, no stock-based employee compensation cost is reflected in the net loss. Had the fair value method been applied, our compensation expense would have been different.

The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value method, to stock-based employee compensation for the following three and six months ended:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2005	2004	2005	2004
Net loss to common shareholders - as reported	\$ (1,063,628)	\$ (883,047)	\$ (1,954,634)	\$ (1,585,883)
Less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(29,961)	(37,980)	(61,526)	(86,322)
Net loss - pro forma	\$ (1,093,589)	\$ (921,027)	\$ (2,016,160)	\$ (1,672,205)
Basic and diluted net loss per common share - as reported	(\$0.09)	(\$0.07)	(\$0.16)	(\$0.13)
Basic and diluted net loss per common share - pro forma	(\$0.09)	(\$0.08)	(\$0.17)	(\$0.14)

**Note 7. Adoption of New Accounting Pronouncement**

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004) (SFAS 123R), *Share-Based Payment*. This statement requires the compensation cost relating to share-based payment transactions to be recognized in a company's financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The Company is required to apply Statement 123(R) effective April 1, 2006. Management has not yet determined the impact.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Statements in this Report about future sales prospects and other matters to occur in the future are forward looking statements and are subject to uncertainties due to many factors, many of which are beyond our control. These factors include, but are not limited to, the continued development of our products, acceptance of those products by potential customers, our ability to sell such products at a profitable price, and our ability to fund our operations. For further discussion regarding these factors, see "Factors That May Influence Future Results."

**OVERVIEW**

APA Enterprises, Inc., (formerly known as APA Optics, Inc.) consists of the Optronics group and the Cables & Networks group (APACN or Cables & Networks). Optronics is active in the development, design, manufacture and marketing of ultraviolet (UV) measurement instruments for consumers and industrial customers, and gallium nitride (GaN) based transistors for power amplifiers and other commercial applications. APACN designs, manufactures and markets a variety of fiber optic and copper components for the data communication and telecommunication industries. Both groups also source components and devices from third parties for direct and value-added sales to our customers in all these technology areas.

APACN provides broadband service providers a complete line of high-performance components and connectivity solutions that enable customers to implement reliable networks that extend from the central office through the outside plant including the APACN Fiber Scalability Center (FSC), a modular line of outside plant cabinets, for the Fiber to the Premise (FTTP) market. The Company began shipping FSCs in Fiscal 2005.

In addition, APACN supplies custom products and value-added services to Original Equipment Manufacturers (OEMs) and commercial data networks.

In January 2004 Optronics terminated its optics manufacturing in Blaine, Minnesota as described in Note 4. Additionally in January 2004 Optronics consolidated its fiber optics product line operations within Blaine. Optronics plans to continue to market and sell fiber optic products using mainly APACN's sales team and channels. We outsource several components from third parties including passive optical splitters, arrayed waveguides (AWGs) and wavelength division multiplexers (WDMs) based on Thin Film Filter (TFF) technology, which we combine with our internally manufactured products to create value added components for our customers. The majority of our outsourced product providers are located offshore.

Plastic and metal models of the consumer Personal UV Monitor (PUVM) offered by Optronics continue in production, and the focus remains on sales for the spring/summer 2006 season. An attractive new clip-on hybrid plastic/metal model that can be manufactured to our quality standards by the supplier has been developed. A new product called the *SunUVStation*<sup>TM</sup> has also been introduced and we plan to provide samples to retail channels in the third quarter of fiscal 2006. This product is similar in size to an outdoor temperature gauge, measures the UV Index and is targeted to consumers and institutions for use in backyards, patios, swimming pool areas, and other public places where people need to be reminded about UV intensity. Manufacturing will be performed, in part, in our APA facility in India. The SunUVStation complements the PUVM and retailers are interested in offering both.

Optronics' 4-band *Profiler M* radiometer, which serves the printing and coating industries that use UV curing, is now in production and sales have started. This instrument measures the intensity and distribution of four UV bands to help set up and monitor the curing process. Two domestic distributors offer the product, and additional domestic and international distribution discussions are underway. We plan to sell the instrument through equipment and supplies manufacturers in addition to general distributors.

Optronics continues to offer epitaxial foundry services for GaN/AlGaN transistors to third parties. We also use our foundry for internal research and development, to advance our development of power amplifiers used primarily for cellular infrastructure applications. Manufacturing reliable transistors is difficult and costly due to the challenge of developing long-lived, stable transistors and the necessary large investment in capital equipment. While the Optronics R&D division routinely processes epitaxial layers to ensure suitability for power transistors, we have, in the past, relied on contractual services and support from other sources to process, package, and test the transistors needed to develop these power amplifiers. As others in the industry work to demonstrate and manufacture reliable transistors, the Optronics R&D group will now procure such transistors while concentrating on the development and manufacture of power amplifiers. If we are successful in establishing procurement of such transistors from outside parties, our reliance on our foundry services will decrease. We will continue to seek licensing of our intellectual property and establish strategic business alignments.

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Our wholly owned subsidiary, APA Optronics, Pvt. Ltd, India, established in fiscal year 2005, is now operational. The subsidiary, with its prime focus on low cost manufacturing of our products and components, has already started supplying samples for our Gallium Nitride and fiber optic products with expectations for products to be sold in the near future. The subsidiary is also providing software development for our Profiler M product. The subsidiary is also in process of providing marketing and sales support for our products both in the U.S. and India. The subsidiary, currently located in a leased facility, is in the process of constructing a larger facility in India, expected to be completed in the 4<sup>th</sup> quarter of fiscal 2006, to accommodate its future operations requirements.

**RESULTS OF OPERATIONS**

**THREE MONTHS ENDED SEPTEMBER 30, 2005 VS. THREE MONTHS ENDED SEPTEMBER 30, 2004**

Consolidated revenues for the three months ended September 30, 2005 increased \$401,299, or 11%, to \$4,069,367 from \$3,668,068 in 2004.

Revenues at Cables & Networks were \$4,057,740, compared to sales of \$3,622,735 reported in the same quarter a year ago, an increase of 12%. Sales for the current quarter to broadband service providers and commercial data networks were \$2,847,000 versus \$2,478,000 in the prior year quarter. The increase was primarily due to higher revenues from customers in the Fiber-to-the-Premise market which were offset by slightly lower sales to commercial data networks. Sales to OEM's were \$1,210,000 versus \$1,145,000 in the year ago period. The increase is due to orders from a new customer serving the test equipment market, offset by lower sales to our previously largest OEM customer compared to last year. This customer serves primarily the semiconductor industry. We expect that future sales of Cables & Networks products will continue to account for a substantial portion of our revenue. Historically, Cables & Networks has experienced a downturn in sales during the third quarter of the fiscal year due to the seasonal nature of some of the industries it serves. However, with the introduction of a broader product offering coupled with the expansion of the sales team into additional markets, we anticipate revenues at Cables & Networks to remain consistent with the second quarter of this year.

Gross revenues at Optronics decreased 26% to \$109,877 from \$149,194 in the same quarter a year ago. Gross revenues for the second quarter ended September 30, 2005 reflect \$98,250 of sales to Cables & Networks for fiber optics products and subcontracted labor versus \$103,861 in the comparable period last year. These sales are eliminated as intercompany sales in the consolidated financials in each quarter.

**GROSS PROFIT AND COST OF SALES**

Cables & Network's gross profit increased \$75,562, or 7%, to \$1,097,245 from \$1,021,683. The increase in gross profit was mainly from higher sales in the current quarter. The Company has successfully lowered product costs over the past year and continues to pursue component and labor cost reductions to respond to ongoing market pressures in order to maintain its gross margins.

Gross cost of sales at Optronics decreased \$86,486, or 22%, to \$302,127 from \$388,613. Gross cost of sales reflects \$97,325 related to cost of sales to Cables & Networks for fiber optics products and subcontracted labor versus \$103,861 in the last year period. These costs are eliminated as intercompany cost of sales in the consolidated financials in each quarter. Cost of sales expenses for the current period for all Optronics product lines consists of approximately \$146,000 in personnel costs, \$64,000 in depreciation and \$92,000 in materials and allocated overhead. This compares to prior year personnel expenses of approximately \$171,000, depreciation of \$71,000 and supplies and overhead of \$147,000. The overall decrease in cost of sales expenses is due to lower materials and personnel related costs between years, mainly within the GaN area, both due to expense reductions related to the procurement of GaN products from off shore suppliers.



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We anticipate comparable gross margins for Cables & Networks and cost of sales for Optronics for the third quarter.

**RESEARCH AND DEVELOPMENT EXPENSES**

Research and development expenses consist of the research and development expense at Optronics. There have been no significant research and development expenses at Cables & Networks. Expenses increased \$126,112 to \$346,707, from \$220,595 in the prior year period. The increase is due mainly to personnel and materials costs associated with power amplifier development, along with additional facility rent and depreciation expenses associated with the semiconductor machine housed at an outside facility which began operating in November 2004.

**SELLING, GENERAL, AND ADMINISTRATIVE**

Consolidated selling, general, and administrative (S, G, & A) expenses increased \$202,823, or 14%, to \$1,677,031 from \$1,474,208 in 2004.

S, G, & A expenses at Cables & Networks increased \$181,254, or 20%, to \$1,090,184 from \$908,930. The majority of the increase is attributable to additional sales personnel and related selling costs as a part of our plan to grow our revenue and customer base. We expect expenses to increase slightly as we continue to expand our sales presence and grow revenue.

S, G, & A expenses at Optronics increased \$22,494, or 4%, to \$587,772 from \$565,278. The increase is due mainly to higher personnel and material expenses associated with the start up our newly acquired India facility, offset by lower professional fees.

**INCOME (LOSS) FROM OPERATIONS**

Consolidated losses from operations increased \$207,129, or 23%, to \$1,119,668 from \$912,539 in 2004. The income from operations at Cables & Networks was \$7,061 versus income of \$112,753 in the fiscal 2004 quarter. The decreased income in the quarter was mainly due to increased selling expenses absorbed as part of Cables & Networks planned investment in revenue growth.

The loss from operations at Optronics increased \$101,437, or 10%, to \$1,126,729, from a loss of \$1,025,292 in the year ago period. The increase in the loss is related to additional R&D expenses. We expect to incur losses at Optronics until we realize significant revenues from the sales of our PUVM and GaN related products.

**OTHER INCOME AND EXPENSE**

Consolidated other income and expense increased \$26,548 to \$56,790 from \$30,242 in 2004.

Other income at Cables & Networks increased \$4,321. Other expense increased \$19,123 due to an increase in interest expense, primarily due to a higher interest rate in the current period.

Other income at Optronics increased \$40,118 to \$168,284. This resulted from an increase in interest income due to a higher rate of interest earned on investments over the prior year quarter ending September 30, 2004. Other expense decreased \$1,232 to \$21,599, from \$22,831 in the prior year period ending September 30, 2004.

**NET LOSS**



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Consolidated net loss for the quarter increased \$180,581, or 20%, to \$1,063,628, or \$.09 cents per share, from \$883,047, or \$.07 cents per share in the year ago period.

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Cables & Networks had a net loss of \$83,334 in the quarter, compared to income of \$37,160 in the year ago quarter. The decrease was due to increased S, G, & A expenses of \$181,254 and higher interest expense of \$19,123, offset by an increase of \$75,562 in gross margin.

Optronics recorded a net loss of \$980,294, an increase of \$60,087 from a loss of \$920,207 from the same period of fiscal 2005. The increased losses were mainly due to start up costs incurred in its India operations. The fiscal 2006 quarter reflects reduced cost of sales from the prior year period due to cost reductions implemented, offset by increased R&D expenses related to the additional semiconductor machine and slightly increased S, G & A expenses. Achieving profitability in the future will strongly depend upon Optronics' ability to successfully manufacture and market gallium-nitride products.

### **SIX MONTHS ENDED SEPTEMBER 30, 2005 VS. SIX MONTHS ENDED SEPTEMBER 30, 2004**

Consolidated revenues for the six months ended September 30, 2005 increased \$226,144, or 3%, to \$7,581,930 from \$7,355,786 in 2004.

Revenues at Cables & Networks increased \$271,581, or 4% to \$7,566,128 from \$7,294,547. Sales to broadband service provider and commercial data networks were \$5,432,000 or 72% of revenue, compared to sales of \$4,961,000, or 68% of revenue, in the year ago period ending September 30, 2004. Sales to OEM's were \$2,134,000, or 28% of revenue, compared to sales of \$2,334,000, or 32% of revenue, in the year ago period. The change reflects higher demand in the Fiber-to-the-Premise market, offset by slightly lower demand from OEM's, principally from a large customer serving the semiconductor industry.

Gross revenues at Optronics decreased \$78,913, or 27%, to \$212,775 from \$291,688 in the same period a year ago. Gross revenues reflect \$196,973 of sales to Cables & Networks for fiber optics products and subcontracted labor versus \$230,449 last year. These sales are eliminated as intercompany sales in the consolidated financials in each quarter.

### **COST OF SALES AND GROSS PROFIT**

Cables & Network's gross profit decreased \$42,438, or 2%, to \$2,009,185 from \$2,051,623. The decrease is due mainly to higher production variances and personnel related overhead. Gross margins as a percent of revenues decreased slightly from 28% to 27%. The decrease in margin percentage is attributable to the competitive marketplace along with increased overhead support.

Gross cost of sales at Optronics decreased \$369,660, or 38%, to \$590,512 from \$960,172. Gross cost of sales reflects \$194,705 related to cost of sales to Cables & Networks for fiber optics products and subcontracted labor versus \$230,449 last year. These costs are eliminated as intercompany cost of sales in the consolidated financials in each quarter. Cost of sales expenses for the six month period for all Optronics product lines consists of approximately \$283,000 in personnel costs, \$131,000 in depreciation and \$177,000 in materials and allocated overhead. This compares to prior year personnel expenses of approximately \$543,000, depreciation of \$148,000 and supplies and overhead of \$269,000. The overall net decrease in cost of sales is due mainly to lower personnel and material costs associated with production outsourcing efforts in the GaN area implemented in the prior year.

### **RESEARCH AND DEVELOPMENT EXPENSES**

Research and development expenses consist of the research and development expense at Optronics. There have been no research and development expenses at Cables & Networks. Expenses increased \$258,502 to \$670,305 from \$411,803 in the prior period. The increase in the expense is due mainly to increased personnel and operating costs

associated with the semiconductor machine which was installed and brought on line in November of 2004.

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**SELLING, GENERAL AND ADMINISTRATIVE**

Consolidated S, G & A expenses increased \$322,324, or 11%, to \$3,147,439 from \$2,825,115 in 2004.

Selling, general and administrative expenses at Cables & Networks increased \$225,445, or 12%, to \$2,069,732 from \$1,844,287. The majority of the increase is attributable to increased personnel expenses within the sales area generated as a part of the plan to expand sales presence and grow revenue.

Selling, general and administrative expenses at Optronics increased \$99,147, or 10%, to \$1,079,975 from \$980,828. The increase is due to additional expense related to the India operations which were acquired in March, 2005.

**INCOME (LOSS) FROM OPERATIONS**

Consolidated losses from operations increased \$334,785, or 18%, to \$2,188,564 from \$1,853,779 in 2004.

The loss from operations at Cables & Networks was \$60,547 versus income of \$207,336 in the year ago period. The loss was mainly the result of higher selling and personnel expenses related to Cables & Networks planned investment in revenue growth.

The loss from operations at Optronics increased \$66,902, or 3%, to \$2,128,017, from \$2,061,115. The increase is mainly due to the expenses related to the start up of the India operations.

**OTHER INCOME AND EXPENSE**

Consolidated other income and expense decreased \$34,966 to \$235,630 from \$270,596.

Other expense increased at Cables & Networks by \$41,986 to \$176,763 for the six month period ended September 30, 2005, versus an expense of \$134,777 in the year ago period, due to a higher rate of interest paid in the current six month period.

Other income at Optronics increased \$4,555, or 1%, to \$455,590 from \$451,035. The sale of land at our Aberdeen facility and loss on disposal of other assets resulted in a gain of \$93,126 in fiscal 2006. Additionally, interest income increased \$108,814 in the current period due to a higher outstanding receivable due from Cables & Networks and a higher rate of interest earned versus last year. Rental income for part of our Blaine facility which is leased to the buyer of our optics operations increased approximately \$11,000 in fiscal 2006 over the prior year. The sale of the optics manufacturing operations in April 2004 accounted for approximately \$208,000 in other income in fiscal 2005.

**NET INCOME (LOSS)**

Consolidated net loss increased \$368,751, or 23%, to \$1,954,634, or \$.16 cents per share, from \$1,585,883, or \$.13 cents per share in the year ago period.

Cables & Networks had a net loss of \$238,510 versus net income of \$70,359 in the year ago period. The loss reflects slightly decreased gross margins and increased S, G, & A expenses attributable to revenue growth plans.

Optronics recorded a net loss of \$1,716,124, an increase of \$59,882, or 4%, from the loss of \$1,656,242 reported in the same period of fiscal 2005. The increase is due mainly to start up costs of the India operations..

**LIQUIDITY AND CAPITAL RESOURCES**

The Company's cash and cash equivalents consist primarily of money market funds, U.S. Government instruments and other government instruments with original maturities of less than three months.

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Cash used in operating activities was \$1,787,137 for the six month period ending September 30, 2005 compared to \$945,590 used in the same period in fiscal 2004. The increase in the cash used in the current period reflects the negative impact of working capital changes in the amount of \$286,640, primarily from growth in APACN's accounts receivable and inventory as a result of increased sales, an overall increase in loss from operations, and \$291,125 in cash consumed for capital expenditures and start up costs related to our India operations.

We used net cash of \$123,113 in investing activities for the six months ended September 30, 2005 compared to \$73,909 used in the same period of the preceding fiscal year. The higher net use of cash in the current period occurred despite a decrease in capital expenditures in the amount of \$59,116, and reflects proceeds from the sale of assets of \$108,320 in the prior period. We anticipate approximately \$300,000 to \$500,000 in capital expenditures in fiscal 2006, including the building of a new facility in India.

Net cash used in financing activities for the six months ended September 30, 2005 totaled \$22,435. We used \$68,083 for reduction of debt and generated \$45,648 from the reduction of bond reserve funds. During the same period in fiscal 2004 we used \$161,956 in financing activities, of which \$205,648 was used for the scheduled reduction of debt and \$43,692 was generated from the reduction of bond reserve funds.

We believe we have sufficient funds for operations for at least the next twelve months.

Our contractual obligations and commitments are summarized in the table below (in 000's):

	Total	Less than 1 Year	1-3 years	4-5 years	After 5 years
Long-term debt	\$ 1,392	\$ 1,366	\$ 26	\$ 0	\$ 0
Leases	1,159	420	507	207	25
Total Contractual Cash Obligations	\$ 2,551	\$ 1,786	\$ 533	\$ 207	\$ 25

**APPLICATION OF CRITICAL ACCOUNTING POLICIES**

In preparing our consolidated financial statements, we make estimates, assumptions and judgments that can have a significant impact on our revenues, loss from operations and net loss, as well as on the value of certain assets and liabilities on our consolidated balance sheet. We believe that there are several accounting policies that are critical to an understanding of our historical and future performance, as these policies affect the reported amounts of revenues, expenses and significant estimates and judgments applied by management. While there are a number of accounting policies, methods and estimates affecting our consolidated financial statements, areas that are particularly significant include:

- Accounting for income taxes; and
- Valuation and evaluating impairment of long-lived assets and goodwill
- Revenue recognition

**Accounting for Income Taxes**

As part of the process of preparing our consolidated financial statements, we are required to estimate our income tax liability in each of the jurisdictions in which we do business. This process involves estimating our actual current tax expense together with assessing temporary differences resulting from differing treatment of items for tax and

accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that these deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not more likely than not or unknown, we must establish a valuation allowance.

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Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our deferred tax assets. At March 31, 2005, we recorded a full valuation allowance of \$12,167,207 against our deferred tax assets, due to uncertainties related to our ability to utilize our deferred tax assets, consisting principally of certain net operating losses carried forward. The valuation allowance is based on our estimates of taxable income by jurisdiction and the period over which our deferred tax assets will be recoverable. The Company had U.S. net operating loss (NOL) carryforwards of approximately \$31,531,000 which expire in fiscal years 2006 to 2025.

Realization of the NOL carryforwards and other deferred tax temporary differences are contingent on future taxable earnings. The deferred tax asset was reviewed for expected utilization using a “more likely than not” approach by assessing the available positive and negative evidence surrounding its recoverability. We will continue to assess and evaluate strategies that will enable the deferred tax asset, or portion thereof, to be utilized, and will reduce the valuation allowance appropriately at such time when it is determined that the “more likely than not” approach is satisfied.

We will continue to assess and evaluate strategies that will enable the deferred tax asset, or portion thereof, to be utilized, and will reduce the valuation allowance appropriately at such time when it is determined that the “more likely than not” approach is satisfied.

## Valuation and evaluating impairment of long-lived assets and goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired. Goodwill should not be amortized but reviewed for impairment at the fiscal year end or whenever conditions exist that indicate an impairment could exist. The Company performed the annual impairment test in fiscal years 2005 and 2004 and concluded that no impairment had occurred.

The Company evaluates the recoverability of its long-lived assets in accordance with SFAS 144, “Accounting for the Impairment or Disposal of Long-Lived Assets.” SFAS 144 requires recognition of impairment of long-lived assets in the event that events or circumstances indicate an impairment may have occurred and when the net book value of such assets exceeds the future undiscounted cash flows attributed to such assets. We assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. No impairment of long-lived assets has occurred through the year ended September 30, 2005.

## Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed and determinable, acceptance by the customer is reasonably certain and collection is probable. Our warranties exist for all products sold to all customer types and are generally covered for a period of one year. We record provisions against our revenue for estimated product returns in the period the related revenue is recorded. We estimate the costs to service our warranty obligations and record them within cost of sales. These estimates are based on historical sales returns, repair activity, and expectation of future market conditions. If our actual product returns and allowances exceed our estimates, additional reductions to our recorded revenue would result.

## **FACTORS THAT MAY INFLUENCE FUTURE RESULTS**

The statements contained in this Report on Form 10-Q that are not purely historical are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitations, statements regarding the Company’s expectations, hopes, beliefs, anticipations, commitments, intentions and strategies regarding the future.



Forward-looking statements include, but are not limited to, statements contained in “Item 1. Business” and “Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations” in our Report on Form 10-K for the year ended March 31, 2005. Actual results could differ from those projected in any forward-looking statements for the reasons, among others, detailed below. We believe that many of the risks detailed here are part of doing business in the industry in which we compete and will likely be present in all periods reported. The fact that certain risks are characteristic to the industry does not lessen the significance of the risk. The forward-looking statements are made as of the date of this Report as Form 10-Q and we assume no obligation to update the forward-looking statements or to update the reasons why actual results could differ from those projected in the forward-looking statements.

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**Our Results of Operations**

*Unless we generate significant revenue growth, our expenses and negative cash flow will significantly harm our financial position.*

We have not been profitable since fiscal 1990. As of September 30, 2005, we had an accumulated deficit of \$35.1 million. We may incur operating losses for the foreseeable future, and these losses may be substantial. Further, we may continue to incur negative operating cash flow in the future. We have funded our operations primarily through the sale of equity securities and borrowings. We have significant fixed expenses and we expect to continue to incur significant and increasing manufacturing, sales and marketing, product development and administrative expenses. As a result, we will need to generate significantly higher revenues while containing costs and operating expenses if we are to achieve profitability.

*Acquisitions or investments could have an adverse affect on our business.*

In March 2003, we completed the acquisition of the assets of CSP as part of our strategy to expand our product offerings, develop internal sources of components and materials, and acquire new technologies. We acquired the assets of Americable in June 2003 and integrated them with the assets of CSP. We acquired assets in India in March 2005 as part of a strategy to take advantage of lower manufacturing costs in India. We intend to continue reviewing acquisition and investment prospects. There are inherent risks associated with making acquisitions and investments including but not limited to:

- Challenges associated with integrating the operations, personnel, etc., of an acquired company;
  - Potentially dilutive issuances of equity securities;
  - Reduced cash balances and or increased debt and debt service costs;
  - Large one-time write-offs of intangible assets;
- Risks associated with geographic or business markets different than those we are familiar with; and
  - Diversion of management attention from current responsibilities.

**Our Products and Introduction of New Products**

*We must introduce new products and product enhancements to increase revenue.*

The successful operation of our business depends on our ability to anticipate market needs and develop and introduce new products and product enhancements that respond to technological changes or evolving industry standards on a timely and cost-effective basis. Our products are complex, and new products may take longer to develop than originally anticipated. These products may contain defects or have unacceptable manufacturing yields when first introduced or as new versions are released. Our products could quickly become obsolete as new technologies are introduced or as other firms introduce lower cost alternatives. We must continue to develop leading-edge products and introduce them to the commercial market quickly in order to be successful. Our failure to produce technologically competitive products in a cost-effective manner and on a timely basis will seriously harm our business, financial condition and results of operations.

*Our products may infringe on the intellectual property rights of others.*

Our products are sophisticated and rely on complicated manufacturing processes. We have received multiple patents on aspects of our design and manufacturing processes and we have applied for several more. Third parties may still assert claims that our products or processes infringe upon their intellectual property. Defending our interests against

these claims, even if they lack merit, may be time consuming, result in expensive litigation and divert management attention from operational matters. If such a claim were successful, we could be prevented from manufacturing or selling our current products, be forced to redesign our products, or be forced to license the relevant intellectual property at a significant cost. Any of these actions could harm our business, financial condition or results of operations.

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*We may make additional strategic changes in our product portfolio, but our strategic changes and restructuring programs may not yield the benefits that we expect.*

In connection with the downturn in the communications industry we have divested or closed product lines and businesses that either were not profitable or did not match our new strategic focus. As necessary, we may make further divestitures or closures of product lines and businesses. We may also make strategic acquisitions.

The impact of potential changes to our product portfolio and the effect of such changes on our business, operating results and financial condition, are unknown at this time. If we acquire other businesses in our areas of strategic focus, we may have difficulty assimilating these businesses and their products, services, technologies and personnel into our operations. These difficulties could disrupt our ongoing business, distract our management and workforce, increase our expenses and adversely affect our operating results and financial condition. In addition to these integration risks, if we acquire new businesses, we may not realize all of the anticipated benefits of these acquisitions, and we may not be able to retain key management, technical and sales personnel after an acquisition. Divestitures or elimination of existing businesses or product lines could also have disruptive effects and may cause us to incur material expenses.

## Manufacturing and Operations

*Our dependence on outside manufacturers may result in product delivery delays.*

We purchase components and labor that are incorporated into our products from outside vendors. In the case of the SunUV® Personal UV Monitor, we supply components to an outside assembler who delivers the completed product. If these vendors fail to supply us with components or completed assemblies on a timely basis, or if the quality of the supplied components or completed assemblies is not acceptable, we could experience significant delays in shipping our products. Any significant interruption in the supply or support of any components or completed assemblies could seriously harm our sales and our relationships with our customers. In addition, we have increased our reliance on the use of contract manufacturers to make our products. If these contract manufacturers do not fulfill their obligations or if we do not properly manage these relationships, our existing customer relationships may suffer.

*We may be required to rapidly increase our manufacturing capacity to deliver our products to our customers in a timely manner.*

Manufacturing of our products is a complex and precise process. We have limited experience in rapidly increasing our manufacturing capacity or in manufacturing products at high volumes. If demand for our products increases, we will be required to hire, train and manage additional manufacturing personnel and improve our production processes in order to increase our production capacity. There are numerous risks associated with rapidly increasing capacity, including:

- Difficulties in achieving adequate yields from new manufacturing lines,
- Difficulty maintaining the precise manufacturing processes required by our products while increasing capacity,
- The inability to timely procure and install the necessary equipment, and
- Lack of availability of qualified manufacturing personnel.

If we apply our capital resources to expanding our manufacturing capacity in anticipation of increased customer orders, we run the risk that the projected increase in orders will not be realized. If anticipated levels of customer orders are not received, we will not be able to generate positive gross margins and profitability.



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*We are dependent upon skilled employees; if we lose the services of our key personnel our ability to execute our operating plan, and our operating results, may suffer.*

Our future performance depends in part upon the continued service and contributions of key management, engineering, sales and marketing personnel, many of whom would be difficult to replace quickly. If we lose any of these key personnel, our business, operating results and financial condition could be materially adversely affected or delay the development or marketing of existing or future products. Competition for these personnel is intense and we may not be able to retain or attract such personnel. Our success will depend in part upon our ability to attract and retain additional personnel with the highly specialized expertise necessary to generate revenue and to engineer, design and support our products and services.

## **Markets and Market Conditions**

*Demand for our products is subject to significant fluctuation. Adverse market conditions in the communications equipment industry and any slowdown in the United States economy may harm our financial condition.*

Demand for our products is dependent on several factors, including capital expenditures in the communications industry. Capital expenditures can be cyclical in nature and result in protracted periods of reduced demand for component parts. Similarly, periods of slow economic expansion or recession can result in periods of reduced demand for our products. Such periods of reduced demand will harm our business, financial condition and results of operations. Changes to the regulatory requirements of the telecommunications industry could also affect market conditions, which could also reduce demand for our products.

*Our industry is highly competitive and subject to pricing pressure.*

Competition in the communications equipment market is intense. We have experienced and anticipate experiencing increasing pricing pressures from current and future competitors as well as general pricing pressure from our customers as part of their cost containment efforts. Many of our competitors have more extensive engineering, manufacturing, marketing, financial and personnel resources than we do. As a result, these competitors may be able to respond more quickly to new or emerging technologies and changes.

*Declining average selling prices for our fiber optic products will require us to reduce production costs to effectively compete and market these products.*

Since the time we first introduced our fiber optic components to the marketplace we have seen the average selling price of fiber optic components decline. We expect this trend to continue. To achieve profitability in this environment we must continually decrease our costs of production. In order to reduce our production costs, we will continue to pursue one or more of the following:

- Seek lower cost suppliers of raw materials or components.
- Work to further automate our assembly process.
- Develop value-added components based on integrated optics.
- Seek offshore sources for manufacturing and assembly services.

We will also seek to form strategic alliances with companies that can supply these services. Decreases in average selling prices also require that we increase unit sales to maintain or increase our revenue. There can be no guarantee that we will achieve these objectives. Our inability to decrease production costs or increase our unit sales could seriously harm our business, financial condition and results of operations.

*Our markets are characterized by rapid technological changes and evolving standards.*

The markets we serve are characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. In developing our products, we have made, and will continue to make, assumptions with respect to which standards will be adopted within our industry. If the standards that are actually adopted are different from those that we have chosen to support, our products may not achieve significant market acceptance.

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*Conditions in global markets could affect our operations.*

We have acquired facilities in India which will support design and production of our products. We also source products and labor from off shore suppliers. We expect that our foreign operations and reliance on off shore sourcing will increase in the future. As such we are subject to the risks of conducting business internationally. Those risks include but are not limited to:

- local economic and market conditions;
- political and economic instability;
- fluctuations in foreign currency exchange rates;
- tariffs and other barriers and restrictions;
- geopolitical and environmental risks; and
- changes in diplomatic or trade relationships and natural disasters.

We cannot predict whether our business operations and reliance in these markets will be affected adversely by these conditions.

**Our Customers**

*Our sales could be negatively impacted if one or more of our key customers substantially reduce orders for our products.*

If we lose a significant customer, our sales and gross margins would be negatively impacted. In addition, the loss of sales may require us to record impairment, restructuring charges or exit a particular business or product line. As of September 30, 2005, no one customer provides greater than 10% of sales for all periods presented.

*Consolidation among our customers could result in our losing a customer or experiencing a slowdown as integration takes place.*

It is likely that there will be increased consolidation among our customers in order for them to increase market share and achieve greater economies of scale. Consolidation is likely to impact our business as our customers focus on integrating their operations and choosing their equipment vendors. After a consolidation occurs, there can be no assurance that we will continue to supply the surviving entity.

*Customer payment defaults could have an adverse effect on our financial condition and results of operations.*

As a result of competitive conditions in the telecommunications market, some of our customers may experience financial difficulties. It is possible that customers from whom we expect to derive substantial revenue will default or that the level of defaults will increase. Any material payment defaults by our customers would have an adverse effect on our results of operations and financial condition.



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**Performance Requirements and Performance of our Products**

*Our products may have defects that are not detected before delivery to our customers.*

Some of the Company's products are designed to be deployed in large and complex networks and must be compatible with other components of the system, both current and future. Our customers may discover errors or defects in our products only after they have been fully deployed. In addition, our products may not operate as expected over long periods of time. In the case of the SunUV® Personal UV Monitor, a consumer product, customers could encounter a latent defect not detected in the quality inspection. If we are unable to fix errors or other problems, we could lose customers, lose revenues, suffer damage to our brand and reputation, and lose our ability to attract new customers or achieve market acceptance. Each of these factors would negatively impact cash flow and would seriously harm our business, financial condition and results of operations.

*Product defects could cause us to lose customers and revenue or to incur unexpected expenses.*

If our products do not meet our customers' performance requirements, our customer relationships may suffer. Also, our products may contain defects. Any failure or poor performance of our products could result in:

· delayed market acceptance of our products;

· delays in product shipments;

· unexpected expenses and diversion of resources to replace defective products or identify the source of errors and correct them;

· damage to our reputation and our customer relationships;

· delayed recognition of sales or reduced sales; and

· product liability claims or other claims for damages that may be caused by any product defects or performance failures.

**Intellectual Property**

*If we are unable to adequately protect our intellectual property, third parties may be able to use our technology, which could adversely affect our ability to compete in the market.*

Our success will depend in part on our ability to obtain patents and maintain adequate protection of the intellectual property related to our technologies and products. The patent positions of technology companies, including our patent position, are generally uncertain and involve complex legal and factual questions. We will be able to protect our intellectual property rights from unauthorized use by third parties only to the extent that our technologies are covered by valid and enforceable patents or are effectively maintained as trade secrets. The laws of some foreign countries do not protect intellectual property rights to the same extent as the laws of the U.S., and many companies have encountered significant problems in protecting and defending such rights in foreign jurisdictions. We will apply for patents covering our technologies and products as and when we deem appropriate. However, these applications may be challenged or may fail to result in issued patents. Our existing patents and any future patents we obtain may not be sufficiently broad to prevent others from practicing our technologies or from developing competing products. Furthermore, others may independently develop similar or alternative technologies or design around our patents. In

addition, our patents may be challenged, invalidated or fail to provide us with any competitive advantages.

We rely on trade secret protection for our confidential and proprietary information. We have taken security measures to protect our proprietary information and trade secrets, but these measures may not provide adequate protection. While we seek to protect our proprietary information by entering into confidentiality agreements with employees, collaborators and consultants, we cannot assure you that our proprietary information will not be disclosed, or that we can meaningfully protect our trade secrets. In addition, our competitors may independently develop substantially equivalent proprietary information or may otherwise gain access to our trade secrets.

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*Our business will suffer if we are unable to protect our patents or our proprietary rights.*

Our success depends to a significant degree upon our ability to develop proprietary products. However, patents may not be granted on any of our pending patent applications in the United States or in other countries. In addition, the scope of any of our issued patents may not be sufficiently broad to offer meaningful protection. Furthermore, our issued patents or patents licensed to us could potentially be successfully challenged, invalidated or circumvented so that our patent rights would not create an effective competitive barrier.

*Intellectual property litigation could harm our business.*

It is possible that we may have to defend our intellectual property rights in the future. In the event of an intellectual property dispute, we may be forced to litigate or otherwise defend our intellectual property assets. Disputes could involve litigation or proceedings declared by the United States Patent and Trademark Office or the International Trade Commission. Intellectual property litigation can be extremely expensive, and this expense, as well as the consequences should we not prevail, could seriously harm our business.

If a third party claimed an intellectual property right to technology we use, we might be forced to discontinue an important product or product line, alter our products and processes, pay license fees or cease certain activities. We may not be able to obtain a license to such intellectual property on favorable terms, if at all.

*Litigation or third party claims of intellectual property infringement could require us to spend substantial time and money and adversely affect our ability to develop and commercialize products.*

Our commercial success depends in part on our ability to avoid infringing patents and proprietary rights of third parties, and not breaching any licenses that we have entered into with regard to our technologies. Other parties have filed, and in the future are likely to file, patent applications covering genes and gene fragments, techniques and methodologies relating to model systems, and products and technologies that we have developed or intend to develop. If patents covering technologies required by our operations are issued to others, we may have to rely on licenses from third parties, which may not be available on commercially reasonable terms, or at all.

Third parties may accuse us of employing their proprietary technology without authorization. In addition, third parties may obtain patents that relate to our technologies and claim that use of such technologies infringes these patents. Regardless of their merit, such claims could require us to incur substantial costs, including the diversion of management and technical personnel, in defending ourselves against any such claims or enforcing our patents. In the event that a successful claim of infringement is brought against us, we may be required to pay damages and obtain one or more licenses from third parties. We may not be able to obtain these licenses at a reasonable cost, or at all. Defense of any lawsuit or failure to obtain any of these licenses could adversely affect our ability to develop and commercialize products.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We invest in short-term securities of high credit issuers with maturities ranging from overnight up to 24 months. The average maturity of the portfolio does not exceed 12 months. The portfolio includes only marketable securities with active secondary or resale markets to ensure liquidity. We have no investments denominated in foreign country currencies and, therefore, our investments are not subject to foreign exchange risk.



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**ITEM 4. CONTROLS AND PROCEDURES.**

(a) *Evaluation of disclosure controls and procedures.* The Company's chief executive officer and chief financial officer have concluded that as of the end of the fiscal period covered by this report the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-14(c)) were effective to ensure that the information required to be disclosed by the Company in the report was gathered, analyzed and disclosed with adequate timeliness, accuracy and completeness.

(b) *Changes in internal controls.* There were no changes in the Company's internal controls over financial reporting during the fiscal period covered by this report that materially affected, or are likely to materially affect, the Company's control over financial reporting.

**PART II**

**ITEM 1. LEGAL PROCEEDINGS**

See Item 3 in Part 1 of our report on Form 10-K for the fiscal year ended March 31, 2005 for information on EIT v. APA Enterprises, Inc. This is currently scheduled for trial at the end of December 2005.

**ITEMS 2 THROUGH 5. NOT APPLICABLE**

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.**

(a) Exhibits.

Exhibit 10.6 - Amended and Restated Change of Control Agreement with Anil K. Jain, Ph.D. dated September 15, 2005

Exhibit 10.11 - Severance Agreement with Cheri B. Podzimek dated September 15, 2005

Exhibit 31.1 - Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 - Certification required of Chief Executive Officer and Chief Financial Officer by Section 906 of the Sarbanes Oxley Act of 2002

(b) Reports on Form 8-K.

A report on Form 8-K dated August 18, 2005 reporting changes in compensation and incentive plans for executive officers

A report on Form 8-K dated September 15, 2005 reporting the company entering into an a severance and change of control agreements with executive officers

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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.

APA ENTERPRISES, INC.

11/14/05  
Date

/s/ Anil K. Jain  
Anil K. Jain  
President,  
Chief Executive Officer and Chief  
Financial Officer (Principal  
Executive and Principal Financial  
Officer)

11/14/05  
Date

/s/ Daniel Herzog  
Comptroller  
(Principal Accounting Officer)