

ADVANCED PHOTONIX INC  
Form 10-Q  
February 14, 2011

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 December 31, 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 No.)

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 February 9, 2011, there were 29,149,307 shares of Class A Common Stock, \$.001 par value, outstanding.

2

---

Advanced Photonix, Inc.  
Form 10-Q  
For the Quarter Ended December 31, 2010

Table of Contents

	Page
PART I	FINANCIAL INFORMATION
<u>Item 1.</u>	<u>Financial Statements</u>
	<u>Condensed Consolidated Balance Sheets at December 31, 2010 and March 31, 2010</u> 5
	<u>Condensed Consolidated Statements of Operations for the three-month and nine-month periods ended December 31, 2010 and December 25, 2009 (unaudited)</u> 6
	<u>Condensed Consolidated Statements of Cash Flows for the nine-month periods ended December 31, 2010 and December 25, 2009 (unaudited)</u> 7
	<u>Notes to Condensed Consolidated Financial Statements</u> 8
<u>Item 2.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> 22
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u> 31
<u>Item 4.</u>	<u>Controls and Procedures</u> 31
PART II	OTHER INFORMATION
<u>Item 1.</u>	<u>Legal Proceedings</u> 33
<u>Item 1A.</u>	<u>Risk Factors</u> 33
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u> 37
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u> 39
<u>Item 5.</u>	<u>Other Information</u> 39
<u>Item 6.</u>	<u>Exhibits and Reports on Form 8-K</u> 39-103
	Exhibit 10.1 SPA between API and In-Q-Tel
	Exhibit 10.2 Letter Agreement between API and In-Q-Tel
	Exhibit 10.3 Development Agreement with In-Q-Tel
	Exhibit 10.4 Royalty Agreement with In-Q-Tel
	Exhibit 10.5 Amended & Restated SPA with Related Parties
	Exhibit 10.6 Class A Common Stock Purchase Warrants – Related Parties – Rob Risser



Exhibit 10.7 Class A Common Stock Purchase Warrants – Related Parties – Steve Williamson

Exhibit 10.8 5th Amendment to Secured Promissory Note - Risser

Exhibit 10.9 5th Amendment to Secured Promissory Note - Williamson

Exhibit 10.10 4th Amendment to Loan Agreement with The PrivateBank

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

	December 31, 2010 (Unaudited)	March 31, 2010
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,188,000	\$ 1,762,000
Accounts receivable, net	4,186,000	2,679,000
Inventories	4,776,000	3,656,000
Prepaid expenses and other current assets	268,000	200,000
Total current assets	10,418,000	8,297,000
Equipment and leasehold improvements, net	3,514,000	3,284,000
Goodwill	4,579,000	4,579,000
Intangibles and patents, net	6,089,000	7,096,000
Restricted cash	500,000	500,000
Other assets	276,000	99,000
Total Assets	\$ 25,376,000	\$ 23,855,000
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,562,000	\$ 1,006,000
Accrued compensation	724,000	530,000
Accrued interest	51,000	640,000
Accrued warrant liability	428,000	111,000
Other accrued expenses	1,409,000	1,071,000
Current portion of long-term debt - related parties	525,000	1,401,000
Current portion of long-term debt - bank term loan	434,000	434,000
Current portion of long-term debt - bank line of credit	1,994,000	--
Current portion of long-term debt – MEDC/MSF	506,000	254,000
Total current liabilities	8,633,000	5,447,000
Long-term debt, less current portion – related parties	725,000	--
Long-term debt, less current portion – MEDC/MSF	1,589,000	1,970,000
Long-term debt, less current portion - bank line of credit	--	1,394,000
Long-term debt, less current portion - bank term loan	362,000	687,000
Total liabilities	11,309,000	9,498,000
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; December 31, 2010 – 26,041,199 shares issued and outstanding, March 31, 2010 – 24,463,978 shares issued and outstanding	26,000	24,000

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Additional paid-in capital	51,192,000		50,164,000
Accumulated deficit	(37,151,000 )		(35,831,000 )
Total shareholders' equity	14,067,000		14,357,000
Total Liabilities and Shareholders' Equity	\$ 25,376,000	\$	23,855,000

See notes to condensed consolidated financial statements.



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

	Three Months Ended		Nine Months Ended	
	December 31, 2010	December 25, 2009	December 31, 2010	December 25, 2009
Sales, net	\$ 7,720,000	\$ 4,588,000	\$ 20,972,000	\$ 15,947,000
Cost of products sold	4,636,000	3,009,000	12,068,000	9,306,000
Gross profit	3,084,000	1,579,000	8,904,000	6,641,000
<b>Operating expenses:</b>				
Research, development and engineering	1,362,000	1,183,000	3,953,000	3,413,000
Sales and marketing	455,000	380,000	1,352,000	1,249,000
General and administrative	1,028,000	998,000	2,992,000	3,152,000
Amortization expense	409,000	518,000	1,223,000	1,552,000
Wafer fabrication relocation expenses	--	--	--	40,000
Total operating expenses	3,254,000	3,079,000	9,520,000	9,406,000
Loss from operations	(170,000 )	(1,500,000 )	(616,000 )	(2,765,000 )
<b>Other income (expense):</b>				
Interest income	--	1,000	2,000	4,000
Interest expense	(50,000 )	(66,000 )	(156,000 )	(202,000 )
Interest expense, related parties	(15,000 )	(15,000 )	(45,000 )	(44,000 )
Change in fair value of warrant liability	(97,000 )	174,000	(186,000 )	121,000
Loss on debt extinguishment	(318,000 )	--	(318,000 )	--
Other income/(expense)	1,000	62,000	(1,000 )	54,000
Net loss	\$ (649,000 )	\$ (1,344,000 )	\$ (1,320,000 )	\$ (2,832,000 )
Basic and diluted loss per share	\$ (0.03 )	\$ (0.05 )	\$ (0.05 )	\$ (0.12 )
<b>Weighted average common shares outstanding</b>				
Basic and diluted	25,908,000	24,483,000	25,410,000	24,323,000

See notes to condensed consolidated financial statements.

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

	Nine Months Ended	
	December 31, 2010	December 25, 2009
Cash flows from operating activities:		
Net loss	\$ (1,320,000 )	\$ (2,832,000 )
Adjustments to reconcile net loss to net cash provided by operating activities		
Depreciation	707,000	847,000
Amortization	1,223,000	1,552,000
Stock based compensation expense	158,000	303,000
Change in fair value of warrant liability	186,000	(121,000 )
Loss on debt extinguishment	318,000	--
Changes in operating assets and liabilities:		
Accounts receivable – net	(1,507,000 )	779,000
Inventories	(1,119,000 )	(12,000 )
Prepaid expenses and other assets	(245,000 )	192,000
Accounts payable and accrued expenses	1,904,000	(187,000 )
Net cash provided by operating activities	305,000	521,000
Cash flows from investing activities:		
Capital expenditures	(937,000 )	(93,000 )
Patent expenditures	(216,000 )	(182,000 )
Net cash used in investing activities	(1,153,000 )	(275,000 )
Cash flows from financing activities:		
Borrowings on bank line of credit	600,000	--
Payments on bank term loan	(325,000 )	(326,000 )
Payments on notes payable – MEDC/MSF	(129,000 )	--
Payments on notes payable – related parties	(151,000 )	--
Proceeds from issuance of common stock	279,000	--
Proceeds from exercise of stock options	--	15,000
Net cash provided by (used in) financing activities	274,000	(311,000 )
Net decrease in cash and cash equivalents	(574,000 )	(65,000 )
Cash and cash equivalents at beginning of period	1,762,000	2,072,000
Cash and cash equivalents at end of period	\$ 1,188,000	\$ 2,007,000
Supplemental disclosure of cash flow information:		
	December 31, 2010	December 25, 2009
Cash paid for income taxes	\$ --	--
Cash paid for interest	\$ 223,000	\$ 136,000
Non-cash financing activities:		
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  
December 31, 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 December 31, 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 December 31, 2010, under all of our plans, there were 7,200,000 shares authorized for issuance, with 1,353,766 shares remaining available for future grant.



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 December 25, 2009 and December 31, 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
Granted	--	--		
Exercised	--	--		
Expired	(10 )	\$ 2.12		
Balance of September 25, 2009	2,794	\$ 1.88	2,547	\$ 1.94
Granted	--	--		
Exercised	(30 )	\$ 0.52		
Expired	(78 )	\$ 1.07		
Balance of December 25, 2009	2,686	\$ 1.92	2,474	\$ 1.96

	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
Granted	8	\$ 2.56		
Exercised	--	--		
Expired	(350 )	\$ 3.19		
Balance of October 1, 2010	2,391	\$ 1.57	2,117	\$ 1.67
Granted	25	\$ 1.01		

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Exercised	--	--		
Expired	(21	) \$	0.79	
Balance of December 31, 2010	2,395	\$	1.57	2,167 \$ 1.65

9

---

Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

Information regarding stock options outstanding as of December 31, 2010 is as follows:

Options Outstanding			
Price Range	Shares (in 000s)	Weighted Average Exercise Price	Weighted Average Remaining Life
0.44 - \$ \$1.25	910	\$ 0.71	8.39
1.50 - \$ \$2.50	1,172	\$ 1.91	5.18
2.56 - \$ \$5.34	313	\$ 2.83	4.78

Options Exercisable			
Price Range	Shares (in 000s)	Weighted Average Exercise Price	Weighted Average Remaining Life
0.44 - \$ \$1.25	754	\$ 0.74	6.68
1.50 - \$ \$2.50	1,100	\$ 1.93	5.00
2.56 - \$ \$5.34	313	\$ 2.83	4.76

The intrinsic value of options exercised during the nine months ended December 31, 2010 was zero since no options were exercised and approximately \$7,200 during the nine months ended December 25, 2009.

During fiscal year 2010 and fiscal year 2011, 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
Granted	149	\$ 0.67
Vested	(160)	) \$ 0.65
Expired	--	--
Unvested, September 25, 2009	184	\$ 0.67
Granted	--	--
Vested	(10)	) \$ 0.66
Expired	--	--
Unvested, December 25, 2009	174	\$ 0.66



Edgar Filing: ADVANCED PHOTONIX INC - Form 10-Q

	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
Granted	169	\$ 0.67
Vested	--	--
Expired	--	--
Unvested, October 1, 2010	239	\$ 0.60
Granted	--	--
Vested	--	--
Expired	--	--
Unvested, December 31, 2010	239	\$ 0.60

The Company estimates the fair value of stock-based awards utilizing the Black-Scholes pricing model for stock options using 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 December 31, 2010 and December 25, 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 December 31, 2010 and December 25, 2009 averaged 65% and 70%, 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 December 31, 2010 and December 25, 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 December 31, 2010 and December 25, 2009 on the implied yield available on U.S. Treasury issues with an equivalent expected term, which averaged 2.0% and 2.2% during the respective periods.

The forfeiture rate, for awards issued during the three month periods ended December 31, 2010 and December 25, 2009, were approximately 26.0% and 19.0%, respectively, and was based on the Company's actual historical forfeiture trend.

The Company's stock-based compensation expense is classified in the table below:

	Three months ended		Nine months ended	
	Dec. 31, 2010	Dec. 25, 2009	Dec. 31, 2010	Dec. 25, 2009
Cost of Products Sold	\$5,000	\$3,000	\$12,000	\$12,000
Research and Development expense	12,000	9,000	27,000	61,000
General and Administrative expense	65,000	63,000	110,000	217,000
Sales and Marketing expense	2,000	3,000	9,000	13,000
Total Stock Based Compensation	\$84,000	\$78,000	\$158,000	\$303,000

At December 31, 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 \$132,000. This expense will be amortized on a straight-line basis over a weighted-average period of approximately 2.2 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 December 31, 2010, the Company had cash at two financial institutions in excess of federally insured amounts. As excess cash is available, the Company invests in short-term and long-term investments, primarily consisting of Government Securities Money Market instruments, and Repurchase agreements. As of December 31, 2010, cash deposits held at financial institutions in excess of FDIC insured amounts of \$250,000 were approximately \$1.2 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 December 31, 2010, two customers individually comprised 10% or more of receivables (28.8% of total accounts receivable). As of March 31, 2010, one customer individually comprised 10% or more of receivables (10.6% of total accounts receivable). For the three months ended December 31, 2010, the Company had two customers that comprised 10% or more of revenue, and combined accounted for 23.8%. For the three months ended December 25, 2009, one customer comprised 10% or more of revenue.

Note 5. Detail of Certain Asset Accounts

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

Compensating Cash Balance - 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 was \$47,000 and \$51,000 on December 31, 2010 and March 31, 2010, respectively.

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 December 31, 2010 and March 31, 2010:

	December 31,	
	2010	March 31, 2010
Raw material	\$ 3,208,000	\$ 2,375,000
Work-in-process	1,273,000	867,000
Finished products	295,000	414,000
Inventories, net	\$ 4,776,000	\$ 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.

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

	December 31, 2010				
	Weighted Average Lives in Years	Amortization Method	Carrying Value	Accumulated Amortization	Intangibles Net
Non-Compete agreement	3	Cash Flow	\$ 130	\$ 130	\$ --
Customer list	15	Straight Line	475	356	119
Trademarks	15	Cash Flow	2,270	762	1,508
Customer relationships	5	Cash Flow	1,380	1,380	--
Technology	10	Cash Flow	10,950	7,530	3,420
Patents pending			646	--	646
Patents	10	Straight Line	559	163	396
Total Intangibles			\$ 16,410	\$ 10,321	\$ 6,089

	March 31, 2010				
	Weighted Average Lives in Years	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 nine-month periods ended December 31, 2010 and December 25, 2009 was approximately \$1.2 million and \$1.6 million, respectively. The current patents held by the Company have remaining useful lives ranging from 1 year to 17 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	\$ 409
2012	1,356
2013	1,139
2014	951
2015	608
2016 & after	981
Total	\$ 5,444

a) Patent pending costs of \$646,000 are not included in the future amortization 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 December 31, 2010 and March 31, 2010 consisted of the following (dollars in thousands):

	December 31, 2010	March 31, 2010
Bank term loan	\$ 796	\$ 1,121
Bank line of credit	1,994	1,394
MEDC/MSF loans	2,095	2,224
Debt to Related Parties	1,250	1,401
Total	\$ 6,135	\$ 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 \$36,167, plus interest at prime plus 2%, until maturity on September 25, 2012, 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 December 31, 2010 was 5.25%. The line of credit bears interest at prime plus 2% and any outstanding borrowings are due on September 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 is \$190,000, October 1, 2010 is \$190,000, December 31, 2010 is \$260,000 and March 31, 2011 is \$400,000 test dates and thereafter on a trailing twelve month basis is \$1,160,000. The minimum Net Worth requirement is \$13.0 million for the first quarter of fiscal year 2011, \$12.5 million for the second quarter of fiscal year 2011, \$12.1 million for the third quarter of fiscal year 2011 and \$11.8 million for the fourth quarter of fiscal year 2011. The Company was in compliance with its financial covenants as of December 31, 2010.

In addition to the financial covenants, the Company was required to amend the secured promissory notes issued to Robin Risser and Steve Williamson, the Company's CFO and CTO, respectively (the "Related Parties" and such notes, the "Related Party Notes") by December 1, 2010 to defer the December 1, 2010 and March 1, 2011 installment payments owed under the Related Party Notes (the "Amendment Undertaking"). On November 29, 2010, the Company amended the Related Party Notes to comply with the Amendment Undertaking. See the Related Parties Debt section of this footnote for details on the amendment.

Interest payments made to The PrivateBank and Trust Company during the nine-month periods ended December 31, 2010 and December 25, 2009 were approximately \$88,000 and \$91,000, respectively.

MEDC/MSF 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 the second quarter of 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.

Related Parties Debt - As a result of the 2005 acquisition of Picotronic, Inc., the Company issued four-year promissory notes in the aggregate principal amount of \$2.9 million to the Related Parties (“Related Party Notes”). API has the option of prepaying the Related Party Notes without penalty.

On November 30, 2009, the Company and the Related Parties entered into the fourth amendments to the Related Party Notes to extend the due date for the remaining principal balance of the Related Party 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

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 required that the Company amend the Related Party Notes to defer the December 1, 2010 and March 1, 2011 installment payments (the "Amendment Undertaking"). In compliance with the Amendment Undertaking, on November 29, 2010, the Company and the Related Parties entered into the fifth amendments to the Related Party Notes. This amendment required the Company to pay the related parties a restructuring fee of \$156,312 (11%) and extended the due dates for the remaining principal balance payments on the Related Party Notes (in the aggregate amount of \$1,400,500) to September 1, 2012 per the payment schedule below:

Payment Date	Principal Payment
December 1, 2010	\$ 150,000
March 1, 2011	\$ 75,000
June 1, 2011	\$ 75,000
September 1, 2011	\$ 150,000
December 1, 2011	\$ 225,000
March 1, 2012	\$ 225,000
June 1, 2012	\$ 225,000
September 1, 2012	\$ 275,500

The interest rate on the Related Party notes was increased from prime plus 1% to prime plus 2% (5.25% at December 31, 2010), and interest is to be paid quarterly through the maturity date. The balance outstanding under the Related Party Notes was \$1,250,500 at December 31, 2010. The Related Party Notes are secured by all of the intellectual property of Picometrix.

In conjunction with the Fifth Amendment to the Related Party Notes, on November 29, 2010, the Company entered into a Securities Purchase Agreement (SPA) with Robin Risser and Steve Williamson whereby the Company issued 66,779 units to the note holders. Each unit represents 1 share of the Company's Class A Common Stock and 4 warrants to purchase the Company's Class A Common Stock. The shares of Class A Common Stock were valued at \$1.17 per share, which represents the market value of the Company's closing stock price on November 29, 2010. Each warrant is exercisable over a 5 year period for one share of the Company's Class A Common Stock at an exercise price per share of approximately \$1.40, subject to adjustment as defined in the warrant agreements. Such adjustment cannot reduce the exercise price below \$1.17.

The Company performed an assessment of the fifth amendment made to the Related Party Notes and determined that the amendment constituted a "substantial modification" in accordance with FASB guidance as the present value of future cash flows under the terms of the fifth amendment, combined with the fair value of the consideration given as part of the SPA, was more than 10% different than the present value of cash flows under the prior amendment. As a result, the Company recorded a loss on debt extinguishment of \$317,725, which is equal to the \$156,312 restructuring fee and the fair value of the warrants issued in conjunction with the SPA which was \$161,413 at November 29, 2010. See Note 7 to the Condensed Consolidated Financial Statements for additional information on the warrants.

Interest payments made to Related Parties during both the nine-month periods ended December 31, 2010 and December 25, 2009 were approximately \$45,000 each year.

## 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 Tranche *	695	\$ 1.7444
Convertible Note – 2nd Tranche	695	\$ 1.7444
Private Placement	741	\$ 1.8500

\*Expired on April 18, 2010

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

	Shares (000's)	Exercise Price
Convertible Note – 2nd Tranche	713	\$ 1.7000
Private Placement	765	\$ 1.7900
Related Parties	267	\$ 1.4040

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. In addition, the number of warrants increased as a result of the change in exercise price. 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. In addition, the number of warrants increased as a result of the change in exercise price. Future adjustments cannot reduce the exercise price below \$1.79.

On November 29, 2010, the Company agreed to issue and sell to the Related Party Note holders in exchange for an aggregate payment of \$78,156, 66,799 units comprised of (i) 66,799 shares of Common Stock at \$1.17 (Fair Market Value) and (ii) Warrants to purchase an aggregate of 267,196 shares of Common Stock at an exercise price of \$1.404 per share pursuant to separately executed warrant agreements upon the closing of the SPA. The exercise price for the warrants is subject to adjustment, based on a formula in the warrant agreements, if common stock is issued in the future below \$1.404. Future adjustments cannot reduce the exercise price below \$1.17.

The Convertible Notes and Related Parties warrants described above are recorded as liabilities because of their exercise price reset features. The Private Placement warrants were recorded as liabilities because of their exercise price reset features. However, as a result of the May 2010 issuance of Class A Common Stock to the MEDC and MSF at a price of \$0.54 per share, the exercise price of the Private Placement warrants is no longer variable. Consequently, the fair value of the Private Placement warrants as of May 2010 (approximately \$32,000) was recorded to Additional Paid in Capital. The Company made this reclassification during the current quarter. The fair value liability of the Convertible Note warrants and the Related Parties warrants was approximately \$428,000 as of December 31, 2010. During the three months ended December 31, 2010, the Company recorded other expense of \$97,000, compared to recording other income of \$174,000 for the three months ended December 25, 2009 for the change in the fair value of the warrant liability. During the nine months ended December 31, 2010, the Company recorded other expense of \$186,000 and for the nine months ended December 25, 2009 recorded other income of \$121,000 for the change in fair value of the warrant liability. The change in the fair value of the warrant liability for the three and nine months ended December 31, 2010 excludes the initial fair value of the Related Parties warrants which was \$161,000 and was included in the loss on debt extinguishment as described in Note 6 to the Condensed

Consolidated Financial Statements.

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

	December 31, 2010	December 25, 2009
Expected term (in years)	0.7 – 4.9	0.3 – 2.7
Volatility	50.64% - 65.49%	69.8% - 85.46%
Expected dividend	--	--
Risk-free interest rate	0.83% - 1.16%	0.58% - 1.16%

Expected volatility is based primarily on historical volatility using 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. Because FASB guidance indicates historical volatility, a significant factor in the fair value determination, is a Level 3 input.

**IQT Securities Purchase Agreement** - The Company entered into a Securities Purchase Agreement (the "IQT SPA") with In-Q-Tel (IQT) on November 4, 2010, pursuant to which in exchange for a payment of \$200,000 (the "IQT Purchase Price") API agreed to issue and IQT agreed to purchase the number of shares of the Company's Class A Common Stock, par value \$0.001 per share ("Common Stock"), determined by dividing the IQT Purchase Price by the volume-weight average price per share of the Company's Common Stock on the NYSE Amex Stock exchange for the five (5) trading days (the "5-Day VWAP") ending on the business day immediately preceding the signing of the IQT SPA. The closing of the purchase and sale transactions contemplated by the IQT SPA was subject to the receipt of NYSE Amex approval of an additional listing application covering the shares issued pursuant to the IQT SPA (the "IQT Additional Listing Application") and other closing conditions customary for transactions of this nature. On November 10, 2010, NYSE Amex approved the IQT Additional Listing Application and the parties satisfied the other closing conditions to the transaction on November 12, 2010, the following business day. The 5-Day VWAP calculated in the aforementioned manner was determined to be \$1.0074 and accordingly, the Company issued IQT 198,524 shares of Common Stock upon the closing of the IQT SPA on November 12, 2010.

**Universal Shelf Registration Statement on Form S-3** - On November 15, 2010, the Company filed a universal shelf registration statement on Form S-3 with the SEC (File No. 333-170607 and such registration statement, the "Original Registration Statement"). The shelf registration statement would have allowed the Company to sell up to \$7 million of various securities. On December 23, 2010, the Company requested withdrawal of the registration statement because it determined that it may not have met the conditions to use Form S-3 set forth in General Instruction 1A(3)(b). The Company believes the withdrawal to be consistent with the public interest and the protection of investors and hereby confirms that (i) the Original Registration Statement has not been declared effective, and (ii) that none of the Company's securities have been sold pursuant to the registration restatement.

On December 23, 2010, the Company re-filed a universal shelf registration statement on Form S-3 with the SEC (File No. 333-17390 and such registration statement, the "Revised Registration Statement"). The registration statement was declared effective by the Securities and Exchange Commission (SEC) on January 5, 2011 and allows the Company to sell up to \$7 million of various securities. See Note 10 to the Condensed Consolidated Financial Statements for details of securities issued related to this registration statement. The Company has no commitment to sell any of its securities under this registration statement.



## 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:

Basic and Diluted	Three months ended		Nine months ended	
	Dec. 31, 2010	Dec. 25, 2009	Dec. 31, 2010	Dec. 25, 2009
Weighted Average Basic Shares Outstanding	25,908,000	24,483,000	25,410,000	24,323,000
Dilutive effect of Stock Options and Warrants	--	--	--	--
Weighted Average Diluted Shares Outstanding	25,908,000	24,483,000	25,410,000	24,323,000
Net loss	\$ (649,000 )	\$ (1,344,000 )	\$ (1,320,000 )	\$ (2,832,000 )
Basic & diluted loss per share	\$ (0.03 )	\$ (0.05 )	\$ (0.05 )	\$ (0.12 )

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 December 31, 2010, the number of anti-dilutive shares excluded from diluted earnings per share totaled approximately 4.1 million shares, which includes 1.7 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.

## Note 10. Subsequent Events

On January 5, 2011, the Revised Registration Statement was declared effective January 5, 2011.

On January 6, 2011, the Company entered into an Underwriting Agreement with B. Riley & Co., LLC (the "Underwriter"), as sole underwriter for the offer and sale in a firm commitment underwritten public offering of 2,702,703 shares of the Company's Class A Common Stock, par value \$0.001 per share at a price to the public of \$1.48 per share (\$1.391 per share, net of underwriting discounts) (the "Offering"). Pursuant to the Underwriting Agreement, the Company also (i) granted to the Underwriter a 30-day option to purchase up to an additional 405,405 shares of Common Stock to cover over-allotments, if any, at the same price and (ii) agreed to reimburse the Underwriter for certain of its out-of-pocket expenses.



On January 10, 2011, the Underwriter gave notice to the Company that it was exercising its over-allotment option to purchase an additional 405,405 shares of the Company's Common Stock.

The Offering was made pursuant to a prospectus supplement dated January 6, 2011, an additional prospectus supplement dated January 11, 2011 and an accompanying prospectus dated December 23, 2010 pursuant to the Revised Registration Statement. The Offering was expected to close on or about January 18, 2011, or such earlier date as the Underwriter and the Company agreed to, subject to the satisfaction of customary closing conditions including, but not limited to, NYSE Amex approval of the Company's additional listing application to list the Common Stock issued in accordance with the underwriting agreement on NYSE Amex (the "B. Riley Additional Listing Application"). On January 10, 2011, the NYSE Amex approved the B. Riley Additional Listing Application and the Offering closed on January 11, 2011, when the Company and Underwriter satisfied the other closing conditions.

The gross proceeds from the offering were \$4,600,000 and the net proceeds to the Company from the Offering, after underwriting discounts and estimated transaction expenses, were approximately \$4,264,000. The Company intends to use the net proceeds of the Offering for general corporate purposes including, but not limited to, reducing its outstanding indebtedness, increasing its working capital and expanding its products.

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

### Forward-Looking Statements

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

### 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. As a result of these market conditions, the cost and availability of capital and 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.

### 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.

## 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 December 31, 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 contributed to volatility in our stock price during the first nine months of fiscal year 2011. Our stock price has increased from a low of \$0.42 to a high of \$1.77 during the first nine months of fiscal year 2011. As of December 31, 2010, our stock price was \$1.62 and thus, as of December 31, 2010, our market capitalization exceeded our book value. 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 stock price declines substantially and our market capitalization falls below our carrying value for a sustained period, it is reasonably likely that a goodwill impairment may be recorded. A non-cash goodwill impairment charge would have the effect 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 and nine-months ended December 31, 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 December 31, 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 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.

## RESULTS OF OPERATIONS

## Revenues

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

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

Revenues	Three months ended						Nine months ended					
	Dec. 31, 2010		Dec. 25, 2009		Dec. 31, 2010		Dec. 25, 2009					
Telecommunications	\$ 3,273	42 %	\$ 1,222	26 %	\$ 7,187	34 %	\$ 4,411	28 %				
<b>I n d u s t r i a l</b>												
Sensing/NDT	2,382	31 %	1,838	40 %	9,088	43 %	5,829	36 %				
Military/Aerospace	1,525	20 %	1,462	32 %	3,928	19 %	5,212	33 %				
Medical	447	6 %	80	2 %	676	3 %	340	2 %				
Homeland Security	93	1 %	(14 )	--	93	1 %	155	1 %				
Total Revenues	\$ 7,720	100 %	\$ 4,588	100 %	\$ 20,972	100 %	\$ 15,947	100 %				

The Company's revenues for the quarter ended December 31, 2010 were approximately \$7.7 million, an increase of 68% (or \$3.1 million) from revenues of \$4.6 million for the quarter ended December 25, 2009. Year to date revenues were approximately \$21.0 million, an increase of 32% (or approximately \$5.0 million) from the prior year.

Telecommunications revenue in the third quarter of fiscal year 2011 was \$3.3 million, an increase of approximately 168% (\$2.1 million) over the prior year third quarter. For the nine-month period ended December 31, 2010, revenues were \$7.2 million, up \$2.8 million (63%) over the prior year. This increase in the Company's telecommunications revenue is the result of our product development investment over the past few years and the rapid growth in the 40G and emerging 100G markets. The Company expects telecommunication revenue growth to continue for the balance of fiscal year 2011 and beyond.





Industrial Sensing/NDT market revenue was approximately \$2.4 million in Q3 2011 and \$9.1 million for the nine-month period, increases of 30% (or \$500,000) and 56% (or \$3.3 million) from the comparable prior year periods. This growth reflects a strengthening in our industrial markets as the economy continues to strengthen and additional revenue from our Terahertz NDT application development contracts to inspect the F-35 Joint Strike Fighter. The Company expects growth to slow in the industrial/NDT market for the balance of fiscal year 2011.

Military/Aerospace market revenue in the third quarter of fiscal year 2011 was \$1.5 million, an increase of 4% (or \$63,000) from the comparable prior year revenues. Military/Aerospace market revenues for the nine-month period were approximately \$3.9 million, 25% lower (or approximately \$1.3 million lower) than the comparable prior year period. This decrease was attributable primarily to the timing of customer order releases. The Company's expects military revenues to decline slightly during the remainder of fiscal year 2011.

Medical market revenues in the third quarter of fiscal year 2011 were \$447,000, an increase of \$367,000 (or 458%) from the prior year second quarter of \$80,000. Revenues for the nine-months ending December 31, 2010 were \$676,000, up \$336,000 (99%) from the prior year. This increase was primarily a result of new orders from existing customers in fiscal year 2011. The Company expects growth to decline slightly for the balance of fiscal year 2011.

Homeland Security revenues were \$93,000 for the three-month and nine-month periods ended December 31, 2010, compared to \$(14,000) (Q3 2010) and \$155,000 (nine-months ended December 25, 2009). The Company expects Homeland Security revenues to grow substantially for balance of fiscal year 2011 and fiscal year 2012.

#### Gross Profit

Gross profit for Q3 2011 was \$3.1 million compared to \$1.6 million for Q3 2010, an increase of \$1.5 million on an increase in revenue volume of 68% (or \$3.1 million). Gross profit margins increased 6% to 40% of sales for Q3 2011 compared to 34% of sales for the comparable prior year. The higher gross profit margin for Q3 2011 was due primarily to volume, offset partially by product mix, 100G HSOR Telcordia qualification costs and low hybrid assembly manufacturing yields on the ramp up of the new 100G line side products.

Year to date Gross profit was \$8.9 million (43% of revenue), compared to the first nine months of fiscal year 2010 of \$6.6 million (42% of revenue). The higher gross profit margin for the first nine months was due primarily to volume and favorable product mix, offset partially by 100G HSOR Telcordia qualification expenses and high scrap and rework expenses associated with the manufacturing ramp up of 100G line side products.

#### Operating Expenses

Total operating expenses were \$3.3 million during Q3 2011, compared to \$3.1 million during Q3 2010, primarily due to increase in selling, general and administrative expenses (G&A) and research development and engineering expenses (RD&E), partially offset by lower amortization expense on intangible assets.

Total operating expenses for the nine-month period ended December 31, 2010 were \$9.5 million, compared to \$9.4 million during the same prior year period. This was primarily driven by increases in Selling and R&D expenses due to the increase in revenue, partially offset by a decrease G&A expenses and lower amortization expense. The Company expects operating expenses to increase for the balance of fiscal year 2011 as the Company reinstates some employee benefits and lifts its wage freeze.

RD&E expenses of \$1.4 million increased by \$180,000 in Q3 2011 compared to Q3 2010, primarily due to higher spending on product development in our high speed optical receiver (HSOR) product platform, our THz application development for the F-35 Joint Strike Fighter and the new development contract for an anomaly detector targeted at the homeland security market.

RD&E expenses were \$541,000 higher for the nine-month period ended December 31, 2010 compared to the nine month period ended December 25, 2009 of \$3.4 million. 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 manufacturing floor and into homeland security applications.

Sales and marketing expenses increased 20% to \$455,000 in Q3 2011, as compared to \$380,000 for Q3 2010, as a result of revenue increase.

Sales and marketing expenses increased 8% to \$1.4 million for the nine-month period ended December 31, 2010, compared to \$1.2 million for nine month period ended December 25, 2009. As revenues increase, we expect increases in sales and marketing expenses for the balance of the fiscal year.

Total G&A increased 3% (\$30,000), to approximately \$1.0 million in Q3 2011 as compared to Q3 2010. The increase was primarily attributable to higher expenses related to salaries and consulting costs.

Total G&A decreased by \$160,000 (or 5%), to approximately \$3.0 million for the nine-month period ended December 31, 2010, compared to \$3.2 million for nine-month period ended December 25, 2009. This decrease was primarily attributable to expenses in fiscal year 2011 related to lower stock option expense, lower accounting services due to the elimination of the Sarbanes-Oxley government requirement relating to external audit of internal controls, and cost savings initiatives resulting from labor and other spending reductions. The Company expects an increase in G&A expenses for the balance of fiscal year 2011 compared to 2010, primarily driven by the reinstatement of wage increases and the Company 401(K) matching benefit for the balance of the fiscal year.

Amortization expense of \$409,000 in Q3 2011 was \$109,000 lower compared to Q3 2010. For the nine month period ended December 31, 2010, amortization expense decreased 21% to \$1.2 million compared to \$1.6 million for the nine month period ended December 25, 2009. 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 \$84,000 for the three month period ended December 31, 2010 compared to \$78,000 for the three months ended December 25, 2009, an increase of \$6,000.

The non-cash expensing of stock option and restricted stock grants included in operating expenses was \$158,000 for the nine month period ended December 31, 2010 compared to \$303,000 for the nine months ended December 25, 2009, a decrease of \$145,000.

Other Income (Expense), net

Interest income for Q3 2011 was zero, down \$1,000 from Q3 2010. Interest income for the nine month period ended December 31, 2010 totaled approximately \$2,000, compared to \$4,000 for the nine month period ended December 25, 2009, due to lower interest rates and lower cash balances available for short-term investments.



Interest expense in Q3 2011 was \$65,000 compared to \$81,000 in Q3 2010, a decrease of \$16,000 (or 20%). Interest expense for the nine month period ended December 31, 2010 was \$201,000, compared to \$246,000 for the nine month period ended December 25, 2009, a decrease of \$45,000 (or 18%). The Company incurred lower interest expense to banks and related parties, primarily due to the combination of lower debt obligations and lower interest rates.

As discussed in Note 7 to the Condensed Consolidated Financial Statements, 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 its statements of operations. The expense of \$97,000 on the change in fair value of the warrant liability in the third quarter of fiscal year 2011 is 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.

For the nine month period ended December 31, 2010, the Company incurred a net expense of \$186,000 on the change in fair value of the warrant liability.

During the third quarter of fiscal year 2011, the Company recorded a Loss on debt extinguishment of \$318,000, as a result amending the Related Party Notes as described in Note 6 to the Condensed Consolidated Financial Statements.

The Company incurred a net loss for Q3 2011 of approximately \$649,000 (\$0.03 per share), as compared to a net loss of \$1.3 million (\$0.05 per share) in Q3 2010, a decrease in loss of approximately \$695,000.

Net loss for the nine month period ended December 31, 2010 was \$1.3 million (\$0.05 per share), as compared to a net loss of \$2.8 million (\$0.12 per share) for the comparable prior year periods, a decrease in loss of approximately \$1.5 million. This decrease in losses for the quarter and on a year-to-date basis is primarily attributable to higher revenue which resulted in higher gross margins.

#### 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, manufacturing inefficiencies, 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 December 31, 2010, the Company had cash and cash equivalents of \$1.2 million, a decrease of \$575,000 from the March 31, 2010 balance of \$1.8 million. The lower balance is attributable to a decrease in cash from investing activities of \$1.2 million, offset by an increase of cash from operating activities of \$305,000 and financing activities of \$274,000.

### Operating Activities

The increase of \$305,000 in cash resulting from operating activities was primarily attributable to net cash provided by operations of \$1.3 million, offset by net cash used for operating assets and liabilities of \$967,000. This net cash decrease from operating assets and liabilities was primarily the result of an increase in net accounts receivable of \$1.5 million, an increase in inventories of \$1.1 million, an increase in prepaid and other assets of \$245,000, offset by an increase in accounts payable and accrued expenses of \$1.9 million. Cash provided by operations of \$1.3 million included a loss from operations of \$1.3 million, offset by \$2.1 million in depreciation, amortization and stock-based compensation expense, \$186,000 for the change in warrant liability fair value, and \$318,000 recorded for Loss on debt extinguishment.

### Investing Activities

The Company used \$1.2 million in investing activities including capital expenditures of \$937,000 and patent expenditures of \$216,000.

### Financing Activities

For the nine-months ended December 31, 2010, \$274,000 was provided by financing activities, comprised primarily of proceeds from the Company's line of credit of \$600,000, proceeds from stock sales of \$278,000, offset by payments on the bank term loan (\$325,000), related parties loans (\$150,000) and on the MEDC and MSF loans (\$129,000).

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 of \$190,000, October 1, 2010 of \$190,000, December 31, 2010 of \$260,000 and March 31, 2011 of \$400,000 test dates and thereafter on a trailing twelve month basis of \$1,160,000. The minimum Net Worth requirement is \$13.0 million for the first quarter of fiscal year 2011, \$12.5 million for the second quarter of fiscal year 2011, \$12.1 million for the third quarter of fiscal year 2011 and \$11.8 million for the fourth quarter of fiscal year 2011. The Company was in compliance with its financial covenants as of December 31, 2010. In addition to the financial covenants, the second amendment required the Company to amend the secured promissory notes issued to our CFO and CTO (the "Related Parties") in connection with the Company's acquisition of their respective equity interests in Picometrix, Inc. in 2005 (the Related Party Notes) to defer the December 1, 2010 and March 1, 2011 installment payments owed under the Related Party Notes (the "Amendment Undertaking"). Failure to amend the Related Party Notes by August 25, 2010 would constitute an event of default under the credit agreement.

On August 27, 2010, the Company executed a third amendment to the credit agreement with The PrivateBank and Trust Company. The third amendment (1) increased the amount of proceeds from equity issuances that the Company may use to make payments in respect of the Company's existing indebtedness under the Related Party Notes and (2) extended the deadline set forth in the second amendment for satisfying the Amendment Undertaking.



On November 30, 2010, the Company executed a fourth amendment to the credit agreement with The PrivateBank and Trust Company, effective as of November 30, 2010. Among other things, the fourth amendment (1) deleted the Amendment Undertaking, (2) approved the amendments to the Related Party Notes described below and the payment of a restructuring fee in connection therewith, (3) amended the definition of “Adjusted EBITDA” to add back a portion of the restructuring fee to the calculation of the “Adjusted EBITDA” and (4) amended the definition of “Debt Service Coverage Ratio” to exclude the proceeds raised pursuant to a securities purchase agreement by and among the Company, its CFO and its CTO from the calculation of the “Debt Service Coverage Ratio”.

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.

On November 29, 2010, the Company and the Related Party note holders entered into the fifth amendments to the Related Party Notes to remain in compliance with its bank covenants with The PrivateBank and Trust Company. This amendment required the Company to pay the related parties a restructuring fee of \$156,312 (11%) and extended the due dates for the remaining principal balance payments on the Related Party Notes (in the aggregate amount of \$1,400,500) to September 1, 2012 per the payment schedule below:

Payment Date	Principal Payment
December 1, 2010	\$ 150,000
March 1, 2011	\$ 75,000
June 1, 2011	\$ 75,000
September 1, 2011	\$ 150,000
December 1, 2011	\$ 225,000
March 1, 2012	\$ 225,000
June 1, 2012	\$ 225,000
September 1, 2012	\$ 275,500

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 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 for 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 December 31, 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 December 31, 2010 that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

32

---

## Part II — OTHER INFORMATION

### Item 1. Legal Proceedings

The information regarding litigation proceedings described in our Annual Report on Form 10-K for the year ended March 31, 2010 is incorporated herein by reference.

### Item 1A. Risk Factors

The Company's Annual Report on Form 10-K 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 10-K.

The Company has listed below both additional risk factors not mentioned in prior filings as well as revisions to certain of the risks factors previously disclosed by the Company in its prior filings.

#### Risks Relating to Our Business

We may be unable to obtain financing to fund ongoing operations and future growth.

Our future cash flows from operations, combined with our accessibility to cash and credit, may not be sufficient to allow us to finance ongoing operations or to make required investments for future growth. We may need to seek additional credit or access capital markets for additional funds. The recent disruption in credit markets and our recent operation losses make it uncertain whether we will be able to access the credit markets when necessary or desirable. If we are not able to access credit markets and obtain financing on commercially reasonable terms when needed, our business could be materially harmed and our results of operations could be adversely affected.

We have previously violated certain covenants under our Loan Agreement with The PrivateBank and Trust Company.

At March 31, 2010, the company was not in compliance with the financial covenants under its loan agreement (the "Loan Agreement") with The PrivateBank and Trust Company (the "Lender"). This constituted an event of default under the terms of our Loan Agreement which gave the Lender the ability to provide us with notice that it is exercising its rights under the Loan Agreement to demand payment in full of the outstanding indebtedness under our Loan Agreement.

On June 25, 2010, the company and the Lender entered into a second amendment to the Loan Agreement (the "Second Amendment") pursuant to which the Lender waived any event of default under the Loan Agreement resulting from the covenant violations for the fiscal quarters ended December 31, 2009 and March 31, 2010 (the "covenant violations"). Among other things, the Second Amendment (1) updated the financial covenants (as defined in the Second Amendment) and (2) required the company to amend the secured promissory notes (the "Picometrix Notes") issued to Robin Risser and Steve Williamson, the company's CFO and CTO, respectively (the "Note Holders"), in connection with the company's acquisition of Picometrix, Inc. on May 2, 2005 by August 25, 2010 to defer the payment of the remaining fourth and fifth installment payments owed under the Picometrix Notes (the "Amendment Undertaking"). Under the Second Amendment, failure to satisfy the Amendment Undertaking by August 25, 2010 would constitute an event of default under the Loan Agreement.

On August 27, 2010, the company and the Lender entered into a third amendment to the Loan Agreement (the “Third Amendment”) pursuant to which the Lender waived any event of default under the Loan Agreement resulting from the company’s failure to satisfy the Amendment Undertaking. Among other things, the Third Amendment (1) increased the amount of proceeds from equity issuances that the company may use to make payments in respect of the Picometrix Notes and (2) extended the deadline set forth in the Second Amendment for amending the Picometrix Notes from August 25, 2010 to December 1, 2010.

As disclosed in the Current Report on Form 8-K that we filed with the SEC on December 2, 2010, on November 30, 2010, the company and the Lender entered into a fourth amendment to the Loan Agreement (the “Fourth Amendment”) pursuant to which, among other things, the Lender terminated the Amendment Undertaking in connection with the amendment of the Picometrix Notes.

While we believe we have good relations with our Lender, we can provide no assurance that we will be able to obtain waivers or amendments if future covenant violations occur under our Loan Agreement. Failure to obtain such waivers or amendments, if necessary, could materially affect our business, financial condition and results of operations.

Any impairment of goodwill and other intangible assets, could negatively impact our results of operations.

The company’s goodwill is subject to an impairment test on an annual basis and is also tested whenever events and circumstances indicate that goodwill may be impaired. Any excess goodwill value resulting from the impairment test must be written off in the period of determination. Intangible assets (other than goodwill) are generally amortized over the useful life of such assets. In addition, from time to time, we may acquire or make an investment in a business which will require us to record goodwill based on the purchase price and the value of the acquired tangible and intangible assets. We may subsequently experience unforeseen issues with such business which adversely affect the anticipated returns of the business or value of the intangible assets and trigger an evaluation of the recoverability of the recorded goodwill and intangible assets for such business. Future determinations of significant write-offs of goodwill or intangible assets as a result of an impairment test or any accelerated amortization of other intangible assets could have a negative impact on our results of operations and financial condition.

We are dependent upon several suppliers for a significant portion of raw materials used in the manufacturing of our products and any significant interruption could have a material adverse affect on our manufacturing.

The principal raw materials we use in the manufacture of our semiconductor components and sensor assemblies are silicon and III-IV wafers, chemicals and gases used in processing wafers, gold wire, lead frames, specialized semiconductor amplifiers, and a variety of packages and substrates, including metal, printed circuit board, flex circuits, ceramic and plastic packages. All of these raw materials can be obtained from several suppliers. During the last several years, the number of suppliers of components has decreased significantly and, more recently, demand for components has increased rapidly. Any supply deficiencies relating to the quality or quantities of components we use to manufacture our products could adversely affect our ability to fulfill customer orders and our results of operations. For example, during the quarter ended March 31, 2010, we experienced some limitations on the components available from certain of our suppliers, resulting in losses of anticipated sales and the related revenues.

Our sales to overseas markets expose us to additional, unpredictable risks which could have a material adverse affect on our business and to exposure under the Foreign Corrupt Practices Act.

A portion of our sales are being derived from overseas markets. These international sales are primarily focused in Asia, Europe and the Middle East. These operations are subject to unpredictable risks that are inherent in operating in foreign countries and which could have a material adverse affect on our business, including the following:

- foreign countries could change regulations or impose currency restrictions and other restraints;
- changes in foreign currency exchange rates and hyperinflation or deflation in the foreign countries in which we operate;
- exchange controls;
- some countries impose burdensome tariffs and quotas;
- political changes and economic crises may lead to changes in the business environment in which we operate;
- international conflict, including terrorist acts, could significantly impact our financial condition and results of operations; and
- economic downturns, political instability and war or civil disturbances may disrupt distribution logistics or limit sales in individual markets.

In addition, the company utilizes third-party distributors to act as our representative for the geographic region that they have been assigned. 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 title transfers to the distributor at the time of shipment by the company, the products are not considered inventory on consignment. Our success is dependent on these distributors finding new customers and receiving new orders from existing customers.

We are subject to the Foreign Corrupt Practice Act (“FCPA”) and other laws that prohibit improper payments to foreign governments and their officials for the purpose of obtaining or retaining business. Our activities in our overseas markets create the risk of unauthorized payments or offers of payments by one of our employees, consultants, sales agents or distributors, because these parties are not always subject to our control. While it is our policy to implement safeguards to discourage these practices, our existing safeguards and any future improvements may prove to be less than effective, and our employees, consultants, sales agents or distributors may engage in conduct for which we might be held responsible. Violations of the FCPA may result in severe criminal or civil sanctions, and we may be subject to other liabilities, which could negatively affect our business, operating results and financial condition. In addition, certain governmental authorities may seek to hold us liable for successor liability FCPA violations committed by companies in which we invest or that we acquire.

Changes in the spending priorities of the federal government can materially adversely affect our business.

In fiscal year 2010, approximately 30% of our sales were related to products and services purchased by military contractors. Our business depends upon continued federal government expenditures on defense, intelligence, aerospace and other programs that we support. In addition, foreign military sales are affected by U.S. government regulations, regulations by the purchasing foreign government and political uncertainties in the U.S. and abroad. There can be no assurance that the U.S. defense and military budget will continue to grow or that sales of defense related items to foreign governments will continue at present levels. The terms of defense contracts with the U.S. government generally permit the government to terminate such contracts, with or without cause, at any time. Any unexpected termination of a significant U.S. government contract with a military contractor that we sell our products to could have a material adverse affect on the company.

Decreases in average selling prices of our products may reduce operating profit and net income, particularly if we are not able to reduce our expenses commensurately.



The market for optical components and subsystems continues to be characterized by declining average selling prices resulting from factors such as increased price competition among optical component and subsystem manufacturers, excess capacity, the introduction of new products and increased unit volumes as manufacturers continue to deploy network and storage systems. Recently, we have observed a modest acceleration in the decline of average selling prices. We anticipate that average selling prices will continue to decrease in the future in response to product introductions by our competitors or us, or in response to other factors, including price pressures from significant customers. In order to sustain profitable operations, we must, therefore, continue to develop and introduce new products on a timely basis that incorporate features that can be sold at higher average selling prices. Failure to do so could cause our sales and operating profit to decline.

In the current environment of declining average selling prices, we must continually seek ways to reduce our costs to maintain our operating profit and net income. The company's cost reduction efforts may not allow us to keep pace with competitive pricing pressures. To remain competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in redesigning our products or delivering our products to market in a timely manner. We cannot assure you that any redesign will result in sufficient cost reductions enabling us to reduce the price of our products to remain competitive or maintain our operating profit and net income.

If we are unable to protect our intellectual property rights adequately, the value of our products could be diminished.

Our success and ability to compete is dependent in part on our proprietary technology. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as confidentiality agreements and internal procedures, to establish and protect our proprietary rights. We utilize proprietary design rules and processing steps in the development and fabrication of our PIN photodiodes, APD photodiodes and our Terahertz ("THz") systems and sensors. In addition, our products rely upon over 105 patents or patents pending. There can be no assurance that any issued patents will provide us with significant competitive advantages, or that challenges will not be instituted against the validity or enforceability of any patent utilized by us, or, if instituted, that such challenges will not be successful. The cost of litigation to uphold the validity and to prevent the infringement of a patent could be substantial and could have a material adverse affect on our operating results. Furthermore, there can be no assurance that our PIN photodiodes, APD photodiodes and THz technology will not infringe on patents or rights owned by others, licenses to which might not be available to us. Based on limited patent searches, contacts with others knowledgeable in the field of PIN photodiodes, APD photodiodes and our THz technology, and a review of the published materials, we believe that our competitors hold no patents, licenses or other rights to the PIN photodiodes, APD photodiodes and our THz technology which would preclude us from pursuing our intended operations.

In some cases, we may rely on trade secrets to protect our innovations. There can be no assurance that trade secrets will be established, that secrecy obligations will be honored or that others will not independently develop similar or superior technology. To the extent that consultants, key employees or other third parties apply technological information independently developed by them or by others to our projects, disputes might arise as to the proprietary rights to such information which may not be resolved in our favor.

We may not be able to successfully integrate future acquisitions, which could result in our not achieving the expected benefits of the acquisition, the disruption of our business and an increase in our costs.

Our ability to continue to grow may depend upon identifying and successfully acquiring attractive companies, effectively integrating these companies, achieving cost efficiencies and managing these businesses as part of our company.

We may not be able to effectively integrate the acquired companies and successfully implement appropriate operational, financial and management systems and controls to achieve the benefits expected to result from these acquisitions. Our efforts to integrate these businesses could be affected by a number of factors beyond our control, such as regulatory developments, general economic conditions and increased competition. In addition, the process of integrating these businesses could cause the interruption of, or loss of momentum in, the activities of our existing business. The diversion of management's attention and any delays or difficulties encountered in connection with the integration of these businesses could negatively impact our business and results of operations. Further, the benefits that we anticipate from these acquisitions may not develop.

We may be liable for damages based on product liability claims brought against our customers in our end-use markets.

Many of our products may provide critical performance attributes to our customers' products that will be sold to end users who could potentially bring product liability suits in which we could be named as a defendant. The sale of these products involves the risk of product liability claims. If a person were to bring a product liability suit against one of our customers, this customer may attempt to seek contribution from us. A person may also bring a product liability claim directly against us. A successful product liability claim or series of claims against us in excess of our insurance coverage for payments, for which we are not otherwise indemnified, could have a material adverse effect on our financial condition or results of operations. We have acquired product liability coverage of up to \$4 million.

Our current and planned systems, procedures and controls may not be adequate to support our future operations.

The laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the rules adopted or proposed by the SEC, will result in increased costs to us as we evaluate the implications of any new rules and respond to their requirements. New rules could make it more difficult or more costly for us to comply with regulatory requirements, including our reporting obligations under the Exchange Act, and obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. We cannot predict or estimate the amount of the additional costs we may incur or the timing of such costs to comply with any new rules and regulations, or if compliance can be achieved.

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

As previously disclosed in the Company's definitive Proxy Statement filed with SEC on July 15, 2010, pursuant to the Company's 2007 Equity Incentive Plan (Equity Plan), on September 1 of each year, each then serving non-employee Company director receives an automatic annual stock grant covering that number of shares of the Company's Class A Common Stock having a fair market value of \$25,000 on the date of grant, which fully vests on the six month anniversary of the grant date. In accordance with the Equity Plan, on September 1, 2010, the Company granted 153,844 shares of Restricted Class A Common Stock to the Company's four (4) non-employee Company directors at an exercise price of \$0.65 per share. These shares are considered fully vested six months from the grant date.

On September 24, 2010, the Company granted 15,000 shares of Restricted Class A Common Stock having a fair market value of \$12,300 on the date of the grant to an outside firm for services for the benefit of API. These shares are considered fully vested six months from the grant date.





The Company entered into a Securities Purchase Agreement (the "IQT SPA") with In-Q-Tel, Inc. ("IQT") on November 4, 2010, pursuant to which in exchange for a payment of \$200,000 (the "IQT Purchase Price") API agreed to issue and IQT agreed to purchase the number of shares of the Company's Class A Common Stock, par value \$0.001 per share ("Common Stock"), determined by dividing the IQT Purchase Price by the volume-weighted average price per share of the Company's Common Stock on the NYSE Amex stock exchange for the five (5) trading days (the "5-Day VWAP") ending on the business day immediately preceding the signing of the IQT SPA. The offer and sale of the shares issued pursuant to the IQT SPA (the "IQT Shares") was made pursuant to Section 4(2) of the Securities Act of 1933, as amended (the "Securities Act"), which exempts transactions by an issuer not involving any public offering from the registration requirements of the Securities Act. The closing of the purchase and sale transactions contemplated by the IQT SPA was subject to the receipt of NYSE Amex approval of an additional listing application covering the IQT Shares (the "IQT Additional Listing Application") and other closing conditions customary for transactions of this nature. On November 10, 2010, NYSE Amex approved the IQT Additional Listing Application and the parties satisfied the other closing conditions to the transaction on November 12, 2010, the following business day. The 5-Day VWAP calculated in the aforementioned manner was determined to be \$1.0074 and accordingly, the Company issued IQT 198,524 shares of Common Stock upon the closing of the IQT SPA on November 12, 2010.

The Company's credit agreement with The PrivateBank and Trust Company required the Company to amend the secured promissory notes issued to its CFO and CTO (the "Related Parties") in connection with the Company's acquisition of their respective equity interests in Picometrix, Inc. in 2005 (the Related Party Notes) to defer the December 1, 2010 and March 1, 2011 installment payments owed under the Related Party Notes (the "Amendment Undertaking"). In connection with the Amendment Undertaking, on November 15, 2010, the Company and the Related Parties entered into a securities purchase agreement, which was subsequently amended and restated in its entirety on November 29, 2010 to reflect certain structural changes in the transaction as originally agreed upon by the parties (the "Related Parties SPA"). Pursuant to the Related Parties SPA, the Company agreed to issue and sell to the Related Parties in exchange for an aggregate payment of \$78,156.25 (the "Related Parties Purchase Price") the number of units of the Company's securities ("Units") determined by dividing the Related Parties Purchase Price by the per share closing price of the Company's Common Stock on NYSE Amex on the day preceding the closing (the "Formula Price"). Each Unit was to consist of one share of Common Stock and a five-year warrant to purchase four shares of Common Stock at an exercise price equal to 120% of the Formula Price ("Warrants"). The offer and sale of the Units issued pursuant to the Related Parties SPA was made pursuant to Section 4(2) of the Securities Act. The closing of the purchase and sale transactions contemplated by the Related Parties SPA was subject to the receipt of NYSE Amex approval of an additional listing application covering the Units (the "Related Parties Additional Listing Application") and other closing conditions customary for transactions of this nature. On November 30, 2010, NYSE Amex approved the Related Parties Additional Listing Application and the parties to the Related Parties SPA satisfied the other closing conditions. The Formula Price was determined to be \$1.17 (the closing price of the Common Stock on November 29, 2010) and accordingly, the Company issued the Related Parties 66,799 Units comprised of (i) 66,799 shares of Common Stock and (ii) Warrants to purchase an aggregate of 267,196 shares of Common Stock at an exercise price of \$1.404 per share pursuant to separately executed warrant agreements upon the closing of the Related Parties SPA on November 30, 2010.

Item 3. Defaults upon Senior Securities

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K (including those incorporated by reference)

The following documents are filed as Exhibits to this report:

Exhibit No.

- 10.1 Securities Purchase Agreement dated November 4, 2010, by and between Advanced Photonix, Inc. and In-Q-Tel, Inc.
- 10.2 Letter Agreement dated November 4, 2010, executed by Advanced Photonix, Inc. in favor of In-Q-Tel, Inc.
- 10.3\* Development Agreement dated November 12, 2010, by and among Advanced Photonix, Inc., Picometrix, LLC and In-Q-Tel, Inc.
- 10.4 Royalty Agreement dated November 12, 2010, by and among Advanced Photonix, Inc., Picometrix, LLC and In-Q-Tel, Inc.
- 10.5 Amended and Restated Securities Purchase Agreement dated November 29, 2010, by and among Advanced Photonix, Inc., Robin F. Risser and Steven Williamson - incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K, filed December 2, 2010.
- 10.6 Class A Common Stock Purchase Warrant dated November 30, 2010, between Advanced Photonix, Inc. and Robin F. Risser - incorporated by reference to Exhibit 10.2 to the Registrant's Form 8-K, filed December 2, 2010.
- 10.7 Class A Common Stock Purchase Warrant dated November 30, 2010, between Advanced Photonix, Inc. and Steven Williamson - incorporated by reference to Exhibit 10.3 to the Registrant's Form 8-K, filed December 2, 2010.
- 10.8 Fifth Amendment dated November 29, 2010 to Secured Promissory Note dated May 2, 2005 by and between Advanced Photonix, Inc. and Robin F. Risser - incorporated by reference to Exhibit 10.4 to the Registrant's Form 8-K, filed December 2, 2010.
- 10.9 Fifth Amendment dated November 29, 2010 to Secured Promissory Note dated May 2, 2005 by and between Advanced Photonix, Inc. and Steven Williamson - incorporated by reference to Exhibit 10.5 to the Registrant's Form 8-K, filed December 2, 2010.
- 10.10 Fourth Amendment dated November 30, 2010 to the Loan Agreement between Advanced Photonix, Inc. and The PrivateBank and Trust Company – incorporated by reference to Exhibit 10.6 to the Registrant's Form 8-K, filed December 2, 2010



- 31.1 Certificate of the Registrant's Chief Executive Officer, President 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

\* Confidential treatment has been requested for this exhibit and the confidential portions have been filed with the Securities and Exchange Commission pursuant to Rule 24b-2 of the Securities Exchange Act of 1934, as amended.

**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)

February 14, 2011

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

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