

PECO II INC  
Form 10-Q  
August 14, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended June 30, 2006

or

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

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

Commission File Number 000-31283

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**PECO II, INC.**

(Exact name of registrant as specified in its charter)

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**OHIO**  
(State or other jurisdiction of  
incorporation or organization)

**34-1605456**  
(I.R.S. Employer  
Identification No.)

1376 STATE ROUTE 598, GALION, OHIO

44833

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(Address of principal executive office)

(Zip Code)

Registrant's telephone number including area code: (419) 468-7600

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Indicate by check mark whether the registrant: (1) has filed all reports 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 is a large accelerated filer, an accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

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

CLASS	Outstanding At July 31, 2006
Common Shares, without par value	27,149,201

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(In thousands, except for share data)

	June 30, 2006 (Unaudited)	December 31, 2005
<b><u>ASSETS</u></b>		
Current Assets:		
Cash and cash equivalents	\$ 9,811	\$ 8,778
Accounts receivable, net of allowance of \$82 in June 30, 2006 and \$119 in December 31, 2005	6,667	7,046
Inventories, net of allowance of \$2,094 in June 30, 2006 and \$2,110 in December 31, 2005	13,149	8,124
Prepaid expenses and other current assets	188	732
Assets held for sale	1,300	3,518
Costs and estimated earnings in excess of billings on uncompleted contracts	2,700	898
Restricted cash	3,578	3,683
<b>Total current assets</b>	<b>37,393</b>	<b>32,779</b>
Property and equipment, at cost:		
Land and land improvements	195	195
Buildings and building improvements	4,638	4,608
Machinery and equipment	9,034	9,072
Furniture and fixtures	5,862	5,853
	19,729	19,728
Less-accumulated depreciation	(14,344)	(13,904)
<b>Property and equipment, net</b>	<b>5,385</b>	<b>5,824</b>
Other Assets:		
Goodwill	6,100	1,774
Intangibles, net	5,432	
Investment in joint venture	6	6
<b>Total Assets</b>	<b>\$ 54,316</b>	<b>\$ 40,383</b>
<b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>		
Current Liabilities:		
Borrowings under line of credit	\$ 2,401	\$ 1,419
Capital leases payable	95	92
Accounts payable	4,457	1,880
Accrued compensation expense	1,466	1,106
Billings in excess of costs and estimated earnings on uncompleted contracts	110	79
Accrued income taxes	65	144

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Other accrued expenses	5,047	4,455
<b>Total current liabilities</b>	<b>13,641</b>	<b>9,175</b>
Long-term Liabilities:		
Capital leases payable, net of current portion	305	354
Shareholders' Equity:		
Common shares, no par value: authorized 150,000,000 shares; 27,059,201 and 22,201,666 shares issued at June 30, 2006 and December 31, 2005, respectively	3,433	2,816
Warrants	4,979	
Additional paid-in capital	115,705	109,978
Accumulated deficit	(83,747)	(81,420)
Treasury shares, at cost, 0 and 346,925 shares at June 30, 2006 and December 31, 2005, respectively		(520)
<b>Total shareholders' equity</b>	<b>40,370</b>	<b>30,854</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 54,316</b>	<b>\$ 40,383</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****PECO II, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(unaudited)

(In thousands, except for per share data)

	<b>For the Three Months Ended June 30,</b>		<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net sales:				
Product	\$ 10,130	\$ 6,509	\$ 17,681	\$ 13,174
Services	3,448	2,922	6,368	5,469
	13,578	9,431	24,049	18,643
Cost of goods sold:				
Product	8,429	4,722	14,146	9,787
Services	3,089	2,642	5,819	5,070
	11,518	7,364	19,965	14,857
Gross margin:				
Product	1,701	1,787	3,535	3,387
Services	359	280	549	399
	2,060	2,067	4,084	3,786
Operating expenses:				
Research, development and engineering	897	741	1,686	1,444
Selling, general and administrative	2,823	1,970	5,027	3,942
	3,720	2,711	6,713	5,386
Loss from operations	(1,660)	(644)	(2,629)	(1,600)
Loss from joint venture				(8)
Loss from operations after joint venture	(1,660)	(644)	(2,629)	(1,608)
Interest income, net	123	52	238	100
Loss before income taxes	(1,537)	(592)	(2,391)	(1,508)
Income tax benefit (provision)	82		64	(20)
Net loss	\$ (1,455)	\$ (592)	\$ (2,327)	\$ (1,528)
Net loss per common share:				
Basic and diluted	\$ (0.05)	\$ (0.03)	\$ (0.09)	\$ (0.07)
Weighted average common shares outstanding:				
Basic and diluted	27,005	21,576	24,639	21,571

The accompanying notes are an integral part of these condensed consolidated financial statements.



**Table of Contents****PECO II, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)

(In thousands)

	<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (2,327)	\$ (1,528)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation and amortization	809	708
Loss on disposals of property and equipment	10	11
Investment loss in joint venture		8
Compensation expense from share-based payments	326	
Working capital changes:		
Accounts and notes receivable	379	(126)
Inventories	(3,025)	(356)
Costs and earnings in excess of billings on uncompleted contracts	(1,802)	127
Prepaid expenses and other current assets	544	38
Accounts payable, other accrued expenses and accrued income taxes	3,173	(3,265)
Accrued compensation expense	360	164
Billings in excess of costs and earnings on uncompleted contracts	31	(558)
Net cash used for operating activities	(1,522)	(4,777)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capital expenditures	(130)	(23)
Acquisition	(695)	
Proceeds from sale of property and equipment	2,153	
Net cash provided by (used for) investing activities	1,328	(23)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Transfer from (to) restricted cash	105	(128)
Net usage (repayments) under line of credit agreement .	982	(155)
Repayment of long-term debt and capital leases	(46)	(44)
Proceeds from issuance of common shares - options exercised	164	
Proceeds from issuance of common shares Employee Stock Purchase Plan	22	25
Net cash provided by (used for) financing activities	1,227	(302)
Net increase (decrease) in cash	1,033	(5,102)
Cash and cash equivalents at beginning of period	8,778	