

PECO II INC
Form 10-Q
August 14, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

(Mark One)

x **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

PECO II, INC.

(Exact name of registrant as specified in its charter)

OHIO
(State or other jurisdiction of
incorporation or organization)

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

1376 STATE ROUTE 598, GALION, OHIO

44833

Edgar Filing: PECO II INC - Form 10-Q

(Address of principal executive office)

(Zip Code)

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

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 |
|----------------------------------|
| Common Shares, without par value |

| Outstanding At July 31, 2006 |
|------------------------------|
| 27,149,201 |

Table of Contents

PECO II, INC.

INDEX

| | Page |
|--|-------------|
| PART I | |
| <u>FINANCIAL INFORMATION</u> | |
| Item 1. | |
| <u>Financial Statements:</u> | |
| <u>Condensed Consolidated Balance Sheets</u> | 3 |
| <u>Condensed Consolidated Statements of Operations</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 6 |
| Item 2. | |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 16 |
| Item 3. | |
| <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 22 |
| Item 4. | |
| <u>Controls and Procedures</u> | 22 |
| PART II | |
| <u>OTHER INFORMATION</u> | |
| Item 1A. | |
| <u>Risk Factors</u> | 23 |
| Item 2(b). | |
| <u>Use of Proceeds</u> | 23 |
| Item 4. | |
| <u>Submission of Matters to a Vote of Security Holders</u> | 23 |
| Item 6. | |
| <u>Exhibits</u> | 24 |
| <u>SIGNATURES</u> | 24 |

Table of Contents**PECO II, INC.****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****PECO II, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except for share data)

| | June 30, 2006 (Unaudited) | December 31, 2005 |
|---|---------------------------------|----------------------|
| <u>ASSETS</u> | | |
| 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 |
| Total current assets | 37,393 | 32,779 |
| 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) |
| Property and equipment, net | 5,385 | 5,824 |
| Other Assets: | | |
| Goodwill | 6,100 | 1,774 |
| Intangibles, net | 5,432 | |
| Investment in joint venture | 6 | 6 |
| Total Assets | \$ 54,316 | \$ 40,383 |
| <u>LIABILITIES AND SHAREHOLDERS' EQUITY</u> | | |
| 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 |

Edgar Filing: PECO II INC - Form 10-Q

| | | |
|--|------------------|------------------|
| Other accrued expenses | 5,047 | 4,455 |
| Total current liabilities | 13,641 | 9,175 |
| 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) |
| Total shareholders' equity | 40,370 | 30,854 |
| Total Liabilities and Shareholders' Equity | \$ 54,316 | \$ 40,383 |

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)

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|--|-------------|--|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| 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)

| | For the Six Months Ended June 30, | |
|--|--|-------------|
| | 2006 | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| 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) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| 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) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| 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 | 9,723 |
| Cash and cash equivalents at end of period | \$ 9,811 | \$ 4,621 |
| Supplemental disclosure of cash flow information: | | |
| Income taxes paid | \$ 55 | \$ 131 |
| Interest paid | 57 | 117 |

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

Table of Contents

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited, in thousands except for share and per share data)

1. Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of PECO II, Inc. (the Company) and its wholly and partially owned subsidiaries. In the opinion of management, the accompanying unaudited interim condensed consolidated financial statements reflect all adjustments, of a normal and recurring nature, necessary to present fairly the results for the interim periods presented.

In May 2004, PECO II Global Services, Inc. (PGS), a wholly owned subsidiary of PECO II, Inc., and b+w Electronic Systems Verwaltung-GmbH (BWESV), a German corporation, formed a corporation named b+w II, Inc. The corporation is established under the laws of the state of Ohio and the principal office is at 1376 State Route 598, Galion, Ohio. The ownership structure is 50% PGS and 50% BWESV, with a \$100 equity investment by both parties. This joint venture is accounted for under the equity method of accounting.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The December 31, 2005 balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. It is suggested that these condensed statements be read in conjunction with the Company's most recent Annual Report on Form 10-K.

2. Reclassifications

Certain amounts in prior years have been reclassified to conform to the 2006 consolidated financial statements.

3. Acquisitions

On March 28, 2006, PECO II acquired exclusive rights to certain business and inventory for Delta's U.S. and Canadian Telecom Power Division in exchange for an equity position in PECO II that enables Delta to become the Company's largest shareholder. Additionally, the transaction included the execution of a supply agreement that will allow PECO II to access Delta's substantial engineering capabilities and high-quality, cost-effective component manufacturing for its power systems.

The original purchase price was \$11,808, which included issuance of 4,740,375 shares (primary shares) of common stock without par value and a warrant to purchase up to approximately 13 million shares of PECO II's common stock, or such number of shares that when aggregated with the primary shares, will represent 45% of the Company's issued and outstanding shares of capital stock measured as of five business days before the exercise of the warrant, at an exercise price of \$2.00 per share, exercisable immediately upon issuance and for a period of 30 months thereafter. Due to the warrant coverage requirement of 45% and the issuance of common shares under the 2000 Performance Plan Amendment 1 and Employee Stock Purchase plans, the number of shares that can be issued under the warrant at June 30, 2006 increased to approximately 13.5 million shares resulting in an increase in the warrant value of \$218. This in turn increased the purchase price to \$12,026 and the excess purchase price was assigned to goodwill.

The value of the 4,740,375 shares of common stock was determined based on the average closing price of PECO II's common shares over the five business days prior to, the date of, and the five days after the public announcement of the execution of the Asset Purchase Agreement. The fair value of the warrant was also determined using the Black-Scholes option pricing model with the following assumption: stock price of \$1.34; volatility of 60%; risk-free interest rate of 3.96%; and an expected life of 2.5 years.

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

The following table summarizes the estimated fair values of the net assets acquired. A third-party valuation of certain intangible assets was as follows:

| | June 30, 2006 |
|---------------------|----------------------|
| Inventory | \$ 2,000 |
| Intangible assets | 5,700 |
| Goodwill | 4,326 |
| Net assets acquired | \$ 12,026 |

Of the \$5,700 of intangible assets, \$2,000 was allocated to customer relationships and \$3,700 was allocated to supply agreement. The Company estimates the amortization period for the customer relationships to be six years and five years for the supply agreement and will be amortized using the straight-line method.

The following table provides a supplemental disclosure of non-cash investing activities related to the acquisition:

| | June 30, 2006 |
|---|----------------------|
| Supplemental disclosure of non-cash investing activities: | |
| Inventory | \$ 2,000 |
| Goodwill | 4,326 |
| Intangible assets | 5,700 |
| Capital stock | (601) |
| Warrants | (4,979) |
| Additional paid-in-capital | (5,751) |
| Net of cash paid | \$ 695 |

Proforma Adjustments Statement of Operations

Results of operations attributable to the Delta acquisition have been included in the Company's condensed consolidated financial statements prospectively from the effective date of the acquisition. The following table provides selected, unaudited proforma financial information for the three and six month periods ended June 30, 2006 and 2005 as if the acquisition occurred on January 1, 2005. Proforma amounts have been adjusted for expected amortization expense and other post-closing effects including the effect on the weighted average common shares outstanding.

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---------------------------|--|-------------|--|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| Proforma Sales - Product | \$ 10,130 | \$ 9,411 | \$ 20,289 | \$ 18,599 |
| Proforma Sales - Services | 3,448 | 2,922 | 6,368 | 5,469 |
| Proforma Net Sales: | \$ 13,578 | \$ 12,333 | \$ 26,657 | \$ 24,068 |

Edgar Filing: PECO II INC - Form 10-Q

| | | | | |
|--|------------|-----------|------------|------------|
| Proforma Net Loss | \$ (1,455) | \$ (328) | \$ (2,231) | \$ (1,001) |
| Proforma Loss per share, basic and diluted | \$ (0.05) | \$ (0.01) | \$ (0.08) | \$ (0.04) |

The proforma information does not necessarily reflect the results that would have occurred if the acquisitions had been in effect for the periods presented. In addition, they are not intended to be a projection of future results and do not reflect any synergies that might be achieved from combining the operations.

Table of Contents

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)

(unaudited, in thousands except for share and per share data)

4. Warrants

The warrant gives Delta the right to purchase 45% of PECO II issued and outstanding shares of capital stock measured as of five business days before the exercise of the warrant, at an exercise price of \$2.00 per share, exercisable immediately upon issuance and for a period of 30 months thereafter. Therefore, the amount of shares available to Delta under the terms of the warrant may continue to increase as a result of stock issuances from stock option exercises, employee stock purchase plans, restricted stock awards, etc. The warrant is valued at \$0.37 per share as of October 13, 2005 and will be updated quarterly to Warrants and Goodwill. The original shares available under the warrant at the time of acquisition were approximately 13 million and were valued at \$4,761 net of issuance costs. At June 30, 2006, there are approximately 13.5 million shares available under the warrant and are valued at \$4,979 net of issuance costs.

5. Recent Issued Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 151, Inventory Costs, an amendment to Accounting Research Bulletin No. 43, Chapter 4, Inventory Pricing. This statement clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted material should be recognized as current period charges. The provisions of this statement became effective for fiscal years beginning after June 15, 2005. The statement was adopted in 2005 and included in the Annual Report on Form 10-K under Note 1 of Significant Accounting Policies.

In December 2004, FASB issued Statement No. 123R, Stock Based Payment (SFAS 123R), a revision of Statement No. 123, Accounting for Stock Based Compensation, and superseding APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires the Company to expense grants made under the stock option and employee stock purchase plans. SFAS 123R is effective for the annual period beginning on or after June 15, 2005. SFAS 123R was adopted January 1, 2006. Information about the fair value of stock options under the Black Scholes model and its proforma impact on the Company's net loss and loss per share can be found in Note 12 to the condensed consolidated financial statements.

Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections (SFAS 154), replaces APB No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Changes in Interim Financial Statements. APB No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 changes the accounting for, and reporting of, a change in accounting principle. SFAS 154 requires retrospective application to prior period's financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and was adopted effective January 1, 2006. SFAS 154 is not expected to have a material financial impact on PECO II, Inc.

In February 2006, the FASB issued FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments, amendment of FASB Statements No. 133 and 140 (SFAS 155). SFAS 155 amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 140). SFAS 155 gives entities the option of applying fair value accounting to certain hybrid financial instruments in their entirety if they contain embedded derivatives that would otherwise require bifurcation under SFAS 133. SFAS 155 will be effective as of January 1, 2006. The Company does not expect to have a material financial impact as a result of SFAS 155.

Table of Contents

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)

(unaudited, in thousands except for share and per share data)

In March 2006, the FASB issued SFAS Statement No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 (SFAS 156). SFAS 156 amends SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS 156 is effective for fiscal years beginning after September 15, 2006 and is required to be adopted by the Company in the first quarter of fiscal year 2007, beginning January 1, 2007. The Company is still assessing SFAS 156 but believes there will be no material impact.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes which clarifies the accounting for uncertainty in income taxes recognized in the Company's financial statements in accordance with FAS 109, Accounting for Income Taxes. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on description, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is required to adopt the provisions of the Interpretation effective January 1, 2007. The Company is currently evaluating the impact this statement will have on its consolidated financial statements.

6. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Estimates are used for, but not limited to, the accounting for doubtful accounts, inventory obsolescence, depreciation and amortization, sales returns, warranty costs, taxes and contingencies. Actual results could differ from those estimates.

7. Treasury Shares and Restricted Stock

The Company did not repurchase shares during the first or second quarter of 2006 or in 2005. The Company issued the remaining 346,925 treasury shares at an average cost of \$1.50 per share during first quarter of 2006 for various stock options and stock awards. An additional 42,575 common shares were issued during the first quarter of 2006 to satisfy outstanding restricted stock awards expected to vest by December 31, 2006.

8. Contingencies

The Company is subject to certain legal proceedings and claims which arise in the ordinary course of its business. Although the outcomes of such matters cannot be predicted with certainty, the Company believes the final disposition of such matters will not have a material adverse effect on its financial position, results of operations or liquidity.

The Company has a \$379 contingency reserve for potential sales tax liability from a prior acquisition, for potential service nexus in states in which the Company is not currently filing and other miscellaneous sales or use tax issues. The Company does not volunteer to pay more taxes than necessary but believes this is an appropriate approach to the risks associated with prior and current year taxes.

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

9. Inventories

Inventory is stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost on the first-in, first-out basis, net of allowances for estimated obsolescence. Major classes of inventory at June 30, 2006 and December 31, 2005 are summarized below:

| | June 30, 2006 | December 31, 2005 |
|-----------------|----------------------|--------------------------|
| Raw materials | \$ 9,925 | \$ 8,670 |
| Work-in-process | 1,108 | 932 |
| Finished goods | 4,210 | 632 |
| Gross Inventory | 15,243 | 10,234 |
| Obsolescence | (2,094) | (2,110) |
| Net Inventory | \$ 13,149 | \$ 8,124 |

10. Assets Held for Sale

At December 31, 2005, the Company had a manufacturing facility and corporate headquarters shell classified as held for sale for \$3,518 valued at estimated fair value less selling expenses. In February 2006, the manufacturing facility was sold and net proceeds after selling expenses and other costs was \$2,134. The corporate headquarters shell remains classified as held for sale at June 30, 2006 for \$1,300.

11. Goodwill and Other Intangibles

Goodwill and intangibles were acquired on March 28, 2006 from the Delta acquisition for \$4,326 and \$5,700, respectively (see Note 3), and is attributable to the Company's product segment. The remaining balance relates to the Thornton Communications acquisition from a prior period and is attributable to the Company's service segment. An annual review of the Thornton Communications goodwill is performed as of October 31 of each year unless current conditions indicate otherwise. An independent third party performed the review of this goodwill as of October 31, 2005. It was determined there was no further impairment of goodwill. The Delta goodwill and other intangibles will be subject to the impairment test no later than the first quarter of 2007.

| Intangible Assets with Determinable Lives | June 30, 2006 |
|--|----------------------|
| Customer Relationships | \$ 2,000 |
| Supply Agreement | 3,700 |
| Total Gross Intangible Assets | 5,700 |
| Less: Accumulated Amortization | 268 |
| Intangible Assets, net | \$ 5,432 |

Amortization Expense for the three months ending June 30, 2006 and year to date was \$268. Amortization is calculated using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of the customer relationship and supply agreement intangibles are 6 years and 5 years, respectively. The estimated amortization expense for the remainder of 2006 is \$537.

The estimated amortization expense for each of the next five years is:

Edgar Filing: PECO II INC - Form 10-Q

| | 2007 | 2008 | 2009 | 2010 | 2011 | Remaining |
|------------------------|--------|--------|--------|--------|--------|-----------|
| Customer Relationships | \$ 333 | \$ 333 | \$ 333 | \$ 333 | \$ 333 | \$ 85 |
| Supply Agreement | \$ 740 | \$ 740 | \$ 740 | \$ 740 | \$ 185 | \$ 0 |

Table of Contents

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)

(unaudited, in thousands except for share and per share data)

12. Stock-Based Compensation

The Company has one plan under which stock-based awards may currently be granted to officers and employees, including non-employee directors. The 2000 Performance Plan Amendment 1 (2000 Plan) provides for the granting of 5,000,000 common shares. The Compensation Committee of the Board of Directors administers the 2000 Plan. The 2000 Plan permits the grant of stock options, restricted stock awards and other stock and performance-based incentives.

Stock options are granted at the fair market value of the Company's common stock at the date of grant, generally vest over three to four years, and generally have a term of 5 years. Restricted stock awards generally vest in a one year period, upon achievement of specific performance criteria.

In addition to the 2000 Plan, the Company has the 2000 Employee Stock Purchase Plan (ESPP) and reserved for issuance an aggregate of 1,000,000 common shares. The ESPP allows eligible employees to purchase common shares through payroll deductions, at prices equal to 85% of fair market value on the first or last business day of the offering period, whichever is lower. The Plan will terminate when all or substantially all of the common shares reserved for purposes of the plan have been purchased. The fair value of the discount is estimated at the beginning of each semi-annual payment period and vests at the end of that period.

Prior to the Adoption of SFAS 123R

Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, as permitted by SFAS No. 123, "Accounting for Stock-Based Compensation." As permitted, no stock-based compensation cost was recognized for stock options in the consolidated financial statements for 2005, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective transition method. Under that transition method, compensation cost recognized in 2006 includes compensation cost for all share-based payments granted prior to, but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and compensation cost for all share-based payments granted on or after January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. In accordance with the modified prospective transition method, results for prior periods have not been restated.

The following table illustrates the effect on net income and earnings per share from continuing operations as if the Company had determined compensation expense for all awards granted under the Company's stock-based compensation plans under the provisions of SFAS No. 123, prior to the adoption of SFAS No. 123R. For purposes of this pro forma disclosure, the fair value of stock-based awards was estimated using a Black-Scholes option-pricing model and amortized on a straight-line basis over the options' vesting periods.

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

| | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|---|---|---|
| Net loss, as reported | \$ (592) | \$ (1,528) |
| Less: Stock-based employee compensation expense determined under fair value based method for awards granted, modified, or settled, net of related tax effects | (68) | (143) |
| Pro forma net loss as if the fair value based method had been applied to all awards | \$ (660) | \$ (1,671) |
| Loss per share, basic and diluted | | |
| As reported | \$ (0.03) | \$ (0.07) |
| Pro forma | \$ (0.03) | \$ (0.08) |

Adoption of SFAS 123R

Total stock-based compensation expense by type of award is as follows:

| | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2006 |
|--|---|---|
| Stock options | \$ 91 | \$ 168 |
| Restricted stock awards | 28 | 150 |
| Employee stock purchase plan | 4 | 8 |
| Total stock-based compensation expense | 123 | 326 |
| Tax effect on stock-based compensation expense | | |
| Net effect on loss from operations | \$ 123 | \$ 326 |
| Effect on basic and diluted loss per share | \$ | \$ (0.01) |

There was no recorded tax effect on the recognition of stock-based compensation expense due to the Company's significant net operating loss carryforward and valuation reserve. In addition, there was no effect on the presentation of the statement of cash flows as excess tax benefits from the exercise of stock options have not been recorded as the Company does not expect to be able to realize current period deductions of taxable income.

Stock Options

The weighted-average fair value of stock options granted in the first six months of 2006 and 2005 was estimated at \$0.94 and \$0.48 per share, respectively, using the Black-Scholes option-pricing model based on the following assumptions:

**Six Months Ended
June 30,**

Edgar Filing: PECO II INC - Form 10-Q

| | 2006 | 2005 |
|-------------------------------------|--------|---------|
| Dividend yield | 0% | 0% |
| Expected volatility | 60.64% | 103.25% |
| Risk-free interest rate | 4.66% | 4.80% |
| Expected life of options (in years) | 2.72 | 3.06 |

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

Expected Term: The Company's expected term represents the period that the Company's share-based awards are expected to be outstanding and was determined based on historical experience of similar awards, given consideration to contractual terms of the awards and vesting schedules.

Expected Volatility: The fair value of share-based awards was determined using the Black-Scholes Model with a volatility factor based on the Company's historical stock prices.

Expected Dividend: The Company has not historically paid dividends nor does it expect to pay dividends in the near future. Therefore, there is no expected dividend yield.

Risk-Free Interest Rate: The Company bases the risk-free interest rate used in the Black-Scholes Model on the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equivalent to the expected term of the share-based awards.

Estimated Pre-Vesting Forfeitures: The Company considers historical pre-vesting forfeiture rates in determining the estimated number of shares that will ultimately vest.

The following table represents stock option activity for the year-to-date period ended June 30, 2006:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contract Life |
|--|------------------------|---------------------------------------|---|
| Outstanding options at December 31, 2005 | 2,462,100 | \$ 1.36 | |
| Granted | 295,000 | 1.94 | |
| Exercised | (199,250) | 0.82 | |
| Forfeited/ Cancelled | (47,000) | 4.85 | |
| Outstanding options at June 30, 2006 | 2,510,850 | \$ 1.30 | 3.21 years |
| Outstanding exercisable at June 30, 2006 | 1,318,350 | \$ 1.31 | 2.56 years |

At June 30, 2006 the aggregate intrinsic value of stock options outstanding and exercisable was approximately \$1,813 and \$1,121, respectively. Total intrinsic value of options exercised during the six months ended June 30, 2006 was \$229.

Restricted Stock Awards

The Company has restricted stock awards from 2005 grants awarded to certain of its employees that vest based on the attainment of certain performance goals. Fair-values of the restricted stock awards is based on the closing market price of the Company's common stock on the grant date. At June 30, 2006, there was \$10 of unrecognized compensation expense from non-vested restricted stock awards which is expected to be recognized prior to December 31, 2006.

The following table represents restricted stock awards activity for the year-to-date period ended June 30, 2006:

| Number of Shares | Weighted |
|---------------------|----------|
|---------------------|----------|

Edgar Filing: PECO II INC - Form 10-Q

| | | Average Grant Date Fair Value |
|--------------------------------|---------|--|
| Nonvested at December 31, 2005 | 250,000 | \$ 1.10 |
| Vested | 200,000 | 1.07 |
| Nonvested at June 30, 2006 | 50,000 | \$ 1.20 |

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

13. Common Shares

PECO II held an Annual Meeting of Shareholders on Thursday, June 1, 2006. During this shareholders meeting, shareholders approved increasing the number of authorized shares of the Company from 55,000,000 to 155,000,000, consisting of 150,000,000 common shares, without par value, and 5,000,000 serial preferred shares, without par value.

14. Segment Information

The following summarizes additional information regarding segments of the Company's operations:

| | For the Three Months Ended June 30, 2006 | | For the Six Months Ended June 30, 2006 | |
|------------|---|----------|---|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| 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 |

| | For the Three Months Ended June 30, 2006 | | For the Six Months Ended June 30, 2006 | |
|--|---|----------|---|------------|
| | 2006 | 2005 | 2006 | 2005 |
| Income (loss) from operations after joint venture: | | | | |
| Product | \$ (1,255) | \$ 66 | \$ (1,644) | \$ 109 |
| Services | (405) | (710) | (985) | (1,717) |
| Consolidated loss from operations | \$ (1,660) | \$ (644) | \$ (2,629) | \$ (1,608) |

The Company changed the allocation method for sales, marketing and administrative expenses between the product and services segments beginning January 1, 2006. This change will more fairly reflect each segment's share of the cost.

15. Revenue Recognition

The Company reports costs and revenues from long-term manufacturing and installation contracts on the percentage-of-completion method of accounting determined on a basis approximating the ratio of costs incurred to total estimated costs. Maintenance revenues are recognized ratably over the term of the agreements. Contract costs are recorded in cost of revenues in the period in which they are incurred, except in the case of manufactured material, which is included in inventory until shipment to the job site. When estimates indicate that a loss will be incurred on a contract, the total estimated loss is recognized currently. Changes in job performance, job conditions, estimated profitability, and final contract settlements may result in revisions to costs and income and are recognized in the year in which the revisions are determined.

The asset, Costs and estimated earnings in excess of billings on uncompleted contracts, represents income recognized in advance of amounts billed. The liability, Billings in excess of costs and estimated earnings on uncompleted contracts, represents billings in advance of revenues recognized.

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

Costs and estimated earnings on uncompleted contracts consist of the following:

| | June 30, 2006 | December 31, 2005 |
|---|--------------------------|------------------------------|
| Costs incurred on uncompleted contracts | \$ 3,936 | \$ 3,518 |
| Estimated earnings | 568 | 1,391 |
| | 4,504 | 4,909 |
| Less: Billings to date | 1,914 | 4,090 |
| | \$ 2,590 | \$ 819 |

Included in the accompanying balance sheet under the following captions:

| | June 30, 2006 | December 31, 2005 |
|---|--------------------------|------------------------------|
| Costs and estimated earnings in excess of billings on uncompleted contracts | \$ 2,700 | \$ 898 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | (110) | (79) |
| | \$ 2,590 | \$ 819 |

16. Related Party Transactions

The Company engages in certain related party transactions throughout the course of its business. On March 28, 2006, PECO II acquired exclusive rights to certain business and inventory for Delta's U.S. and Canadian Telecom Power Division in exchange for an equity position in PECO II that enables Delta to become the Company's largest shareholder. In addition, the transaction included the execution of a supply agreement that allows PECO II to access Delta's substantial engineering capabilities and high-quality, cost-effective component manufacturing for its power systems.

The Company's related party transactions with Delta, for the six months ended June 30, 2006 include \$616 in sales and \$3,050 in purchases. At June 30, 2006, the Company had balances of \$422 and \$1,554 included in accounts receivable and accounts payable, respectively.

17. Warranty

The Company's warranty activity for the six months ended June 30, 2006 and 2005 is summarized below:

| | 2006 | 2005 |
|-------------------------|-------------|-------------|
| Beginning balance | \$ 1,352 | \$ 701 |
| Warranty provision | 348 | 167 |
| Warranty costs incurred | (556) | (51) |
| Ending balance | \$ 1,144 | \$ 817 |

Edgar Filing: PECO II INC - Form 10-Q

The Company continues the rectifiers replacement program for one of the two customers as first discussed in the Annual Report on Form 10-K for year ending December 31, 2005. The other customer has requested replacement on an as needed basis to allow for their aggressive upgrade program. This will slow down PECO II's replacement program. In addition, we have started additional reserves for customers acquired as a result of the Asset Purchase Agreement with Delta Products.

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

18. Loss Per Share

Basic loss per share is calculated using the weighted-average number of common shares outstanding during the periods. Diluted loss per share is calculated using the weighted-average number of common and common equivalent shares outstanding during the periods. Due to the Company's net loss for the three months ended June 30, 2006 and 2005, no common equivalent shares were included in the calculation of diluted loss per share for either period because their effect would have been anti-dilutive. The Company's weighted-average number of options which were in-the-money and, therefore, potentially dilutive at June 30, 2006 and 2005 were 2,184,250 and 1,092,500, respectively.

Stock options which were out-of-the-money and, therefore, were anti-dilutive under the treasury stock method have also been excluded from the calculation of diluted loss per share. The Company's stock options outstanding at June 30, 2006 and 2005 which were excluded because they were out-of-the-money were 326,600 and 970,795, respectively.

Shares of common stock used in calculating loss per share differed from outstanding shares reported in the consolidated financial statements as follows:

| | Six months ended June 30, 2006 | | Six months ended June 30, 2005 | |
|---|-----------------------------------|--------------|-----------------------------------|--------------|
| | Basic loss | Diluted loss | Basic loss | Diluted loss |
| | per share | per share | per share | per share |
| | \$ (0.09) | \$ (0.09) | \$ (0.07) | \$ (0.07) |
| Outstanding shares | 27,059 | 27,059 | 21,595 | 21,595 |
| Effect of weighting changes in outstanding shares | (2,420) | (2,420) | (24) | (24) |
| Weighted average in outstanding shares | 24,639 | 24,639 | 21,571 | 21,571 |

19. Major Customers

Because of the Company's concentration of sales to the Regional Bell Operating Companies (RBOCs) and wireless service providers, a small number of customers typically represent substantial portions of total sales. For the six months ended June 30, 2006, sales to three companies comprised 53.2% of total sales. These customers contributed 21.5%, 17.3%, and 14.4%, respectively, of total sales. For the six months ended June 30, 2005, sales to two companies comprised 54.1% of total sales. These customers contributed 42.0% and 12.1%, respectively, of total sales.

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

References to we, us, our, the Company, or PECO II refer to PECO II, Inc. unless the context indicates otherwise.

Overview

The second quarter of 2006 performance highlights both the continued improvement and challenges PECO II is facing in this competitively charged industry. The revenue growth in the quarter highlighted the Company's ability to grow and serve its customers. The net loss of \$1.5 million included costs related to Delta transaction, other non-cash related charges and one-time costs.

Table of Contents

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

With the closing of the Delta strategic transaction in late March 2006, the Company began to operationally absorb the Delta North American service provider business in the second quarter. As of June 30, 2006, we have relocated all operational activities acquired from Delta into our Galion, Ohio facility. This includes inventory, inventory management, customer service, customer technical support, and all administrative functions. Sales resources are deployed geographically close to our customers. Also in the quarter, the Delta and PECO II engineering teams have embarked on a number of new product initiatives. With our first quarter together now under our belt, we are confident that the relationship will enhance our ability to serve our customers. Delta's world class technology and manufacturing resources complement PECO II's strong customer service, system design and system integration capabilities, making this an outstanding combination.

Our net sales and new orders for the second quarter demonstrated continued strong growth for us. With the projected service carriers CAPEX growth in the high single digits, the second quarter performance resulted in PECO II continuing to take market share in its focused areas. During the quarter we won product and/or services business with existing customers in three new markets. Additionally, we were awarded work with a new wireless carrier that we had not served before and we were notified that another existing wireless carrier will sole source all of their power requirements from us under a to-be-negotiated long term agreement. Our ongoing ability to leverage our capabilities will be the basis for continued share growth.

Recently, we have seen a slowdown in our customer ordering volumes. Currently, this slowdown appears to be temporary. However, to minimize the impact of the reduced orders on the shareowner while ensuring we can continue to meet our customers' requirements, we had a workforce adjustment in July/August that reduced our workforce by 22 people. Currently the workforce comprises 336 people.

Solid trends in the wireless industry fueled continued capacity expansion and the belief in continued CAPEX growth. This is attributable to robust subscriber growth trends and next generation network upgrades. Network convergence and 3G network upgrades remain major initiatives within our customer set.

For wireline, the broadband communications and entertainment focus of Internet Protocol TV (IPTV), which is video to the home, is expected to drive CAPEX in the access arena which has a requirement for small power solutions. High quality power products and services will benefit both Telecom and CATV service providers as they continue to invest in IPTV networks in their battle for leadership in the full service communications market.

We expect to continue to grow PECO II product, systems and services offerings to provide our customers' state-of-the-art, cost-effective solutions to meet their growing customer requirements. Additionally, we plan to continue our business expansion and productivity improvements to ensure that these sales provide attractive returns for our shareholders.

Results of Operations

Our net sales increased to \$13.6 million and \$24.0 million for the three and six months ended June 30, 2006, respectively, an increase of \$4.2 million and \$5.4 million, or 44.0% and 29.0%, respectively, compared to the corresponding prior year periods. Product net sales were \$10.1 million for the second quarter of 2006, an increase of \$3.6 million, or 55.6%, compared to the second quarter of 2005. This significant increase was due to the Delta customer revenues resulting from the asset purchase agreement. The Delta revenues for the second quarter of 2006 were \$2.4 million or 67% of the increase.

Table of Contents

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

Service net sales were \$3.4 million for the second quarter of 2006, an increase of \$526 thousand, or 18.0%, as compared to the second quarter of 2005. The service segment increase was the result of the industry increased CAPEX spending, and we are now seeing more installation as a result of the increased spending.

As of June 30, 2006, our sales backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, was \$7.4 million, a \$0.58 million, or 0.8%, decrease from the comparable prior year period, and a 106% increase of \$3.8 million from December 31, 2005. Product backlog of \$4.8 million was a \$2.2 million, or 85.0% increase from December 31, 2005, while Service backlog was \$2.6 million, a \$1.6 million, or 159.0%, increase from December 31, 2005. Included in our total backlog and product backlog numbers is \$873 thousand of backlog resulting from the Delta acquisition as described in Note 3 to the Condensed Consolidated Financial Statements.

Gross margin dollars were \$2.1 million and \$4.1 million, respectively, for the three and six months ended June 30, 2006, as compared to \$2.1 million and \$3.8 million, respectively, for the three and six months ended June 30, 2005. Gross margin as a percentage of net sales decreased to 15% and 17% for the three and six months ended June 30, 2006, compared to 22% and 20%, respectively, for the comparable prior year periods.

For the quarter ended June 30, 2006, product gross margin was \$1.7 million, or 17%, as compared to \$1.8 million, or 27%, for the corresponding period in 2005, or a product gross margin decrease of 10%. The decrease was primarily a change in product sales mix resulting in lowering gross margin by \$400 thousand, Delta transition costs of \$300 thousand, raw material cost increases that could not be passed on to customers of \$100 thousand, and amortization of \$200 thousand relating to the supply agreement obtained as part of the Delta acquisition. Delta transition costs are expected to continue through the third quarter but at a lower rate.

The service gross margin was \$359 thousand for the second quarter of 2006, as compared to \$280 thousand for the second quarter of 2005, or an increase of 28%. The management team continues to closely monitor indirect costs while maintaining efficiency and quality on the job. The service group was able to maintain their direct costs while increasing sales for the second quarter of 2006, which positively impacted margins.

Research, development and engineering expense incurred was \$897 thousand and \$1.7 million, respectively, for the three and six months ended June 30, 2006, up from \$741 thousand and \$1.4 million, respectively for the three and six months ended June 30, 2005. As a major supplier to the largest telecommunications service providers, we have continued to invest in standards compliance which includes NEBS. The investment comes at a high cost and was the largest expenditure included in our increase this quarter. As a percentage of net product sales, research, development and engineering expense was 9% for the quarter ended June 30, 2006, which was a 2% decrease from the second quarter of 2005.

Selling, general and administrative expense increased to \$2.8 million and \$5.0 million for the three and six months ended June 30, 2006, from \$2.0 million and \$3.9 million, respectively, for the comparable prior year period. Sales, marketing and administrative expenses increased as a result of increased compensation and the recognition of share-based payments per SFAS 123R, as previously discussed in Note 12 to the Condensed Consolidated Financial Statements. The recognition of these payments impacted the selling, general and administrative expenses by \$103 thousand and \$290 thousand, respectively, for the three and six months ended June 30, 2006. Selling, general and administrative also incurred amortization expenses of \$83 thousand for the quarter ended June 30, 2006 resulting from the Customer Relationship intangible asset acquired with the Delta Asset acquisition. As a percentage of net sales, selling, general and administrative remained flat at 20.8% for the quarter ended June 30, 2006, compared to 20.9% in the comparable prior year period.

On March 28, 2006, PECO II acquired exclusive rights to certain business and inventory for Delta's U.S. and Canadian Telecom Power Division in exchange for an equity position in PECO II that enables Delta to become

Table of Contents

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

PECO II's largest shareholder. Additionally, the transaction included the execution of a supply agreement that will allow PECO II to access Delta's substantial engineering capabilities and high-quality, cost-effective component manufacturing for its power systems. Ultimately, we expect this to have a positive effect on reducing cost-of-goods sold for PECO II.

The effective tax rate was a positive 2.7% for the six months ended June 30, 2006 compared to negative 1.3% for the six months ended June 30, 2005. The tax accrual is for various state franchises and net worth taxes where the Company has conducted business.

Liquidity and Capital Resources

As of June 30, 2006, available cash and cash equivalents approximated \$9.8 million. We believe that cash and cash equivalents, anticipated cash flow from operations, and our credit facilities will be sufficient to fund our working capital and capital expenditure requirements for the next 12 months. Working capital at June 30, 2006 was \$23.8 million, which represented a working capital ratio of 2.7 to 1, compared to \$23.6 million at December 31, 2005, which represented a working capital ratio of 3.6 to 1. Capital expenditures for the six months ended June 30, 2006, totaled \$130 thousand. We continue our efforts to conserve cash.

Cash flows used for operating activities for the six months ended June 30, 2006, was \$1.5 million. While this included a net loss and increases in inventories and costs and earnings in excess of billings, it was offset by increases in accounts payable and accruals. There was \$1.3 million of cash provided by investing activities which was primarily from the sale of the excess manufacturing facility less cash paid for the acquisition. Cash provided by financing activities was \$1.2 million, which included use of our credit line and the issuance of common stock for options exercised.

Cash flows used by operating activities for the six months ended June 30, 2005 was \$4.8 million. A significant portion of this was due to a litigation settlement of \$2.67 million. The remainder was primarily due to operating losses and a decrease in accounts payable and accrued expenses, along with increases in accounts receivable and inventory. There was \$23 thousand of cash used for investing activities, while the cash used for financing activities was \$302 thousand.

We continue to strive for positive cash flow from operations. If our working capital needs significantly increase due to circumstances such as our inability to operate on a cash flow positive basis; weakness in the telecommunications industry; faster than expected growth resulting in increased accounts receivable and inventory; additional investment or acquisition activity; research and development efforts; or as a result of capital expenditures, we may have to increase our credit facilities or generate additional funding through the issuance of debt or equity. There can be no assurance, however, that additional financing will be available on terms favorable to the Company or at all.

Contractual Obligations

We have signed an agreement with National City Bank to provide all banking services and a \$3.5 million line of credit. As collateral for the line of credit, the Company established a \$3.5 million deposit account with the bank. As of June 30, 2006, the balance on the line of credit was \$2.4 million.

We do not currently plan to pay dividends.

Other than the acquisition of Delta as previously discussed, there have been no material changes outside the normal course of business in our contractual obligation since December 31, 2005.

Table of Contents

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

Critical Accounting Policies

In response to the SEC's Release No. 33-8040, "Cautionary Advice Regarding Disclosure about Critical Accounting Policies," we consider certain accounting policies related to revenue recognition, inventory valuation, impairment of long lived assets, and deferred income taxes to be critical policies due to the estimation processes involved in each. We state these accounting policies in the notes to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2005, which was filed on March 24, 2006, and in relevant sections in management's discussion and analysis of financial condition and results of operations.

Recent Issued Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 151, "Inventory Costs," an amendment to Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing." This statement clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted material should be recognized as current period charges. The provisions of this statement became effective for fiscal years beginning after June 15, 2005. The statement was adopted in 2005 and included in the Annual Report on Form 10-K under Note 1 of Significant Accounting Policies.

In December 2004, FASB issued Statement No. 123R, "Stock Based Payment" (SFAS 123R), a revision of Statement No. 123, "Accounting for Stock Based Compensation," and superseding APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires the Company to expense grants made under the stock option and employee stock purchase plans. SFAS 123R is effective for the annual period beginning on or after June 15, 2005. SFAS 123R was adopted January 1, 2006. Information about the fair value of stock options under the Black Scholes model and its proforma impact on the Company's net loss and loss per share can be found in Note 11 to the condensed consolidated financial statements.

Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections" (SFAS 154), replaces APB No. 20, "Accounting Changes," and FASB Statement No. 3, "Reporting Changes in Interim Financial Statements." APB No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 changes the accounting for, and reporting of, a change in accounting principle. SFAS 154 requires retrospective application to prior periods' financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and was adopted effective January 1, 2006. SFAS 154 is not expected to have a material financial impact on PECO II, Inc.

In February 2006, the FASB issued FASB Statement No. 155, "Accounting for Certain Hybrid Financial Instruments," amendment of FASB Statements No. 133 and 140 (SFAS 155). SFAS 155 amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (SFAS 140). SFAS 155 gives entities the option of applying fair value accounting to certain hybrid financial instruments in their entirety if they contain embedded derivatives that would otherwise require bifurcation under SFAS 133. SFAS 155 will be effective as of January 1, 2006. The Company does not expect to have a material financial impact as a result of SFAS 155.

Table of Contents

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

In March 2006, the FASB issued SFAS Statement No. 156, *Accounting for Servicing of Financial Assets* an amendment of FASB Statement No. 140 (SFAS 156). SFAS 156 amends SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS 156 is effective for fiscal years beginning after September 15, 2006 and is required to be adopted by the Company in the first quarter of fiscal year 2007, beginning January 1, 2007. The Company is still assessing SFAS 156 but believes there will be no material impact.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* which clarifies the accounting for uncertainty in income taxes recognized in the Company's financial statements in accordance with FAS 109, *Accounting for Income Taxes*. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on description, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is required to adopt the provisions of the Interpretation effective January 1, 2007. The Company is currently evaluating the impact this statement will have on its consolidated financial statements.

Off-Balance Sheet Financings

We do not have any off balance sheet entities or arrangements. All of our subsidiaries and the joint venture investment into the new company, b+w II, Inc., are reflected in our condensed consolidated financial statements. We do not have any interests in or relationship with any special-purpose entities that are not reflected in our condensed consolidated financial statements.

Forward-Looking Statements

Certain of the Company's statements in this Quarterly Report on Form 10-Q and the foregoing Management's Discussion and Analysis of Financial Condition and Results of Operation are not purely historical, and as such are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, but may not be limited to, all statements regarding the Company's and management's intent, beliefs, expectations, and plans, such as statements concerning the Company's future profitability, industry trends, operating results, and product development strategy. These forward-looking statements include numerous risks and uncertainties, including, without limitation: a general economic recession; a downturn in our principal customers' businesses; current and future mergers of key customers; the volatility in the communications industry; the demand for communications equipment generally and in particular for the products and services offered by the Company; the Company's ability to generate sales orders during fiscal 2006 and thereafter; the ability to develop and market new products and product enhancements; the potential environmental issues in regards to an aging manufacturing facility; the ability to attract and retain customers; competition and technological change; and successful implementation of the Company's business strategy. One or more of these factors have affected, and in the future could affect, the Company's business and financial results in future periods and could cause actual results to differ materially from plans and projections.

There can be no assurances that the forward-looking statements included herein will prove to be accurate, and issuance of such forward-looking statements should not be regarded as a representation of the Company, or any other person, that the objectives and plans of the Company will be achieved. In addition, this Quarterly Report on Form 10-Q contains time-sensitive information that reflects management's best analysis only as of the date of this report. PECO II does not undertake any obligation to publicly update or revise any forward-looking statements to

Table of Contents

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

reflect future events, information or circumstances that arise after the date of this release. Further information concerning issues that could materially affect financial performance related to forward-looking statements can be found in the Company's periodic filings with the Securities and Exchange Commission.

Results for the interim period are not necessarily indicative of the results that may be expected for the entire year.

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK

We are exposed to the impact of interest rate changes and, to a lesser extent, foreign currency fluctuations. We have not entered into interest rate transactions for speculative purposes or otherwise. Our foreign currency exposures were immaterial as of June 30, 2006.

We have minimal exposure due to interest rate risk. A change in rates would be immaterial to our results from operations if rates were to increase 1% from June 30, 2006 rates. We currently do not hedge our exposure to floating interest rate risk.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure controls and procedures. We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has performed an evaluation of our disclosure controls and procedures as of June 30, 2006, the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, which included matters discussed below on the identification of a material weakness in our internal control over financial reporting, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

Internal control over financial reporting. Our management is also responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act. We identified a deficiency in our internal control over financial reporting in connection with the preparation and filing of our Annual Report on Form 10-K for the fiscal year ended December 31, 2004 (the "2004 Form 10-K"). The identified material weakness in our internal control over financial reporting relates to insufficient control over the identification of relevant revenue recognition issues in our contracts with our customers.

We implemented several changes to our internal control over financial reporting in response to the aforementioned deficiency identified in our 2004 Form 10-K. To address the material weakness, we implemented the following remediation steps:

We have implemented procedures for senior management to review customer contracts prior to execution;

Table of Contents

We have implemented procedures under which appropriate financial personnel will be notified of the proper revenue recognition treatment that is to be applied to sales under potential customer contracts prior to execution; and

We have implemented procedures for appropriate financial personnel to receive additional reminders, including control and process documents, with respect to revenue recognition treatment upon the actual execution of our sales contracts.

Although management believes that there has been improvement in the operation of our internal controls over financial reporting since the identification of the material weakness, management believes that the material weakness has not been fully remediated to date. We have hired an external consultant to assist in reviewing for potential risk and assessing our testing process regarding various internal controls and that review has begun. They are accessing all internal controls relating to revenue recognition and contract review. The material weakness will not be considered fully remediated until the procedures resulting from the remediation efforts are fully implemented, operate for a period of time, are tested, and we conclude that such procedures are operating effectively.

Changes in internal controls over financial reporting. There were no changes in our internal control over financial reporting made during the quarter ended June 30, 2006, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION**Item 1A. Risk Factors**

Item 1A. of Part 1 of our Annual Report on Form 10-K for the year ended December 31, 2005, includes a detailed discussion of our risk factors as updated by our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

ITEM 2(b). Use of Proceeds

On August 17, 2000, the SEC declared effective a Registration Statement on Form S-1 (File No. 333-37566) filed by us in connection with an initial public offering of our common shares.

From the date of receipt of the proceeds through June 30, 2006, of the \$78.3 million in net proceeds, \$14.4 million was used to repay bank indebtedness, \$5.2 million was used in connection with the acquisitions of Thornton Communications and JNB Communications, \$16.7 million was used for capital expenditures, excluding the purchase of the Denver regional service center in February 2001 which was financed through industrial revenue bonds, \$3.6 million has been restricted by the Company's bank to secure outstanding borrowings, \$5.8 million has been used to pay off the industrial revenue bonds as a result to the sale of the Denver regional service center, \$2.7 million was used to settle assumed litigation from an acquisition in 2001, and approximately \$20.1 million was used for general working capital purposes. The remaining cash equivalents consist of commercial paper and state and municipal securities that are readily convertible into cash and have original maturities of three months or less.

ITEM 4. Submission of Matters to a Vote of Security Holders

PECO II held an Annual Meeting of Shareholders on Thursday, June 1, 2006, to elect three directors in Class III for three-year terms and to increase the number of authorized shares. The results of the two proposals are provided below:

Proposal 1: The election of three directors in Class III for three-year terms and until their successors are duly elected and qualified.

| | Number of Shares Voted | | |
|--------------------|------------------------|-----------------------|------------|
| | FOR | WITHHOLD AUTHORITY | TOTAL |
| James L. Green | 24,980,426 | 364,356 | 25,344,782 |
| Richard W. Orchard | 25,068,161 | 276,621 | 25,344,782 |
| Matthew P. Smith | 25,055,277 | 289,505 | 25,344,782 |

Table of Contents

Each of the nominees was elected. The other directors whose terms of office continue after the 2005 Annual Meeting of Shareholders are: George J. Dallas, Trygve A. Ivesdal, R. Louis Schneeberger, Gerard B. Moersdorf Jr., E. Richard Hottenroth, Thomas R. Thomsen, John G. Heindel and Albert Chang.

Proposal 2: To approve increasing the number of authorized shares of the Company from 55,000,000 to 155,000,000, consisting of 150,000,000 common shares, without par value, and 5,000,000 serial preferred shares, without par value.

| | | Number of Shares Voted | | | |
|--|------------|------------------------|-----------|---------|------------|
| | | FOR | AGAINST | ABSTAIN | TOTAL |
| | Proposal 2 | 22,998,808 | 2,268,435 | 77,539 | 25,344,782 |

ITEM 6. Exhibits

- 3.1 Amended and Restated Articles of Incorporation
- 31.1 Rule 13a-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a) Certification of Chief Financial Officer
- 32.1 Section 1350 Certification of Chief Executive Officer
- 32.2 Section 1350 Certification of Chief Financial Officer

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.

Date: August 14, 2006

PECO II, Inc.

/s/ JOHN G. HEINDEL
John G. Heindel
President and Chief Executive Officer

/s/ SANDRA A. FRANKHOUSE
Sandra A. Frankhouse
Chief Financial Officer