PATIENT INFOSYSTEMS INC
Form 8-K
May 11, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the

Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): **May 11, 2006**

PATIENT INFOSYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation)

0-22319	**16-1476509**
(Commission File No.)	(IRS Employer Identification No.)

46 Prince Street

Rochester, New York 14607

(Address of principal executive offices and zip code)

Registrant s telephone number, including area code**(585) 242-7200**

(Former name or former address, if changed since last report.)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

o Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

o Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

o Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

o Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

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Item 8.01 Other Events.
Patient Infosystems (the Registrant) is voluntarily filing this Current Report on Form 8-K to provide financial information with respect to its subsidiary CCS Consolidated, Inc. as of December 31, 2005 and for the nine-month period then ended. This Form 8-K also contains a Management s Discussion and Analysis of the financial condition and results of operations of CCS Consolidated as of and for the nine months ended December 31, 2005.

Pursuant to an Agreement and Plan of Merger dated September 19, 2005, as amended on November 22, 2005 and December 23, 2005 (as so amended, the Merger Agreement) by and among the Registrant) PATY Acquisition Corp., a wholly-owned subsidiary of the Registrant (Merger Sub) and CCS Consolidated, Inc. (CCS Consolidated), Merger Sub merged with and into CCS Consolidated (the Merger), and CCS Consolidated became a wholly-owned subsidiary of the Registrant. The Merger closed and became effective on January 25, 2006.

As the Merger was effective subsequent to December 31, 2005, the accompanying management s discussion and analysis of CCS Consolidated s results of operations in this Current Report on Form 8-K does not take into account the Merger. Prior to the filing of this Current Report on Form 8-K, the Registrant has filed its Annual Report on Form 10-KSB for the year ended December 31, 2005 (the PATY Form 10-KSB). We encourage you to read this report, and the information incorporated by reference herein, in conjunction with the PATY Form 10-KSB.

The Merger is treated as a reverse merger for accounting purposes, and as such, the financial statements of the accounting acquirer, CCS Consolidated, are the financial statements of the Registrant as the legal acquirer. Additionally, the Registrant has adopted March 31 as its fiscal year end, which was CCS Consolidated s fiscal year end. As a result, the Registrant will file an additional Form 10-KSB for the fiscal year ended March 31, 2006, which will include the historical financial statements of CCS Consolidated and will incorporate the results of operations of Patient Infosystems since the effective date of the Merger of January 25, 2006.

The unaudited interim consolidated financial statements of CCS Consolidated as of and for the nine months ended December 31, 2005 are included as Exhibit 99.1 and are hereby incorporated by reference herein.

Special Note Regarding Forward-Looking Statements

Statements contained in this Current Report on Form 8-K that are not historical facts, including information about management s view of the Registrant's future expectations, plans and prospects, the benefits provided by the combination of services offered by the Registrant as a result of the Merger, the prospects for success of the Merger and the combination of the two companies, such as expected synergies and expanded revenue opportunities, constitute forward-looking statements for purposes of the safe harbor provisions under the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from historical results or those indicated or implied by these forward-looking statements as a result of a variety of factors including, but not limited to, risks and uncertainties associated with the Registrant s financial condition, the continued use of the Registrant s services by its existing customers at current or increased levels, significant concentration of the Registrant s revenues with a limited number of customers, the Registrant s ability to increase and diversify its business and revenue base, including the expansion of the Registrant s Continuous Care Management service, the Registrant s ability to sell its products, the Registrant s ability to compete with competitors, the growth of the healthcare market, the failure to achieve projected operating efficiencies and unfavorable variances in interest rates and financing terms, as well as other factors that are discussed in the Registrant s Annual Report on Form 10-

KSB for the year ended December 31, 2005, as well as other documents filed by the Registrant with the Securities and Exchange Commission, including but not limited to those factors discussed in the Risk Factors sections of such reports. The Registrant has no obligation to publicly release the result of any revisions that may be made to any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements.

Management s Discussion and Analysis of Financial Condition and Results of Operations

We encourage you to read the information presented in this Management s Discussion and Analysis of Financial Condition and Results of Operations of CCS Consolidated in conjunction with the unaudited interim consolidated financial statements included as Exhibit 99.1 hereto, and the PATY Form 10-KSB. Unless the context otherwise requires, the words we, us, the Company, CCS Consolidated, CareGuide and sin words in this Management s Discussion and Analysis of Financial Condition and Results of Operations refer to CCS Consolidated and its consolidated subsidiaries and do not give effect to the Merger.

Overview

Management s discussion and analysis provides a review of our operating results for the nine months ended December 31, 2005 and 2004. We have three types of revenue. First, we accept risk on the providing of post-acute services and receive a Per Member Per Month (PMPM) capitation revenue. Alternatively, we provide services to health plans without accepting risk, and for these types of contracts, we may receive either an administration service fee or we may provide these services on a fee-for-service basis. For risk contracts, the cost of services includes the cost of providing clinical care and the incurred claims.

Our business strategy is to contract with health plans, government agencies, and employer groups to help them reduce health care costs while improving the quality of care. We believe that the steadily rising cost of healthcare for employers, increasing demands on Medicare and Medicaid funding that are outpacing resources, and an emerging interest in care management and disease management services by the federal government and large insurers creates a fertile environment for our business model.

While we have historically derived most of our revenue from risk-based contracts, we are currently diversifying our revenue sources by adding more administrative fee contracts. We will continue to offer risk-based and non-risk-based post acute care management products, but where possible we will link them to a Continuous Care Management service which will allow us to follow the complex patients over the long term after their return to their home environment.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, which require management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of certain assets and liabilities. Management believes that the accounting estimates employed and the resulting balances are reasonable; however, actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different

estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. Management believes the following critical accounting policies reflect the significant estimates and assumptions used in the preparation of the consolidated financial statements of CCS Consolidated.

Revenue Recognition

We recognize capitated revenue for contracts whereby the Company accepts risk. Capitated revenue is recorded by multiplying a contractually negotiated revenue rate per health plan member per month (PMPM) by the number of health plan members covered by our services during the month. These PMPM rates are initially determined during contract negotiations with customers based on estimates of the costs of our services, including the cost of claims. Such rates are generally renegotiated at contract renewal. In certain contracts, the PMPM rates differ depending on the health plan s lines of business, such as Medicare, Commercial or Medicaid. The PMPM rates will also differ in certain cases depending on the type of service provider, such as a skilled nursing facility or a home health provider. Contracts with health plans generally range from one to two years with provisions for subsequent renewal.

We recognize Administrative Services Only (ASO) revenue for contracts whereby the Company receives a fee for providing its services without the Company accepting risk for claims. Such contracts include those that pay a set fee each month. Other contracts include a PMPM ASO fee and other contracts include a per day per member case rate based on the number of health plan members who receive services during the month. Such fees are negotiated with the health plan or employer group based on estimated costs and anticipated level of services.

We recognize fee-for-service revenue for certain services provided for our customers and expenses paid on behalf of our customers for which we are generally reimbursed on a cost-plus basis during the period in which the services are provided.

Some of our revenues are based on contractual arrangements which may be subject to retroactive adjustments as final settlements are determined. Such amounts are recorded on an estimated basis in the period the related services are rendered and are adjusted in future periods upon final settlement.

Intangibles and Other Assets

Intangible and other assets consist primarily of a website, trademarks, and goodwill associated with acquisitions. Our intangible assets are amortized over their respective estimated useful lives. Goodwill is not amortized to expense. Goodwill and identifiable intangible assets are reviewed annually for impairment and their recorded value is reduced whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Based on the evaluation performed as of March 31, 2005, management concluded that no impairment of recorded goodwill or intangible asset existed as of that date. The evaluation approach utilized is dependent on a number of factors, including estimates of future revenues and costs, appropriate discount rates and other variables. Management bases its estimates on assumptions believed to be reasonable, but which are inherently uncertain. Therefore, future impairments could result if actual results differ from those estimates.

Direct Service Costs

Direct service costs are comprised of the incurred claims paid to third-party providers for services for which the Company is at risk and the related expenses of the Company associated with the providing of its services. Network provider and facility charges for authorized services that have yet to be billed to

us are estimated and accrued in our Incurred But Not Reported (IBNR) claims payable liability. Such accruals are based on our historical experience, current enrollment statistics, patient census data, adjudication and authorization decisions and other information. The IBNR liability is adjusted as changes in these factors occur and such adjustments are reported in the period of determination. Although it is possible that actual results could vary materially from recorded claims in the near term, management believes that the recorded IBNR liability is adequate.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with no need for management s judgment in their application. There are also areas in which management s judgment in selecting any available alternative would not produce a materially different result. See the Notes to CCS Consolidated s unaudited interim consolidated financial statements included in Exhibit 99.1 to this Form 8-K, which contain additional accounting policies and other disclosures required by generally accepted accounting principles.

Results of Operations

The following financial table presents data regarding our results of operations, financial position and cash flows as of and for the nine months ended December 31, 2005 and 2004. Such data was derived from CCS Consolidated s unaudited interim financial statements. This information should be read in conjunction with the Company s unaudited interim consolidated financial statements as of December 31, 2005 and for the nine months ended December 31, 2004 and 2005, and the related notes thereto, filed as Exhibit 99.1 to this Form 8-K. All dollar amounts are stated in thousands of dollars:

	Nine Months Ended December 31,		Variance
	2005	2004	Favorable (Unfavorable)
Operating Results			
Capitated Revenue			
Health Net	$ 6,128	$ 29,832	$ (23,704)
Aetna	24,675	9,242	15,433
Total capitated revenue	**$ 30,803**	**$ 39,074**	**$ (8,271)**
Administrative Services Revenue			
Health Net	$ 3,629	$ -	$ 3,629
Aetna	27	1,032	(1,005)
Other	1,489	749	740
Total ASO revenue	**$ 5,145**	**$ 1,781**	**$ 3,364**
Fee-For-Service Revenue			
Health Net	$ 2,047	$ 5,064	$ (3,017)
Other	1,038	1,148	(110)
Total fee-for-service revenue	**$ 3,085**	**$ 6,212**	**$ (3,127)**
Total Revenue			
Health Net	$ 11,804	$ 34,896	$ (23,092)
Aetna	24,702	10,274	14,428
Other	2,527	1,897	630
Total revenue	**$ 39,033**	**$ 47,067**	**$ (8,034)**
Percentage of Revenue by Major Customer			
Health Net	30.2%	74.1%	(43.9)%
Aetna	63.3%	21.8%	41.5%
Other	6.5%	4.1%	2.4%
Total revenue	**100.0%**	**100.0%**	

	Nine Months Ended December 31,		Variance
	2005	2004	Favorable (Unfavorable)
Direct Service Costs			
Incurred claims	$ 27,695	$ 36,433	$ 8,738
Direct clinical expenses	7,912	6,236	(1,676)
Total direct service costs	**$ 35,607**	**$ 42,669**	**$ 7,062**
Direct Service Costs as a Percentage of Revenue			
Incurred claims as a percentage of total revenue	70.9%	77.4%	6.5%
Direct clinical expenses as a percentage of revenue	20.3%	13.2%	(7.1)%
Total direct service costs as a percentage of total revenue	**91.2%**	**90.6%**	**(0.6)%**
Gross profit	**$ 3,426**	**$ 4,398**	**$ (972)**
Gross profit as a percentage of total revenue	**8.8%**	**9.3%**	**(0.5)%**

Selling, General & Administrative Expenses			
Selling and administrative expenses	$ 4,562	$ 4,584	$ 22
Severance and related expenses	-	377	377
Legal expenses (Lawsuit with State of Florida)	-	1,090	1,090
Total selling, general and administrative expenses	**$ 4,562**	**$ 6,051**	**$ 1,489**

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		1,825,189	
Loss from operations		(465,612)	
Other income		110,182	
Other expense		(20,733)	
		89,449	
Loss before income taxes		(376,163)	
Income taxes		24,270	
Net loss	$	(400,433)	$
Net loss per share:			
Basic and diluted		($0.03)	
Weighted average shares outstanding:			
Basic and diluted		11,872,331	

SEE ACCOMPANYING NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

	Six Months Ended September 30,	
	2006	2005
Cash Flow from operating activities		
Net loss	$ (512,451)	$ (1,954,634)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	296,796	543,722
Deferred taxes	40,450	-
Gain on sale of assets	(351,498)	(93,126)
Stock based compensation	30,868	5,183
Foreign currency translation	(14,838)	(2,493)
Changes in operating assets and liabilities:		
Accounts receivable, net	(479,117)	(270,549)
Inventories	(138,361)	(380,341)
Prepaid expenses and other	(110,811)	(51,775)
Accounts payable and accrued expenses	(105,186)	416,025
Net cash used in operating activities	(1,344,148)	(1,787,988)
Cash flow from investing activities		
Purchases of property and equipment	(274,737)	(233,942)
Proceeds from sale of assets	386,592	111,680
Net cash provided by (used in) investing activities	111,855	(122,262)
Cash flow from financing activities		
Repayment of long-term debt	(95,129)	(68,083)
Decrease (increase) in bond reserve funds	(816,020)	45,648
Net cash used in financing activities	(911,149)	(22,435)
Decrease in cash and cash equivalents	(2,143,442)	(1,932,685)
Cash and cash equivalents at beginning of period	8,947,777	10,813,492
Cash and cash equivalents at end of period	$ 6,804,335	$ 8,880,807

SEE ACCOMPANYING NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

The accompanying consolidated condensed financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended March 31, 2006.

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

In preparation of the Company's consolidated financial statements, management is required to make estimates and assumptions that affect reported amounts of assets and liabilities and related revenues and expenses during the reporting periods. Actual results could differ from the estimates used by management.

Note 2. Net Loss Per Share

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

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
Numerator for basic and diluted net loss per share	$ (400,433)	$ 1,063,628)	$ (512,451)	$ (1,954,634)
Denominator for basic and diluted net loss per share - weighted average shares outstanding	11,872,331	11,872,331	11,872,331	11,872,331
Basic and diluted net loss per share	($0.03)	($0.09)	($0.04)	($0.16)

Common stock options and warrants to purchase 618,565 and 647,195 shares of common stock with a weighted average exercise price of $2.77 and $2.96 were outstanding at September 30, 2006 and 2005, respectively, but were excluded from calculating diluted net loss per share because they were antidilutive.

Note 3. Segment Reporting

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

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

	Optronics	Cables & Networks	Eliminations	Consolidated
Three months ended September 30, 2006				
External sales	$ 33	$ 4,785	$ -	$ 4,818
Gross profit (loss)	(116)	1,476	-	1,360
Income (loss) from operations	(655)	189	-	(466)
Depreciation and amortization	84	58	-	142
Capital expenditures	94	5	-	99
Assets	18,406	8,222	(7,691)	18,937
Three months ended September 30, 2005				
External sales	$ 109	$ 4,058	$ (98)	$ 4,069
Gross profit (loss)	(192)	1,097	(1)	904
Income (loss) from operations	(1,143)	7	-	(1,136)
Depreciation and amortization	207	67	-	274
Capital expenditures	42	71	-	113
Assets	20,257	7,440	(7,347)	20,350
Six months ended September 30, 2006				
External sales	$ 84	$ 9,760	$ -	$ 9,844
Gross profit (loss)	(218)	2,908	-	2,690
Income (loss) from operations	(1,016)	359	-	(657)
Depreciation and amortization	172	125	-	297
Capital expenditures	270	5	-	275
Assets	18,406	8,222	(7,691)	18,937
Six months ended September 30, 2005				
External sales	$ 213	$ 7,566	$ (197)	$ 7,582
Gross profit (loss)	(378)	2,009	(2)	1,629
Loss from operations	(2,035)	(60)	-	(2,095)
Depreciation and amortization	417	127	-	544
Capital expenditures	129	105	-	234
Assets	20,257	7,440	(7,347)	20,350

Note 4. Sale of Land

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

Note 5. Closing of Aberdeen Facility

The Company ceased all of its operations in Aberdeen during the later part of fiscal year 2006 as a part of its consolidation of manufacturing operations. The Company owned facility, located approximately on a 10-acre parcel, is designated for lease or sale after sub-division of the land in approximately two 5-acre parcels. The Company does

not have a formal plan for leasing or selling the facility and thus the building remains classified as property, plant and equipment as of September 30, 2006. The company plans to retain the 5-acre vacant land for potential future use. The facility was built using proceeds from bonds issued by the South Dakota Economic Development and Finance Authority. In August 2006, the Company paid $871,911 into an escrow account to retire the bonds. These funds, reflected as Bond Reserve Funds, will be used to make final payment on the bonds on October 1, 2006, the next bond redemption date. The payment was made pursuant to a Notice of Default and Acceleration received by the Company. The primary reason for the notice was related to the Company ceasing all of its South Dakota operations in the latter part of fiscal year 2006 as part of its consolidation of manufacturing operations. The Company has made timely interest and principal payments, and the reason for the notice was not related to the payments.

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Note 6. Sale of Metal Organic Chemical Vapor Deposition (MOCVD) Operation

In March 2006 the Company sold certain equipment and related intellectual property related to its MOCVD operations to an unrelated party for a total consideration of $1.9 million in cash and a license back of the technology within a specified field of use. The asset purchase agreement includes an additional consulting agreement for up to $100,000 over the course of one year. The Company recorded a gain of approximately $1.2 million on the sale in the fourth quarter of fiscal 2006. Because the Company does not track discrete financial information for these assets, this has not been presented as a discontinued operation.

Note 7. Stock Based Compensation

Effective April 1, 2006, the Company adopted FASB Statement No. 123(R), "Share-Based Payment," (SFAS 123(R)) which requires an entity to reflect on its income statement, instead of pro forma disclosures in its financial footnotes, the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. Statement 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees."

The Company adopted SFAS 123(R) using the modified prospective transition method, which provides that the Company's consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). As required by SFAS 123(R), the following pro forma table illustrates the effect on net loss as if the fair-value-based approach of SFAS No.123 (R) had been applied during the three and six months ended September 30, 2005:

		Three Months Ended September 30, 2005		Six Months Ended September 30, 2005
Net loss to common shareholders - as reported	$	(1,063,628)	$	(1,954,634)
Less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(29,961)		(61,526)
Net loss - pro forma	$	(1,093,589)	$	(2,016,160)
Basic and diluted net loss per common share - as reported		($0.09)		($0.16)
Basic and diluted net loss per common share - pro forma		($0.09)		($0.17)

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statements of Operations. The Company recorded $11,243 and $30,868 of related compensation expense for the three and six month periods ended September 30, 2006, respectively. This expense is included in selling, general and administrative expense. There was no tax benefit from recording this non-cash expense. The impact of this compensation expense on both basic and diluted loss per share was less than $0.01 for the three and six months ended September 30, 2006. As of September 30, 2006, $106,152 of total unrecognized compensation expense related to non-vested awards is expected to be recognized over a weighted average period of approximately 3.36years.

The Company uses the Black-Scholes-Merton ("Black-Scholes") option-pricing model as a method for determining the estimated fair value for employee stock awards. This is the same option-pricing model used in prior years to calculate pro forma compensation expense under SFAS 123 footnote disclosures. Compensation expense for employee stock awards is recognized on a straight-line basis over the vesting period of the award. The adoption of SFAS 123(R) also

requires certain changes to the accounting for income taxes and the method used in determining diluted shares, as well as additional disclosure related to the cash flow effects resulting from share-based compensation. The relevant interpretive guidance of Staff Accounting Bulletin 107 was applied in connection with its implementation and adoption of SFAS 123(R).

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The Company estimates the fair value of stock option awards based on the following assumptions:

	Six Months Ended September 30, 2006
Expected volatility	64%
Expected life (in years)	5 years
Expected dividends	0%
Risk-free interest rate	4.78%

The weighted average fair value of options granted during the six months ended September 30, 2006 was $0.77. The Company's approach to estimating expected volatility on its stock awards granted during the quarter considers both the historical volatility in the trading market for its common stock and a look back period equal to the expected life of the grants. Expected volatility is one of several assumptions in the Black-Scholes model used by the Company to make an estimate of the fair value of options granted under the Company's stock plans. The Company believes this approach results in a better estimate of expected volatility.

In estimating the expected term, both exercise behavior and post-vesting termination behavior were included in the analysis, as well as consideration of outstanding options. The risk-free interest rate used in the Black-Scholes option valuation model is the historical yield on U.S. Treasury zero-coupon issues with equivalent remaining terms. The Company does not pay any cash dividends on the Company's common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, an expected dividend yield of zero is used in the Black-Scholes option valuation model.

Stock Option Plans

We have adopted a 1997 Stock Compensation Plan, a Stock Option Plan for Nonemployee Directors, and a 2007 Stock Compensation Plan (the Plans), pursuant to which we may grant stock options, stock appreciation rights, restricted stock, performance shares, and other stock and cash awards to eligible participants. We have also granted stock options outside of the Plans in limited situations. Under the Plans, an aggregate of approximately 681,485 shares of our Company's common stock remained available for issuance at September 30, 2006. In general, the stock options we have issued under the Plans vest over a period of five years and expire six years from the date of grant. New shares are issued under existing registration statements upon exercise. The 1997 Stock Compensation Plan expired with the adoption of the 2007 Stock Compensation Plan. All outstanding incentives, granted under the 1997 Plan will remain in effect until satisfied or terminated.

Options transaction under these plans during the three and six months ended September 30, 2006 are summarized as follows:

	Numberof shares		Weighted average exerciseprice
Outstanding at March31, 2006	276,470	$	2.80
Granted	25,000		1.33
Canceled	(37,490)		2.87
Outstanding at June 30, 2006	263,980		2.65
Granted	15,000		1.28
Canceled	(10,415)		5.39
Outstanding at September 30, 2006	268,565		2.46

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The following table summarizes information concerning outstanding and exercisable stock options at September 30, 2006:

Options outstanding

Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Aggregate Intrinsic value
$ 0.00-$1.29	15,000	5.92 years	$ 1.28	$ 19,200
1.30-2.91	228,565	3.83 years	1.87	427,417
5.53-8.90	25,000	0.23 years	8.56	214,000
	268,565	3.61 years	$ 2.46	$ 660,617

Options exercisable

Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Aggregate intrinsic value
$ 0.00-$1.29	-	0 years	$ -	$ -
1.30-2.91	82,405	3.15 years	2.06	169,754
5.53-8.90	25,000	0.23 years	8.56	214,000
	107,405	2.47 years	3.57	$ 383,754

Note 8. Inventories

Inventories consist of the following as of:

	September 30, 2006	March 31, 2006
Raw Materials	$ 1,654,448	$ 1,588,816
Work-in-progress	36,682	48,474
Finished Goods	284,074	199,553
	$ 1,975,204	$ 1,836,843

Note 9. Major Customer Concentration

As of September 30, 2006, two customers comprised approximately 22% of total sales for the six months ended September 30, 2006 and one customer accounted for 13% of accounts receivable as of the quarter end. No one customer provided greater than 10% of sales for the same period of the prior fiscal year.

Note 10. Commitments and Contingencies

Electronic Instrumentation and Technology, Inc. ("EIT") filed suit against APA on May 25, 2005 (see information in Part II, Item I of this Report.) The suit alleged that APA had committed various fraudulent acts in conjunction with preliminary business discussions between EIT and APA which preceded APA's introduction of its Profiler M product. APA denied EIT's claims of wrongful conduct and the case went to trial in December 2005. The jury found in favor of EIT on one claim and awarded EIT $35,000. EIT filed certain post-trial motions, all of which were denied by the court. EIT did not appeal the verdict and this matter is concluded.

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

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

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OVERVIEW

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

APACN focuses on custom-engineered products for telecommunications customers, primarily related to cabling management requirements of the Fiber-to-the-Home ("FTTH") marketplace and in designing and terminating custom cable assemblies for commercial and industrial original equipment manufacturers ("OEM's"). To date, APACN has been able to successfully establish itself as a value-added supplier to its target market of independent telephone companies and cable television operators as well as OEM's who value a high level of engineering services as part of their procurement process. APACN has expanded its product offerings and broadened its customer base since its inception three years ago.

APACN also invested in expanding its sales and engineering expenditures by 32% during fiscal 2006 to increase its potential revenues during fiscal year 2007 and beyond. APACN is already realizing the impact of these efforts in terms of increased sales, particularly during the last two quarters of the fiscal year 2006 and first two quarters of fiscal year 2007. The increase in revenues is due to additional customers and product acceptance, mainly in the Fiber-to-the-Premise market, as well as an increase in revenue generated from a new supply agreement to an existing customer serving the test equipment market.

Optronics discontinued the fiber optic product line in March 2006.

In fiscal year 2006 Optronics sold its MOCVD facility, certain equipment and intellectual property related to research and development work surrounding gallium nitride based heterojunction field effect transistors. The sale to an unrelated third party for consideration including $1.9 million in cash enables the Company to focus its R&D efforts on power amplifiers built using GaN technology by using commercially available parts, rather than building its own transistors. This is expected to decrease operating costs and shorten the time to market for power amplifiers. The Company also sold certain intellectual capitalized assets for $345,000 during the first quarter of fiscal year 2007. In August 2006, the Company paid approximately $872,000 into an escrow account to retire the bonds issued by the South Dakota Economic Development and Finance Authority. These funds will be used to make final payment on the bonds on October 1, 2006, the next redemption date.

Plastic and metal models of the consumer Personal UV Monitor (PUVM) offered by Optronics continue in production, and the focus remains on marketing and sales. We have also introduced samples of a new product called the *SunUVStation*™ to several catalog and retail distributors for their evaluation. This product, which is similar in size to an outdoor temperature gauge, measures the UV Index and is targeted to consumers and institutions for use in backyards, patios, swimming pool areas, and other public places where people need to be reminded about UV intensity. Final assembly and packaging of this product is being performed in our APA facility in India. The *SunUVStation*™ complements the PUVM and retailers are interested in offering both.

Optronics' 4-band *Profiler M* radiometer, which serves the printing and coating industries that use UV curing, is in production. This instrument measures the intensity and distribution of four UV bands to help set up and monitor the curing process. Two domestic distributors offer the product, and discussions and evaluation tests with additional domestic and international distributors are underway. We are in the process of establishing sales channels through

equipment and supplies manufacturers in addition to general distributors. Optronics is exhibiting the *Profiler M* in selected trade shows with encouraging results. In recent months, the Company held numerous discussions with potential customers of the Profiler M while attending trade shows in Atlanta and Chicago.

Our wholly owned subsidiary, APA Optronics, Pvt. Ltd, India (APA India), established in fiscal year 2005, is now operational. The subsidiary, with its prime focus on low cost manufacturing of APA's products and components, has already started supplying samples of Gallium Nitride and fiber optic products which are expected to be delivered for sale in the near future. The subsidiary is also providing software development for our *Profiler M* product. Phase II of the software for the Profiler has now been completed. The subsidiary provides marketing and sales support for our products both in the U.S. and India. In particular, it has started the marketing of patch cords and associated equipment for fiber optic communications, and during the second quarter began generating revenue from the sale of patch cords and other components to several customers. The subsidiary, currently located in a leased facility, is in the process of constructing a larger facility in India to accommodate its future requirements. The new facility is expected to be completed in fiscal year 2007.

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RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2006 VS. THREE MONTHS ENDED SEPTEMBER 30, 2005

Consolidated revenues for the three months ended September 30, 2006 increased $748,446, or 18%, to $4,817,813 from $4,069,367 in 2005 mainly due to increased revenues at Cables & Networks.

Revenues at Cables & Networks were $4,784,737, compared to $4,057,740 reported in the same quarter a year ago, an increase of 18%. The overall increase in revenue reflects continued growth in new customers and product acceptance in both the broadband and OEM markets. Sales for the current quarter to broadband service providers and commercial data networks were approximately $3,731,000 versus $2,847,000 in the prior year quarter. The increase was primarily due to higher revenues from customers in the Fiber-to-the-Premise market. Sales to OEM's were approximately $1,054,000 versus $1,210,000 in the year ago period. The decrease was due to price pressures that resulted in the loss of a major customer, however, this loss was partially off-set due to additional orders provided under a supply contract to a customer serving the test equipment market. We expect that future sales of Cables & Networks products will continue to account for a substantial portion of our revenue. With the introduction of a broader product offering in both segments, coupled with the expansion of the sales team into additional markets, we anticipate that revenues at Cables & Networks during the third and fourth quarters of fiscal year 2007 will be comparable with the revenue of the first and second quarters of fiscal 2007.

Gross revenues at Optronics decreased 70% to $33,076 from $109,877 in the same quarter a year ago mainly due to the termination of manufacturing activities in Aberdeen, South Dakota. Gross revenues for the quarter ended September 30, 2005 reflect $98,250 of sales to Cables & Networks for subcontracted labor. Optronics did not provide any subcontract labor to Cables & Networks in the quarter ended September 30, 2006.

GROSS PROFIT AND COST OF SALES

Cables & Networks' gross profit increased $378,768, or 35%, to $1,476,013 from $1,097,245. Specifically, gross profit as a percent of revenue was 31% in the current quarter as compared to 27% in the same quarter last year. The increase in gross profit was mainly due to an increase in revenue without an increase in the corresponding fixed costs, as well as component and labor cost reductions.

Gross cost of sales (before inter-company eliminations) at Optronics decreased $152,615, or 50%, to $149,512 from $302,127. Gross cost of sales for second quarter of fiscal year 2006 reflects $97,325 related to cost of sales to Cables & Networks for subcontracted labor. Optronics did not provide any subcontract labor to Cables & Networks in the quarter ended September 30, 2006. These costs are eliminated as inter-company cost of sales in the consolidated financials in each quarter. Cost of sales expenses for the current period for all Optronics product lines consists of approximately $45,000 in personnel costs, $30,000 in depreciation and $75,000 in materials, overhead and other product expenses. This compares to prior year personnel expenses of approximately $146,000, depreciation of $64,000, and materials, allocated overhead and other expenses of $92,000.

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

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses consist of the research and development expense at Optronics. There have been no significant research and development expenses at Cables & Networks. Expenses decreased $208,167 to $135,205, from $343,372 in the prior year period. The change reflects a decrease in personnel, facility and depreciation costs due

to the sale of its MOCVD operations.

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SELLING, GENERAL, AND ADMINISTRATIVE

Consolidated selling, general, and administrative (S, G, & A) expenses during the three months ended September 30, 2006 increased $16,116, or 1%, to $1,696,482 from $1,680,366 in the same period in 2005.

S, G, & A expenses at Cables & Networks during the three months ended September 30, 2006 increased $197,983, or 18%, to $1,288,167 from $1,090,184 in 2005. The majority of the increase is attributable to additional sales personnel and related selling costs as a part of our plan to grow our revenue and customer base. We expect upcoming quarter expenses to remain at levels seen in the second quarter.

S, G, & A expenses at Optronics during the three months ended September 30, 2006 decreased $182,792, or 31%, to $408,315 from $591,107 in the same period in 2005. The decrease is due largely to the expensing of warrants in the prior quarter which were fully amortized as of March 31, 2006.

GAIN ON DISPOSAL OF ASSETS

Consolidated gain on disposal of assets in the three months ended September 30, 2006 was $6,498 versus a loss of $16,809 in 2005. The majority of the activity is at the Optronics division.

INCOME (LOSS) FROM OPERATIONS

Consolidated losses from operations decreased $670,865, or 59% during the three months ended September 30, 2006, to $465,612 from $1,136,477 in the same period in 2005.

The income from operations at Cables & Networks in the three months ended September 30, 2006 was $188,975 compared to $7,061 in the same period in 2005. The increased income in the quarter was mainly due to increased revenues, offset by higher selling expenses absorbed as part of Cables & Networks' planned investment in revenue growth.

The loss from operations at Optronics decreased $488,951 in the three months ended September 30, 2006, or 43%, to $654,587, from a loss of $1,143,538 in the year ago period. The decrease in the loss is mainly due to consolidation and discontinuation of MOCVD and Aberdeen operations.

OTHER INCOME AND EXPENSE

Consolidated other income and expense increased $15,850 to $89,449 in the three months ended September 30, 2006 from $73,599 in 2005.

Other expense at Cables & Networks increased $29,009 in the three months ended September 30, 2006 due to an increase in interest expense, primarily due to a higher interest rate in the current period.

Other income at Optronics increased $43,772 to $228,865 in the three months ended September 30, 2006. This resulted from an increase in interest income due to a higher rate of interest earned on investments over the quarter ending September 30, 2005. Other expense decreased $1,087 to $20,512 in the three months ended September 30, 2006, from $21,599 in the period ending September 30, 2005.

NET LOSS

Consolidated net loss for the quarter decreased $663,195, or 62%, to $400,433, or $.03 cents per share, from $1,063,628, or $.09 cents per share in the year ago period.

Cables & Networks had a net profit of $45,801 in the quarter, compared to a loss of $83,334 in the year ago quarter. The increased profitability was due mainly to increased revenues.

Optronics recorded a net loss of $446,234 in the three months ended September 30, 2006, a decrease of $534,060 from a loss of $980,294 from the same period of 2005. The decrease in the loss is mainly due to the consolidation and termination of MOCVD and Aberdeen operations. Achieving profitability in the future will strongly depend upon Optronics' ability to successfully manufacture and market gallium-nitride products.

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SIX MONTHS ENDED SEPTEMBER 30, 2006 VS. SIX MONTHS ENDED SEPTEMBER 30, 2005

Consolidated revenues for the six months ended September 30, 2006 increased $2,261,800, or 30%, to $9,843,730 from $7,581,930 in 2005.

Revenues at Cables & Networks were $9,759,811, compared to $7,566,128 reported in the same period a year ago, an increase of 29%. The overall increase in revenue reflects continued growth in new customers and product acceptance in both the broadband and OEM markets. Sales for the current two quarters to broadband service providers and commercial data networks were approximately $7,440,000 versus $5,432,000 in the prior year quarter. The increase was primarily due to higher revenues from customers in the Fiber-to-the-Premise market. Sales to OEM's were approximately $2,320,000 versus $2,134,000 in the year ago period. The increase is due to additional orders provided under a supply contract to a customer serving the test equipment market. We expect that future sales of Cables & Networks products will continue to account for a substantial portion of our revenue. With the introduction of a broader product offering in both segments, coupled with the expansion of the sales team into additional markets, we anticipate that revenues at Cables & Networks during the third and fourth quarters of fiscal year 2007 will be comparable with the revenue of the first and second quarters of fiscal 2007.

Gross revenues at Optronics decreased 61% to $83,919 from $212,775 in the same period a year ago mainly due to the termination of manufacturing activities in Aberdeen, South Dakota. Gross revenues for the quarter ended September 30, 2005 reflect $196,973 of sales to Cables & Networks for subcontracted labor. Optronics did not provide any subcontract labor to Cables & Networks in the two quarters ended September 30, 2006.

GROSS PROFIT AND COST OF SALES

Cables & Networks' gross profit increased $899,037, or 45%, to $2,908,222 from $2,009,185. Specifically, gross profit as a percent of revenue was 30% in the first six months of fiscal year 2007 as compared to 27% in the same period last year. The increase in gross profit was mainly due to an increase in revenue without an increase in the corresponding fixed costs, as well as component and labor cost reductions.

Gross cost of sales (before inter-company eliminations) at Optronics decreased $287,935, or 49%, to $302,577 from $590,512. Gross cost of sales for the first six months of fiscal year 2006 reflects $194,705 related to cost of sales to Cables & Networks for subcontracted labor. Optronics did not provide any subcontract labor to Cables & Networks in the quarter ended September 30, 2006. These costs are eliminated as intercompany cost of sales in the consolidated financials in each quarter. Cost of sales expenses for the current period for all Optronics product lines consists of approximately $95,000 in personnel costs, $64,000 in depreciation and $144,000 in materials, overhead and other product expenses. This compares to prior year personnel expenses of approximately $283,000, depreciation of $131,000, and materials, allocated overhead and other expenses of $177,000. The reduced product development expenses within the GaN area also contributed to the decreased cost of sales.

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

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses consist of the research and development expense at Optronics. There have been no significant research and development expenses at Cables & Networks. Expenses decreased $377,978 to $288,992 during the six months ended September 30, 2006, from $666,970 in the prior year period. The change reflects a decrease in personnel, facility and depreciation costs due to the sale of its MOCVD operations.

SELLING, GENERAL, AND ADMINISTRATIVE

Consolidated selling, general, and administrative (S, G, & A) expenses increased $258,711 during the six months ended September 30, 2006, or 8%, to $3,409,485 from $3,150,774 in 2005.

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S, G, & A expenses at Cables & Networks increased $480,327 during the six months ended September 30, 2006, or 23%, to $2,550,059 from $2,069,732 in the same period in 2005. The majority of the increase is attributable to additional sales personnel and related selling costs as a part of our plan to grow our revenue and customer base. We expect upcoming quarter expenses to remain at levels seen in the first and second quarters.

S, G, & A expenses at Optronics decreased $223,884, or 21%, to $859,426 from $1,083,310 in 2005. The decrease is due largely to the expensing of warrants in the prior quarter which were fully amortized as of March 31, 2006.

GAIN ON DISPOSAL OF ASSETS

Gain on disposal of assets were entirely within the Optronics division. Gain on disposal of assets increased $258,372 to $351,498 in the six months ended September 30, 2006 from $93,126 in the prior year. Gains for fiscal year 2007 represent the sale of patents. Gains for fiscal year 2006 were primarily from the exchange of land for the forgiveness of debt.

INCOME (LOSS) FROM OPERATIONS

Consolidated losses from operations decreased $1,438,023, or 69%, to $657,415 in the six months ended September 30, 2006 from $2,095,438 in 2005.

The income from operations at Cables & Networks was $359,292 in the six months ended September 30, 2006 versus loss of $60,547 in the fiscal 2006 period. The increased income in the period was mainly due to increased revenues, offset by higher selling expenses absorbed as part of Cables & Networks' planned investment in revenue growth.

The loss from operations at Optronics decreased $1,018,184, or 50%, to $1,016,707 in the six months ended September 30, 2006, from a loss of $2,034,891 in the year ago period. The decrease in the loss is mainly due to the gain of $345,000 realized due to the sale of two patents and the termination of MOCVD related activities. We expect to incur losses at Optronics until we realize significant revenues from the sales of our PUVM and GaN related products.

OTHER INCOME AND EXPENSE

Consolidated other income and expense increased $45,710 to $188,214 from $142,504 in 2005.

Other expense at Cables & Networks increased $53,782 due to an increase in interest expense, primarily due to a higher interest rate in the current period.

Other income at Optronics increased $97,225 to $459,689. This resulted from an increase in interest income due to a higher rate of interest earned on investments over the six months ended September 30, 2005. Other expense decreased $2,267 to $40,930, from $43,197 in the period ended September 30, 2005.

NET LOSS

Consolidated net loss for the six months ended September 30, 2006 decreased $1,442,183, or 74%, to $512,451, or $.04 cents per share, from $1,954,634, or $.16 cents per share in the year ago period.

Cables & Networks had a net profit of $86,497 year to date, compared to a loss of $238,510 in 2005. The increased profitability was due mainly to increased revenues.

Optronics recorded a net loss of $598,948 in the six months ended September 30, 2006, a decrease of $1,117,176 from a loss of $1,716,124 for the same period in 2005. The decrease in the loss is mainly due to the consolidation of operations resulting in a $859,105 decrease in operating expenses during the six months ended September 30, 2006 as compared to the same period of last year. Achieving profitability in the future will strongly depend upon Optronics' ability to successfully manufacture and market gallium-nitride products.

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LIQUIDITY AND CAPITAL RESOURCES

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

Cash used in operating activities was $1,344,148 for the six month period ended September 30, 2006 compared to $1,787,988 used in the same period in 2005. The cash used in the current period decreased $443,840 despite an increase of $546,835 in the working capital from the prior year. This is primarily attributable to increase in APACN's accounts receivable and inventory associated with its growth in revenues.

We realized net cash increase of $111,855 in investing activities for the six months ended September 30, 2006 compared to $122,262 used in the same period of the preceding fiscal year. The net realized cash due to investing activities in the current period includes proceeds from sale of capital assets in the amount of $386,592 offsetting capital expenditures in the amount of $274,737. The Company sold $111,680 worth of capital assets and had capital expenditures of $233,942 in the comparable period of the previous year. We anticipate approximately $400,000 to $500,000 in capital expenditures in fiscal 2007, including the completion of building of a new facility in India.

Net cash used in financing activities for the six months ended September 30, 2006 totaled $911,149. We used $95,129 for reduction of debt and deposited $816,020 in an escrow account to redeem bonds. During the same period in fiscal 2006 we used $22,435 in financing activities, of which $68,083 was used for the scheduled reduction of debt and $45,648 was generated from the reduction of bond reserve funds.

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

Our contractual obligations and commitments are summarized in the table below (in 000's) as of September 30, 2006:

	Total	Less than 1 Year	1-3 years	4-5 years	After 5 years
Long-term debt (1)	$ 1,266	$ 1,255	$ 11	$ -	$ -
Leases	1,997	325	690	487	495
Total Contractual Cash Obligations	$ 3,263	$ 1,580	$ 701	$ 487	$ 495

(1) Includes fixed interest from 0.62 to 10.60%

APPLICATION OF CRITICAL ACCOUNTING POLICIES

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

- Stock Option Accounting;
- Accounting for income taxes; and

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

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Stock Option Accounting

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123—revised 2004 (“SFAS 123R”), “Share-Based Payment,” which replaces Statement of Financial Accounting Standards No. 123 (“SFAS 123”) and supersedes APB Opinion No. 25, “Accounting for Stock Issued to Employees.” SFAS 123R requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value based method and the recording of such expense in our Consolidated Statements of Operations. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (“SAB 107”), “Share-Based Payment,” which provides interpretive guidance related to the interaction between SFAS 123R and certain SEC rules and regulations, as well as provides the SEC staff’s views regarding the valuation of share-based payment arrangements.

We adopted SFAS 123R using the modified prospective transition method, which requires the application of the accounting standard as of April 1, 2006, the first day of our fiscal year 2007. Our unaudited condensed consolidated financial statements as of and for the three and six months ended September 30, 2006 reflect the impact of SFAS 123R. The compensation expense had impacted both basic and diluted loss per share by less than $0.01 for the three and six months ended September 30, 2006. The Company recorded $11,243 and $30,868 of related compensation expense for the three and six month periods ended September 30, 2006. In accordance with the modified prospective transition method, our unaudited condensed consolidated financial statements for prior periods have not been restated, and do not include, the impact of compensation expense calculated under SFAS 123R.

Accounting for Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income tax liability in each of the jurisdictions in which we do business. This process involves estimating our actual current tax expense together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that these deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not more likely than not or unknown, we must establish a valuation allowance.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our deferred tax assets. At March31, 2006, we recorded a full valuation allowance of $13,390,433 against our deferred tax assets, due to uncertainties related to our ability to utilize our deferred tax assets, consisting principally of certain net operating losses carried forward. The valuation allowance is based on our estimates of taxable income by jurisdiction and the period over which our deferred tax assets will be recoverable. The Company has U.S. net operating loss (NOL)carryforwards of approximately $33,782,000 which expire in fiscal years 2007 to 2026. To date the Company has not completed a section 382 analysis. If certain ownership changes occurred under Section 382 of the Internal Revenue Code, there may be further limitations on the usage of the net operating loss carry forwards.

Realization of the NOL carryforwards and other deferred tax temporary differences are contingent on future taxable earnings. The deferred tax asset was reviewed for expected utilization using a “more likely than not” approach by assessing the available positive and negative evidence surrounding its recoverability.

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

Valuation and evaluating impairment of long-lived assets and goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired. Goodwill is not amortized but reviewed for impairment at the fiscal year end or whenever conditions exist that indicate an impairment could exist.

The Company evaluates the recoverability of its long-lived assets in accordance with SFAS144, “Accounting for the Impairment or Disposal of Long-Lived Assets.” SFAS144 requires recognition of impairment of long-lived assets in the event that events or circumstances indicate an impairment may have occurred and when the net book value of such assets exceeds the future undiscounted cash flows attributed to such assets. We assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. No impairment of long-lived assets has occurred in fiscal 2007 through the six months ended September 30, 2006.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

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

ITEM 4. CONTROLS AND PROCEDURES.

(a) *Evaluation of disclosure controls and procedures*. The Company’s chief executive officer and chief financial officer have concluded that as of the end of the fiscal period covered by this report the Company’s disclosure controls and procedures (as defined in Exchange Act Rule 13a-14(c)) were effective.

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

PART II

ITEM 1. LEGAL PROCEEDINGS

Electronic Instrumentation and Technology, Inc. ("EIT") filed suit against APA on May 25, 2005 in the U.S. District Court for the Eastern District of Virginia, Case Number 1:05 CV 571 (the "EIT litigation"), alleging that APA had committed fraud by knowing concealment, fraud in making contract, fraud by intentional misrepresentation, misappropriation of trade secrets, tortious interference with prospective economic advantage, negligent misrepresentation, breach of contract, unfair competition, and inequitable conduct in conjunction with preliminary business discussions between EIT and APA which preceded APA's introduction of the Profiler M. APA filed an Answer on July 28, 2005, which denied EIT's claims of wrongful conduct.

The EIT litigation was tried to a jury on December 28, 2005. The District Court dismissed, as a matter of law, six of EIT's nine causes of action either before or during the trial. Three of EIT's causes of action were submitted to the jury for determination. The jury found in favor of APA on EIT's claim for fraud in making contract and misappropriation of trade secrets. The jury found in favor of EIT on its breach of contract claim and awarded EIT $35,000. EIT has filed certain post-trial motions, all of which were denied by the court. EIT did not appeal the verdict and this matter is concluded.

ITEM 1A. RISK FACTORS

FACTORS THAT MAY INFLUENCE FUTURE RESULTS

The statements contained in this Report on Form 10-Q that are not purely historical are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitations, statements regarding the Company’s expectations, hopes, beliefs, anticipations, commitments, intentions and strategies regarding the future. Forward-looking statements include, but are not limited to, statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations. Actual results could differ from those projected in any

forward-looking statements for the reasons, among others, detailed below. We believe that many of the risks detailed here are part of doing business in the industry in which we compete and will likely be present in all periods reported. The fact that certain risks are characteristic to the industry does not lessen the significance of the risk. The forward-looking statements are made as of the date of this Report as Form 10-Q and we assume no obligation to update the forward-looking statements or to update the reasons why actual results could differ from those projected in the forward-looking statements. Readers of this Report and prospective investors should also review the Risk Factors set forth in our Report on Form 10-K for the fiscal year ended March 31, 2006.

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Manufacturing and Operations

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

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

Markets and Market Conditions

Our profitability can be adversely affected due to increased raw material costs

Our manufacturing costs may be impacted by unanticipated increases in raw material costs during the time span between the cost quotes and actual procurement of raw materials. The impact can be significant for purchase orders requiring multiple scheduled deliveries. Whereas we may be able to approach some of the customers for costs adjustments, there is no assurance that we would be successful in obtaining these adjustments. Failure to obtain price adjustments would result in decreased profitability and/or losses.

Our inventory of raw material and supplies may incur significant obsolescence

Our market demands rapid turn around from receipt of purchase orders to shipping of the products. We maintain significant inventory of raw materials and supplies to meet this demand resulting in risk of inventory obsolescence. Whereas we anticipate and make provisions for a reasonable fraction of inventory obsolescence, a significant higher level of obsolescence can adversely impact our profitability.

Our Customers

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

If we lose a significant customer, our sales and gross margins would be negatively impacted. In addition, the loss of sales may require us to record impairment, restructuring charges or exit a particular business or product line. As of September 30, 2006, two customers comprised approximately 22% of total sales for the first two quarters ended September 30, 2006 and one customer accounted for 13% of accounts receivable as of the quarter end. No one customer provided greater than 10% of sales for the same period of the prior fiscal year.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITY AND USE OF PROCEEDS

None.

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ITEM 3. DEFAULT UPON SENIOR SECURITIES

On August 30, 2006, the Company paid $871,911 into an escrow account to retire the debt from the South Dakota Economic Development and Finance Authority. These funds will be used to make final payment on the Company's dept to the State of South Dakota on October 1, 2006, the next bond redemption date.

During 1996-97 the Company built its new production facility in Aberdeen, South Dakota. This facility was partially funded by using proceeds of a $1.895 million bond from the State of South Dakota Governor's Office of Economic Development. The bonds required the Company to maintain operations in the state of South Dakota and compliance with certain financial covenants. The repayment will be made pursuant to a Notice of Default and Acceleration received by the Company. The primary reason for the notice was related to the Company ceasing all of its South Dakota operations in the later part of fiscal year 2006 as part of its consolidation of manufacturing operations. The Company has made timely interest and principal payments, and the reason for the notice was not related to the payments

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On August 17, 2006, the Company held its Annual Meeting of Shareholders. At the meeting, the shareholders elected as directors Anil K. Jain (with 10,494,183 shares voting for and 268,605 withheld), John G. Reddan (with 10,592,872 shares voting for and 169,916 withheld), Ronald G. Roth (with 10,594,172 shares voting for and 168,616 withheld), and Stephen A. Zuckerman (with 10,327,298 shares voting for and 435,490 withheld).

The shareholders also approved the adoption of the Company's 2007 Stock Compensation Plan (with 5,382,527 shares voting for, 415,204 against, 52,031 abstaining, and 4,913,026 broker-non votes)

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

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

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Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

APA ENTERPRISES, INC.

November 9, 2006
Date

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