PROFILE TECHNOLOGIES INC
Form 10-Q
November 09, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2010

o 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: 000-29196

PROFILE TECHNOLOGIES, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	91-1418002 (I.R.S. Employer Identification No.)
2 Park Avenue, Suite 201 Manhasset, New York (Address of principal executive offices)	11030 (Zip Code)

(516) 365-1909
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o.

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

(§232.405 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 o No o

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.

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer (Do not check if a smaller reporting company)	o	Smaller reporting company	x

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 18,418,331 shares of common stock, par value $0.001, were outstanding as of November 2, 2010.

PROFILE TECHNOLOGIES, INC.
FORM 10-Q

For the Quarterly Period Ended September 30, 2010

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited).

PROFILE TECHNOLOGIES, INC.

BALANCE SHEETS
SEPTEMBER 30, 2010 AND JUNE 30, 2010
(Unaudited)

		September 30, 2010		June 30, 2010
ASSETS				
Current assets				
Cash and cash equivalents	$	404,120	$	377,127
Accounts receivable		62,232		48,567
Inventory		5,626		2,075
Prepaid expenses and other current assets		12,000		8,496
Total current assets		483,978		436,265
Equipment, net of accumulated depreciation of $8,895 and $7,347		9,684		11,232
Other assets		9,604		9,604
Total assets	$	503,266	$	457,101
LIABILITIES AND STOCKHOLDERS' DEFICIT				
Current liabilities				
Accounts payable	$	180,647	$	184,267
Note payable to stockholder		7,500		7,500
Deferred wages		846,570		840,111
Accrued professional fees		324,450		306,650
Total current liabilities		1,359,167		1,338,528
Commitments and contingencies				
Stockholders' deficit				
Common stock, $0.001 par value: 40,000,000 shares authorized,				
18,398,331 and 17,826,222 shares issued and outstanding at September 30, 2010 and June 30, 2010		18,398		17,826
Common stock issuable; 20,000 and 20,679 shares at September 30, 2010 and June 30, 2010		20		21
Additional paid-in capital		20,126,773		19,693,209

Accumulated deficit		(21,001,092)		(20,592,483)
Total stockholders' deficit		(855,901)		(881,427)
Total liabilities and stockholders' deficit	$	503,266	$	457,101

(The accompanying notes are an integral part of these financial statements)

PROFILE TECHNOLOGIES, INC.

STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2010 AND 2009
(Unaudited)

	Three Months Ended September 30,	
	2010	2009
Revenue	$ 19,757	$ 42,417
Cost of revenue	(29,626)	(53,168)
Gross margin	(9,869)	(10,751)
Operating expenses		
Research and development	103,990	115,291
Selling	61,799	51,419
General and administrative	232,969	192,721
Total operating expenses	398,758	359,431
Loss from operations	(408,627)	(370,182)
Other income (expense)		
Gain on sale of equipment	-	300
Interest expense	(175)	(14,252)
Interest income	193	19
Total other income (expense)	18	(13,933)
Net loss	$ (408,609)	$ (384,115)
Net loss per share - basic and diluted	$ (0.02)	$ (0.02)
Weighted average shares outstanding used to		
	18,164,768	16,249,550

(The accompanying notes are an integral part of these financial statements)

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PROFILE TECHNOLOGIES, INC.

STATEMENTS OF STOCKHOLDERS' DEFICIT
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2010 AND THE YEAR ENDED JUNE 30, 2010
(Unaudited)

	Common Stock		Common Stock Issuable		Additional Paid-in	Accumulated	Total Stockholders'
	Shares	Amount	Shares	Amount	Capital	Deficit	Deficit
Balance at June 30, 2009	15,961,012	$ 15,961	68,618	$ 69	$ 17,474,622	$ (18,450,171)	$ (959,519)
Issuance of common stock previously reported as "issuable"	68,618	69	(68,618)	(69)	-	-	-
Issuance of common stock for services to consultants	623	-	679	1	1,806	-	1,807
Issuance of stock options for services to consultants	-	-	-	-	147,000	-	147,000
Issuance of stock options for services to employees and Board of Directors	-	-	-	-	589,300	-	589,300
Stock compensation amortization expense	-	-	-	-	55,251	-	55,251
Issuance of common stock related to the 2009 Offering	1,300,969	1,301	-	-	1,169,583	-	1,170,884
Common stock issuance costs related to the 2009 Offering	-	-	-	-	(112,588)	-	(112,588)

Issuance of common stock upon conversion of convertible debt to equity	70,000	70	-	-	34,930	-	35,000
Exercise of warrants	425,000	425	20,000	20	333,305	-	333,750
Net loss for the year ended June 30, 2010	-	-	-	-	-	(2,142,312)	(2,142,312)
Balance at June 30, 2010	17,826,222	$ 17,826	20,679	$ 21	$ 19,693,209	$ (20,592,483)	$ (881,427)
Issuance of common stock previously reported as "issuable"	20,679	21	(20,679)	(21)	-	-	-
Stock compensation amortization expense	-	-	-	-	5,563	-	5,563
Exercise of warrants	551,430	551	20,000	20	428,001	-	428,572
Net loss for the three months ended September 30, 2010	-	-	-	-	-	(408,609)	(408,609)
Balance at September 30, 2010	18,398,331	$ 18,398	20,000	$ 20	$ 20,126,773	$ (21,001,092)	$ (855,901)

(The accompanying ntoes are an integral part of these financial statements)

PROFILE TECHNOLOGIES, INC.

STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2010 AND 2009
(Unaudited)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009
Cash flows from operating activities		
Net loss	$ (408,609)	$ (384,115)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,548	579
Gain on sale of equipment	-	(300)
Accreted discount on convertible debt	-	9,951
Amortization of convertible debt discount included in interest expense	-	3,690
Equity issued for services to consultants	-	25,666
Stock compensation amortization expense	5,563	5,563
Changes in operating assets and liabilities:		
Increase in accounts receivable	(13,665)	(23,191)
Increase in inventory	(3,551)	(1,211)
Increase in prepaid expenses and other current assets	(3,504)	(2,979)
Decrease in other assets	-	1,009
Increase (decrease) in accounts payable	(3,620)	13,128
Increase in deferred wages	6,459	10,010
Increase in accrued professional fees	17,800	21,900
Decrease in accrued interest	-	(7)
Net cash used in operating activities	(401,579)	(320,307)
Cash flows from investing activity		
Proceeds from sale of equipment	-	300
Net cash provided by investing activity	-	300
Cash flows from financing activities		
Proceeds from issuance of common stock	-	329,802
Common stock issuance costs	-	(32,980)
Proceeds from exercise of warrants	428,572	-
Net cash provided by financing activities	428,572	296,822
Increase (decrease) in cash and cash equivalents	26,993	(23,185)
Cash and cash equivalents at beginning of period	377,127	270,906
Cash and cash equivalents at end of period	$ 404,120	$ 247,721

Supplemental disclosure of cash flow information:				
Cash paid for interest	$	175	$	619
Convertible debt converted into 20,000 shares of common stock during the three months ended September 30, 2009	$	-	$	10,000

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

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PROFILE TECHNOLOGIES, INC.

NOTES TO FINANCIAL STATEMENTS

September 30, 2010
(Unaudited)

Note 1. Organization and Description of Business

Profile Technologies, Inc. (the "Company") was incorporated in 1986 and commenced operations in fiscal year 1988. The Company is in the business of providing pipeline inspection services to locate corrosion and other anomalies that require assessment to verify pipeline integrity. The Company has developed a patented, non-destructive and non-invasive, high speed scanning process that uses electromagnetic waves to inspect remotely buried and above ground, cased and insulated pipelines for corrosion and other anomalies. The Company's inspection services are available to owners and operators of natural gas and oil pipelines, power plants, refineries, utilities, and other facilities which have cased or insulated pipe. The Company is actively marketing to these sectors. In conjunction with providing inspection services, the Company continues its research and development of new applications for its patented technology, including inspecting pipes for internal corrosion and other anomalies and direct buried pipes for external corrosion and other anomalies.

Note 2. Going Concern Uncertainties

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. The Company has not generated positive cash flows from operations and has an accumulated deficit of $21,001,092 and negative working capital of $875,189 as of September 30, 2010. The Company faces all of the risks common to companies that are actively marketing to customers utilizing a relatively new technology, including under capitalization and uncertainty of funding sources, high expenditure levels, uncertain revenue streams, and difficulties managing growth. Additionally, the Company has expended a significant amount of cash in developing its technology and patented processes. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management recognizes that in order to meet the Company's capital requirements, and continue to operate, additional financing, including seeking industry-partner investment through joint ventures or other possible arrangements, will be necessary. The Company is evaluating alternative sources of financing to improve its cash position and is undertaking efforts to raise capital. If the Company is unable to raise additional capital or secure revenue contracts and generate positive cash flow, it is unlikely that the Company will be able to continue as a going concern. These financial statements do not give effect to any adjustments which will be necessary should the Company be unable to continue as a going concern and therefore be required to realize its assets and discharge its liabilities in other than the normal course of business and at amounts different from those reflected in the accompanying financial statements.

Note 3. Presentation of Interim Information

The accompanying unaudited interim financial statements have been prepared in accordance with accounting principles accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. 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. In the opinion of management, all adjustments (of a normal recurring nature) considered necessary for a fair presentation of the financial statements have been included. Operating results for the three months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ended June 30, 2011 or any other interim period. For further information, refer to the financial statements and notes thereto included in the

Company's 2010 Annual Report on Form 10-K for the year ended June 30, 2010 filed with the Securities and Exchange Commission.

Note 4. Summary of Significant Accounting Policies

Estimates

The preparation of the Company's financial statements requires management to make estimates and use assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for the Company include service contract revenue and cost recognition, accounting for research and development costs, and accounting for stock-based compensation. On an on-going basis, the Company evaluates its estimates. Actual results and outcomes may differ materially from these estimates and assumptions.

Fair Value of Financial Instruments

Fair value estimates of financial instruments are made at a specific point in time, based on relevant information about financial markets and specific financial instruments. As these estimates are subjective in nature, involving uncertainties and matters of significant judgment, they cannot be determined with precision. Changes in assumptions can significantly affect estimated fair value.

The Company measures fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the reporting date. The Company utilizes a three-tier hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1. Valuations based on quoted prices in active markets for identical assets or liabilities that an entity has the ability to access. The Company has no assets or liabilities valued with Level 1 inputs.

Level 2. Valuations based on quoted prices for similar assets or liabilities, quoted prices for identical assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable data for substantially the full term of the assets or liabilities. The Company has no assets or liabilities valued with Level 2 inputs.

Level 3. Valuations based on inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. The Company has no assets or liabilities valued with Level 3 inputs.

The carrying value of cash and cash equivalents, accounts receivable, inventory, accounts payable, and note payable to stockholder approximate their fair value because of the short-term nature of these instruments and their liquidity. Management is of the opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments.

Service Contract Revenue and Cost Recognition

Pursuant to the Company's service contracts, it has two outputs, inspection of the pipelines (service) and delivery of the final inspection report (product). The Company offers both a service and a product in a single transaction in which the product (final inspection report) is incidental to the rendering of the inspection services. The service transaction is based on a pre-determined fixed fee, consisting of:

- the pipeline inspection fee,
- reimbursement of costs incurred to mobilize and demobilize field crews and inspection equipment to and from the inspection site,
- proceeds from the sale of permanent connectors, and

- other travel related costs.

The final act (delivery of the inspection report) is not so significant to the entire transaction taken as a whole that performance cannot be considered to have taken place until delivery. The customer is obligated to fulfill their contractual obligation (via payment) based on the performance of the inspection services.

Accordingly, the Company recognizes revenue from its service contracts (i.e. pipeline inspections) using the proportional performance method of accounting because performance determines the extent to which the earnings process is complete or virtually complete. Contract revenue earned is measured based on the number of measurable units of pipelines inspected to the total number of units contracted to be inspected. Revenue is recognized based on the completion of such measurable units. The proportional performance method is used to recognize revenue because management considers measurable units of completion to be the best available measure of progress towards the completion of service contracts. Changes in estimated revenue on service contracts are recognized during the period in which the change in estimate becomes known.

Cost of revenue includes time incurred and materials used to plan the pipeline inspections, mobilize and demobilize field crews, perform the inspection services, analyze the resulting data and prepare the final inspection report. Cost of revenue also includes any idle time incurred by personnel scheduled to work on customer contracts. Costs are recognized as incurred as they are not an indicator of the progress towards completion of the pipeline inspection services.

Revenue from the sale of permanent connectors is recognized when the permanent connector is both delivered and installed on the pipeline. Cost of revenue related to permanent connectors represents the cost of the parts and components required to build the permanent connectors.

Anticipated losses on service contracts, if any, are charged to earnings in their entirety as soon as such losses can be estimated.

Research and Development

Research and development costs represent costs incurred to develop the Company's technology, including employee and consultant time and material and equipment expense. Research and development costs are expensed when incurred, except for nonrefundable advance payments for future research and development activities which are capitalized and recognized as expense as the related services are performed.

During the three months ended September 30, 2010 and 2009, the Company incurred $103,990 and $115,291 on research and development activities.

Stock-based Compensation

The Company measures all employee stock-based compensation awards using a fair value method on the date of grant and recognizes such expense in its financial statements over the requisite service period. The Company uses the Black-Scholes pricing model to determine the fair value of stock-based compensation awards on the date of grant. The Black-Scholes pricing model requires management to make assumptions regarding the warrant and option lives, expected volatility, risk free interest rates, and forfeitures. See "Note 5. Stock Based Compensation, Stock Options and Warrants" for additional information on the Company's stock-based compensation plans.

Vendor Concentration

Consultant Scientist Fees

The Company relies on the expertise of two consultant scientists to facilitate the development and testing of the Company's hardware and software. These scientists are also instrumental in compiling and assisting in interpreting the data captured during the use of the hardware and software. The loss of the specialized knowledge provided by the scientists could have an adverse effect on the ability of the Company to successfully market its hardware and software. During the three months ended September 30, 2010 and 2009, the Company incurred fees for work performed by the scientists of $66,153 and $90,060.

At September 30, 2010 amd June 30, 2010, the Company owed the consultant scientists a total of $84,076 and $81,417, respectively, which is included in accounts payable.

Recently Adopted Accounting Pronouncements

The Company reviews new accounting standards as issued. Although some of these accounting standards issued or effective after the end of the Company's previous fiscal year may be applicable to the Company, it has not identified any standards that it believes merit further discussion. The Company believes that none of the new standards will have a significant impact on its financial statements.

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Note 5. Stock Based Compensation, Stock Options and Warrants

Stock Option Plans

1999 Stock Plan

On November 16, 1998, the stockholders of the Company ("Stockholders") approved and adopted the 1999 Stock Plan (the "1999 Stock Plan"). The 1999 Stock Plan originally provided for the granting of options to purchase a maximum of 500,000 shares of common stock with expiration dates of a maximum of five years from the date of grant. In November 2006, the Board of Directors amended, and the Stockholders approved, an increase in the maximum number of shares of common stock available for grant to 3,500,000 and an increase in the period of time for which stock options may be exercisable to ten years from the date of grant.

Since the inception of the 1999 Stock Plan, and prior to the amendment approved in November 2006, the Company made various stock option grants that had expiration dates exceeding five years from the date of grant. These stock option grants were deemed to be granted outside of the 1999 Stock Plan.

2008 Stock Plan

On July 10, 2008, the Board approved and adopted the 2008 Stock Ownership Incentive Plan ("2008 Stock Plan") and received Stockholder approval on November 17, 2008. Upon adoption of the 2008 Stock Plan by the Stockholders, the Company may no longer grant stock options under the 1999 Stock Plan.

The 2008 Stock Plan is intended to attract and retain the best available personnel for positions of substantial responsibility, to provide additional incentive to employees and consultants, and to promote the success of the Company's business. In accordance with the 2008 Stock Plan, the Company may grant stock options to purchase up to 3,500,000 shares of common stock. The 2008 Plan allows incentive stock options to be granted with an expiration date of a maximum of five years and nonqualified stock options to be granted with an expiration date of a maximum of ten years from the date of grant.

The Company measures all stock-based compensation awards using a fair value method on the date of grant and recognizes such expense in its financial statements over the requisite service period. In determining the grant date fair value of stock options, the Company uses the Black-Scholes option pricing model which requires management to make assumptions regarding the option lives, expected volatility, risk free interest rates, and forfeitures, all of which impact the fair value of the option and, ultimately, the expense that will be recognized over the life of the option.

The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for a bond with a similar term. The Company does not anticipate declaring dividends in the foreseeable future. Volatility is calculated based on the historical weekly closing stock prices for the same period as the expected life of the option. The Company uses the "simplified" method for determining the expected term of its "plain vanilla" stock options. The Company recognizes compensation expense for only the portion of stock options that are expected to vest. Therefore, the Company applies an estimated forfeiture rate that is derived from historical employee termination data and adjusted for expected future employee turnover rates. To date, the Company has not experienced any forfeitures. If the actual number of forfeitures differs from those estimated by the Company, additional adjustments to compensation expense may be required in future periods. The Company's stock price volatility, option lives and expected forfeiture rates involve management's best estimates at the time of such determination, all of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option.

The following table sets forth the share-based compensation cost resulting from stock option grants, including those previously granted and vesting over time, which was recorded in the Company's Statements of Operations for the three months ended September 30, 2010 and 2009:

	Three Months Ended September 30, 2010	2009
Research and development	$ 5,563	$ 5,563
Selling	-	25,666
Total	$ 5,563	$ 31,229

A summary of the Company's stock option activity for the three months ended September, 2010 and related information follows:

	Number Of Stock Options (1)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (3)	Aggregate Intrinsic Value (3)
Outstanding at September 30, 2010 and June 30, 2010	4,725,000	$ 1.23	5.5 years	$ 428,600
Exercisable at September 30, 2010	4,687,500	$ 1.23	5.5 years	$ 418,725
Available for grant at September 30, 2010 (2)	2,150,000			

(1) Consists of stock options outstanding under the 1999 Stock Plan, 2008 Stock Plan, and stock options outstanding that were granted outside of the 1999 Stock Plan and the 2008 Stock Plan.

(2) Shares available for future stock option grants to employees, officers, directors and consultants of the Company under the 2008 Stock Plan.

(3) The weighted average remaining contractual term and aggregate intrinsic value are as of September 30, 2010.

The aggregate intrinsic value of the table above represents the total pretax intrinsic value for all "in-the-money" options (i.e., the difference between the Company's closing stock price on the last trading day of its first quarter of fiscal year 2011 and the exercise price, multiplied by the number of shares) that would have been received by the option holders had all option holders exercised their options on September 30, 2010. The intrinsic value changes based on the fair market value of the Company's common stock.

As of September 30, 2010, the Company had $22,310 of total unrecognized compensation cost related to unvested stock options, which is expected to be recognized over a weighted average period of 1.1 years.

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The following table summarizes information about stock options outstanding and exercisable at September 30, 2010:

	Stock Options Outstanding			Stock Options Exercisable		
Exercise Prices	Number of Options Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
$ 0.86	435,000	6.1	$ 0.86	435,000	6.1	$ 0.86
0.95	140,000	6.1	0.95	140,000	6.1	0.95
1.05	150,000	1.2	1.05	137,500	1.1	1.05
1.12	285,000	3.7	1.12	285,000	3.7	1.12
1.13	50,000	2.4	1.13	25,000	2.4	1.13
1.16	1,600,000	4.4	1.16	1,600,000	4.4	1.16
1.20	350,000	5.6	1.20	350,000	5.6	1.20
1.21	150,000	5.2	1.21	150,000	5.2	1.21
1.26	35,000	8.2	1.26	35,000	8.2	1.26
1.30	50,000	3.7	1.30	50,000	3.7	1.30
1.32	200,000	7.1	1.32	200,000	7.1	1.32
1.34	590,000	7.4	1.34	590,000	7.4	1.34
1.47	150,000	9.1	1.47	150,000	9.1	1.47
1.50	15,000	6.9	1.50	15,000	6.9	1.50
1.70	390,000	6.7	1.70	390,000	6.7	1.70
1.87	135,000	8.1	1.87	135,000	8.1	1.87
0.86 – $ $ 1.87	4,725,000	5.5	$ 1.23	4,687,500	5.5	$ 1.23

Warrants

The Company has granted warrants to compensate key employees, consultants, and board members for past and future services and as incentives during placements of stock and convertible debt.

A summary of the Company's warrant-related activity for the three months ended September 30, 2010 and related information follows:

	Number Of Warrants Outstanding	Weighted Average Exercise Price
Outstanding at June 30, 2010	7,666,028	$ 0.75
Exercises	(571,430)	0.75
Expirations	(1,435,570)	0.75

Outstanding at September 30, 2010	5,659,028	$	0.75
Exercisable at September 30, 2010	5,659,028	$	0.75

The following table summarizes information about warrants outstanding, all of which were exercisable at September 30, 2010:

Exercise Prices	Number of Warrants Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
$ 0.60	439,600	0.9	$0.60
0.75	4,648,000	1.0	0.75
0.86	450,000	6.1	0.86
1.00	50,000	1.5	1.00
1.05	71,428	1.6	1.05
$ 0.60-1.05	5,659,028	1.4	$0.75

Cash received from warrants exercised during the three months ended September 30, 2010 was $428,572. No warrants were exercised during the three months ended September 30, 2009.

Note 6. Net Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common and dilutive common equivalent shares outstanding during the period. As the Company had a net loss attributable to common stockholders in each of the periods presented, basic and diluted net loss per share are the same.

Excluded from the computation of diluted net loss per share for the three months ended September 30, 2010 and 2009, because their effect would be antidilutive, are stock options and warrants to acquire 10,384,028 and 12,346,028 shares of common stock with weighted-average exercise prices of $0.97 and $0.91 per share, respectively. Also excluded from the computation of diluted net loss per share for the three months ended September 30, 2009 are 50,000 shares of common stock that would have been issued if investors had exercised their conversion right under the Debentures related to the 2003 Offering, as defined in "Note 8. Convertible Debt" below, because their effect would be antidilutive. There were no Debentures outstanding as of September 30, 2010.

For the three months ended September 30, 2010 and 2009, additional potential dilutive securities that were excluded from the diluted net loss per share computation are the exchange rights discussed in "Note 9. Deferred Wages and Accrued Professional Fees" that could result in options to acquire up to 223,000 shares of common stock with an exercise price of $1.00 per share at September 30, 2010 and 2009.

For purposes of earnings per share computations, shares of common stock that are issuable at the end of a reporting period are included as outstanding.

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Following is the computation of basic and diluted net loss per share for the three months ended September 30, 2010 and 2009:

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009
Numerator - net loss	$ (408,609)	$ (384,115)
Denominator - weighted average number of common shares outstanding	18,164,768	16,249,550
Basic and diluted net loss per share	$ (0.02)	$ (0.02)

Note 7. Note Payable to Stockholder

In April 2002, the Company issued a non-interest bearing bridge note payable to a former officer of the Company in the amount of $7,500. The note is payable in full when the Company determines it has sufficient working capital to do so.

Note 8. Convertible Debt

On June 19, 2003, the Board of Directors approved the offering (the "2003 Offering") of $1,000,000 in convertible debentures (the "Debentures"). The Debentures were convertible into that number of shares of the Company's common stock equal to the amount of the converted indebtedness divided by $0.50 per share. The Debentures bear interest at a rate of 5% per annum, payable quarterly. Delinquent interest payments bear interest at a rate of 12% per annum. The Company was required to redeem each Debenture on the 5th anniversary of the date of the Debenture. The Company may, in its discretion, redeem any Debenture at any time prior to the mandatory redemption date of the Debenture by providing no less than 60 days' prior written notice to the holder of the Debenture. Certain events of default will result in the Debentures being redeemable by the Company upon demand of the holder.

Upon the purchase of, and for each $0.50 of the Debenture's principal amount, the Company issued to each investor a warrant (the "Warrant") to purchase one (1) share of the Company's common stock at an exercise price of $0.75 per share. The Warrants are exercisable at any time prior to the 5th anniversary date of the redemption of the Debenture.

Warrants issued in connection with the 2003 Offering were recorded based on their relative fair value as compared to the fair value of the debt at issuance. The relative fair value of the warrants was recorded as paid-in capital. The intrinsic value of the Debentures resulted in a beneficial conversion feature, recorded as a discount against the Debentures, which reduced the book value of the convertible debt to not less than zero. The Company amortized the discount using the effective interest method over the five-year life of the Debentures.

During the quarter ended March 31, 2005, the Board of Directors terminated the 2003 Offering. As of the closing date of the 2003 Offering, the Company had raised $503,000 from the 2003 Offering.

During the three months ended September 30, 2009, one investor exercised his conversion right and converted his Debenture in the principal amount $10,000, pursuant to the terms of the 2003 Offering. Accordingly the investor was issued 20,000 shares of common stock. The carrying value of the convertible debt was reclassified as equity upon conversion. Since the Debentures included a beneficial conversion feature at issuance the remaining unamortized discount of $3,690 at the conversion date was recognized as interest expense during the three months ended September 30, 2009.

The Company recorded interest expense related to the accretion of the discount on the Debentures and amortization of the convertible debt discount as a result of the conversion discussed above of $13,641 for the three months ended September 30, 2009.

As of June 30, 2010, all Debentures had been converted to equity.

Note 9. Deferred Wages and Accrued Professional Fees

To reduce cash outflows, certain of the Company's employees, officers, consultants, and directors have agreed to defer a portion of their salaries and professional fees until the Company has sufficient resources to pay the amounts owed or to exchange such amounts into options as described below. At September 30, 2010, the Company has accrued $1,171,020 related to the deferred payment of salaries and professional fees of which $846,570 is included under deferred wages and $324,450 in accrued professional fees. At June 30, 2010, the Company has accrued $1,146,761 related to the deferred payment of salaries and professional fees of which $840,111 is included under deferred wages and $306,650 in accrued professional fees. On March 18, 2002, the Board approved a conversion right on all deferred wages and accrued professional fees deferred as of March 18, 2002 (the "Conversion Right"). Pursuant to the Conversion Right, employees, officers, consultants, and directors may elect to convert $1.00 of fees owed to them as of March 18, 2002 for an option to purchase two shares of the Company's common stock, at an exercise price of $1.00 per share for a term of five years. Of the total $1,171,020 and $1,146,761 deferred salaries and accrued professional fees at September 30, 2010 and June 30, 2010, respectively, the amount subject to the Conversion Right is $111,500, resulting in the potential issuance of 223,000 options under the terms mentioned above. No conversions have occurred to date. At March 18, 2002, there was no intrinsic value associated with these Conversion Rights. As such, no additional compensation cost was recorded.

Note 10. 2009 Private Placement Equity Offering

On April 2, 2009, the Company entered into a private placement offering (the "2009 Offering") of 1,500,000 shares of common stock at $0.90 per share to accredited investors for a total offering price of $1,350,000. On January 29, 2010, the Board determined that it was in the best interests of the Company to extend the termination date of the 2009 Offering and voted to extend the expiration date to April 1, 2010.

During the three months ended September 30, 2009, the Company raised gross proceeds of $329,802 under the terms of the 2009 Offering. Accordingly, the Company issued 366,445 shares of common stock pursuant to the terms of the 2009 Offering.

The Company engaged two brokerage firms to help in the fund raising efforts of the 2009 Offering. Pursuant to the terms of the agreements with the brokerage firms, the Company owes the brokerage firms a ten percent cash commission on all funds that the brokerage firm helps raise. Accordingly, during the three months ended September 30, 2009, the Company incurred total fees payable to the brokerage firms of $32,980.

The 2009 Offering was closed on April 1, 2010. As of the closing date, the Company had raised gross proceeds of $1,349,564 and issued 1,499,502 shares of common stock pursuant to the terms of the 2009 Offering.

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

Forward-Looking Statements

This Report on Form 10-Q contains forward-looking statements which involve assumptions and describe our future plans, strategies, and expectations, and are generally identifiable by use of words such as “may,” “will,” “should,” “expect,’ “anticipate,” “estimate,” “believe,” “intend,” or “project” or the negative of these words or other variations on these words comparable terminology. These statements are expressed in good faith and based upon a reasonable basis when made, but there can be no assurance that these expectations will be achieved or accomplished.

Such forward-looking statements include statements regarding, among other things, (a) the potential markets for our technologies, our potential profitability, and cash flows, (b) our growth strategies, (c) expectations from our ongoing research and development activities, (d) anticipated trends in the technology industry, (e) our future financing plans, and (f) our anticipated needs for working capital. This information may involve known and unknown risks, uncertainties, and other factors that may cause our actual results, performance, or achievements to be materially different from the future results, performance, or achievements expressed or implied by any forward-looking statements. These statements may be found under “Management’s Discussion and Analysis of Financial Condition and Results of Operations” as well as in this Form 10-Q generally. Actual events or results may differ materially from those discussed in forward-looking statements as a result of various factors, including, without limitation, the matters described in this Form 10-Q generally. In light of these risks and uncertainties, there can be no assurance that the forward-looking statements contained in this filing will in fact occur. In addition to the information expressly required to be included in this filing, we will provide such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

Although forward-looking statements in this report reflect the good faith judgment of our management, forward-looking statements are inherently subject to known and unknown risks, business, economic and other risks and uncertainties that may cause actual results to be materially different from those discussed in these forward-looking statements. Readers are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. We assume no obligation to update any forward-looking statements in order to reflect any event or circumstance that may arise after the date of this report, other than as may be required by applicable law or regulation. Readers are urged to carefully review and consider the various disclosures made by us in our reports filed with the Securities and Exchange Commission which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operation and cash flows. If one or more of these risks or uncertainties materialize, or if the underlying assumptions prove incorrect our actual results may vary materially from those expected or projected.

Overview

The following Management’s Discussion and Analysis (“MD&A”) is intended to help the reader understand our results of operations and financial condition. The MD&A is provided as a supplement to, and should be read in conjunction with our financial statements and the accompanying notes to the financial statements included in this Form 10-Q.

The MD&A is based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities and expenses and related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual

results may differ from these estimates under different assumptions or conditions.

Background

We were incorporated in 1986 under the name "Profile Technologies, Inc." and commenced operations in fiscal year 1988. We are in the business of providing pipeline inspection services to locate corrosion and other anomalies that require assessment to verify pipeline integrity. We have developed a patented, non-destructive and non-invasive, high speed scanning process that uses electromagnetic waves to inspect remotely buried and above ground, cased and insulated pipelines for corrosion and other anomalies. Our inspection services are available to owners and operators of natural gas and oil pipelines, power plants, refineries, utilities, and other facilities which have cased or insulated pipe. We are actively marketing to these sectors. In conjunction with providing inspection services, we continue our research and development of new applications for our patented technology, including inspecting pipes for internal corrosion and other anomalies and direct buried pipes for external corrosion and other anomalies.

EMW-C™ External Inspection Process

Our core business is based on the technologies that we have developed and patented for defect inspection of pipelines using electromagnetic waves. Born from these technologies, we have researched and developed inspection methods that have become commercial or near commercial products and services.

The EMW-C™ inspection process is a non-destructive corrosion inspection method that we patented, for long-range external assessment of cased and insulated pipelines. The technique uses electromagnetic waves to locate and identify corrosion and other anomalous conditions at distances down the length of the pipeline. This non-intrusive and non-destructive method can be performed without disturbing the pipeline casing or removing the protective insulation. After the initial inspection is performed, permanent connectors may be left on the pipeline to allow for repeat and periodic inspections or monitoring. In addition, the EMW-C™ inspection process provides corrosion inspection over long lengths of cased or insulated pipe sections from a single location, as opposed to most other inspection methods, which may only provide for point or localized inspections.

Correlating pipeline corrosion information using our technology requires a combination of state-of-the-art instrumentation plus an understanding of the physical phenomena that are being measured. Management believes that the EMW-C™ measurement and analysis are on the leading edge of inspection technology.

Installation of Permanent Connectors, Inspection of Wax-Filled Cased Pipelines, and Internal Inspection Process

During the beginning of fiscal year 2010, we began selling two additional options with the EMW-C™ inspection service: permanent connectors for recurring inspection and dielectric fill analysis. Adding these two features increases the appeal of the EMW-C™ to the customer. The permanent connectors are a relatively low cost option which allow for quick re-inspection of the pipeline section at later times without the need for repeat excavation or preparation by the customer.

We also now offer a modification to the EMW-C™ which inspects the condition of wax or dielectric fill in cased pipelines. The filling of the void between the casing and the pipe with wax as a means of additional corrosion protection (the "wax-fill technology") has become popular in the oil and gas pipeline industry with the onset of new Federal regulations allowing its use. We have worked closely with key participants in this technology to refine and demonstrate our capability to perform the initial inspection and long-term monitoring of wax-filled pipeline crossings in combination with EMW-C™ permanent connectors.

Capital will be expended to support operations until we can generate sufficient cash flows from operations. In order to do so, we must obtain additional revenue generating contracts for the use of our commercially available EMW-C™ service.

As revenue is generated, we will continue to manufacture our EMW-C™ inspection equipment. We expect that as additional revenue contracts are secured, working capital requirements will increase. We will incur additional expenses as we hire and train field crews and support personnel related to the successful receipt of commercial contracts. Additionally, we anticipate that cash will be used to meet capital expenditure requirements necessary to develop infrastructure to support future growth. In time, with increased sales, we may consider our position as a service provider and alternatively sell or lease our service to pipeline operators and/or inspection service providers while maintaining the intellectual rights to our technology and equipment.

Results of Operations

Revenue

Pursuant to our service contracts, we have two outputs, inspection of the pipelines (service) and delivery of the final inspection report (product). We offer both a service and a product in a single transaction in which the product (final inspection report) is incidental to the rendering of the inspection services. The service transaction is based on a pre-determined fixed fee, consisting of:

- the pipeline inspection fee,
- reimbursement of costs incurred to mobilize and demobilize field crews and inspection equipment to and from the inspection site,
- proceeds from the sale of permanent connectors, and
- other travel related costs.

The final act (delivery of the inspection report) is not so significant to the entire transaction taken as a whole that performance cannot be considered to have taken place until delivery. The customer is obligated to fulfill their contractual obligation (via payment) based on the performance of the inspection services.

Accordingly, we recognize revenue from our service contracts (i.e. pipeline inspections) using the proportional performance method of accounting because performance determines the extent to which the earnings process is complete or virtually complete. Contract revenue earned is measured based on the number of measurable units of pipelines inspected to the total number of units contracted to be inspected. Revenue is recognized based on the completion of such measurable units. The proportional performance method is used to recognize revenue because management considers measurable units of completion to be the best available measure of progress towards the completion of service contracts. Changes in estimated revenue on service contracts are recognized during the period in which the change in estimate becomes known.

Revenue also includes the sale of permanent connectors to the customer for recurring inspections.

Revenue for the three months ended September 30, 2010 and 2009 was $19,757 and $42,417, respectively. During the prior year period we obtained a greater number of revenue generating contracts and completed inspection of more pipelines than we did during the quarter ended September 30, 2010.

Cost of revenue

Cost of revenue includes time incurred and materials used to plan the pipeline inspections, mobilize and demobilize field crews, perform the inspection services, analyze the resulting data and prepare the final inspection report. Cost of revenue also includes the cost of the materials to build the permanent connectors as well as any idle time incurred by personnel scheduled to work on customer contracts. Costs are recognized as incurred as they are not an indicator of the progress towards completion of the pipeline inspection services.

Cost of revenue for the three months ended September 30, 2010 and 2009 was $29,626 and $53,168, resulting in negative gross margins of 50.0% and 25.3%, respectively. Fluctuations in gross margin are caused by the unique requirements of each inspection, including location of each pipeline inspection site and time and resources required to prepare the field crews for the inspection, in addition to the cost of mobilizing and demobilizing field crews and equipment to the inspection site.

Operating Expenses

A summary of our operating expenses for the three months ended September 30, 2010 and 2009 was as follows:

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Increase / (Decrease)	Percentage Change
Operating expenses				
Research and development	$ 103,990	$ 115,291	$ (11,301)	(9.8) %
Selling	61,799	51,419	10,380	20.2
General and administrative	232,969	192,721	40,248	20.9
Total operating expenses	$ 398,758	$ 359,431	$ 39,327	10.9 %

Research and Development

Research and development expense consists of fees paid to consulting scientists to develop our inspection technologies and related hardware, salary and benefit costs for employees, including stock compensation, supplies and testing equipment utilized for the development of the EMW inspection technologies and other supply and travel expenses incurred pursuant to performing research and development related activities.

Research and development expense for the three months ended September 30, 2010 was $103,990, a decrease of $11,301, compared to $115,291 for the same period in 2009. The decrease is substantially attributable to decreases in the rental of equipment and supplies purchased for the use in the development of our EMW inspection technologies.

The net amount of expense incurred for work performed by the consulting scientists and for the allocation of employee's salaries to research and development was fairly consistent between the quarters ended September 30, 2010 and 2009. However, there was a shift from time spent on developing our EMW-C™ technology to further developing our EMW-I™ technology, including work performed on software enhancements for real time analysis, probe modifications for permanent connectors in wax-filled casings, and further development of the internal inspection tool for pipelines and heat exchanger tube inspections.

Selling Expense

Selling expense is primarily comprised of salary and benefit expense for employees who spend time meeting with prospective customers, costs that we incur to provide field demonstrations to prospective customers, including costs incurred by our consulting scientists and other third party consultants, and costs incurred to attend conferences and trade shows.

Selling expense for the three months ended September 30, 2010 was $61,799, an increase of $10,380, compared to $51,419 for the same period in 2009. On June 23, 2009, we retained the services of an independent consultant (the "Consultant") to assist us in seeking new customer opportunities, managing existing customer relationships, and publicizing our EMW inspection technologies. During the three months ended September 30, 2010, we incurred approximately $26,313 in fees for services rendered by the Consultant (compared to $10,750 in the prior year). Additionally, as a result of a direct marketing approach that we enacted last year, we continue to utilize the aid of the Consultant to target specific new and existing customers in an effort to further develop sales leads and to secure additional inspection contracts. Several meetings were held at various customer offices and conferences across the

country during the quarter ended September 30, 2010. As a result of these meetings, our travel related expenses increased approximately $17,700 during the three months ended September 30, 2010 compared to the three months ended September 30, 2009.

Offsetting the increases in fees paid to the Consultant and travel related expenses, was a decrease in stock based compensation of $25,666. On June 23, 2009, we granted a stock option to the Consultant to purchase up to 50,000 shares of our common stock at an exercise price of $1.30 per share. The grant date fair value of this stock option was $44,000. During the three months ended September 30, 2009, we recorded stock based compensation of $25,666 for the amortization of this stock option.

General and Administrative

General and administrative expense consists of costs incurred for professional fees, wages and benefits for the executive team, travel and entertainment, patent filing and maintenance fees, shareholder relations, rent, and other administrative fees such as office supplies, postage and printing costs.

General and administrative expense for the three months ended September 30, 2010 was $232,969, an increase of $40,248, compared to $192,721 for the same period in 2009. The increase is substantially due to increases in legal fees of approximately $18,600 and shareholder relations expense of approximately $18,000.

Legal fees increased substantially as a result of costs incurred related to the exercise of warrants and the change in SEC legal counsel during the fourth quarter of fiscal year 2010. The change in SEC legal counsel was not the result of any disagreement between management and our former law firm, rather, the managing partner on our account transferred to another law firm and we determined that it was in our best interest to continue that relationship.

Shareholder relations expense increased substantially as a result of fees incurred with regard to the exercise of certain warrants issued in connection with the 2003 Offe