

ARCH WIRELESS INC  
Form 10-Q  
November 12, 2003

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

Form 10-Q

(Mark One)

- Quarterly Report Pursuant to Section 13 or 15(d) of  
the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2003  
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 001-14248

**Arch Wireless, Inc.**

*(Exact name of Registrant as specified in its Charter)*

**DELAWARE**  
(State of incorporation)

**31-1358569**  
(I.R.S. Employer Identification No.)

**1800 West Park Drive, Suite 250**  
**Westborough, Massachusetts**  
(address of principal executive offices)

**01581**  
(Zip Code)

**(508) 870-6700**  
(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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate by check mark whether the Registrant has filed all documents and reports required to be filed by Sections 12, 13, or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: no shares of the Registrant's Common Stock (\$.001 per value per share) and 19,480,522 shares of the Company's Class A Common Stock (\$0.0001 par value per share) were outstanding as of November 7, 2003.

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### ARCH WIRELESS, INC. QUARTERLY REPORT ON FORM 10-Q

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**PART I. FINANCIAL INFORMATION**
**Item 1. Condensed Financial Statements**

**ARCH WIRELESS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
*(unaudited and in thousands, except per share amounts)*

	<u>September 30, 2003</u>	<u>December 31, 2002</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 58,890	\$ 37,187
Accounts receivable, net	29,275	45,308
Deposits	5,611	4,880
Prepaid rent	493	9,857
Prepaid expenses and other	11,908	17,999
	<hr/>	<hr/>
Total current assets	106,177	115,231
	<hr/>	<hr/>
Property and equipment	390,381	391,060
Less accumulated depreciation and amortization	(157,780)	(87,278)
	<hr/>	<hr/>
Property and equipment, net	232,601	303,782
	<hr/>	<hr/>
Assets held for sale	1,456	3,311
Intangible and other assets, net	1,226	15,600
	<hr/>	<hr/>
	\$ 341,460	\$ 437,924
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current maturities of long-term debt	\$ 14,493	\$ 55,000
Accounts payable	5,929	8,412
Accrued compensation and benefits	17,118	20,948
Accrued network costs	7,218	10,052
Accrued property and sales taxes	14,011	12,672
Accrued interest	5,034	1,446
Accrued other	9,300	12,324
Customer deposits and deferred revenue	28,580	35,704
	<hr/>	<hr/>
Total current liabilities	101,683	156,558
	<hr/>	<hr/>
Long-term debt, less current maturities	97,373	162,185
	<hr/>	<hr/>
Other long-term liabilities	4,074	788
	<hr/>	<hr/>
Stockholders' equity:		
Common stock - \$0.001 par value		20
Class A common stock - \$0.0001 par value	2	
Additional paid-in capital	122,573	121,456

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	September 30, 2003	December 31, 2002
Deferred stock compensation	(2,993)	(4,330)
Retained earnings	18,748	1,247
	<hr/>	<hr/>
Total stockholders' equity	138,330	118,393
	<hr/>	<hr/>
	\$ 341,460	\$ 437,924
	<hr/>	<hr/>

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

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**ARCH WIRELESS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(unaudited and in thousands, except share and per share amounts)

	Three Months Ended September 30,	
	2003	2002
Revenues	\$ 143,623	\$ 202,157
Operating expenses:		
Cost of products sold (exclusive of depreciation, amortization and stock based and other compensation shown separately below)	1,319	3,791
Service, rental, and maintenance (exclusive of depreciation, amortization and stock based and other compensation shown separately below)	46,736	58,792
Selling (exclusive of stock based and other compensation shown separately below)	11,488	17,386
General and administrative (exclusive of depreciation, amortization and stock based and other compensation shown separately below)	39,526	63,202
Depreciation and amortization	27,998	40,045
Stock based and other compensation	2,761	2,016
	<hr/>	<hr/>
Total operating expenses	129,828	185,232
	<hr/>	<hr/>
Operating income	13,795	16,925
Interest expense, net	(3,511)	(8,068)
Other income (expense)	232	(31)
	<hr/>	<hr/>
Income before provision for income taxes	10,516	8,826
Provision for income taxes	(4,330)	
	<hr/>	<hr/>
Net income	\$ 6,186	\$ 8,826
	<hr/>	<hr/>
Basic net income per common share	\$ 0.31	\$ 0.44
	<hr/>	<hr/>
Diluted net income per common share	\$ 0.31	\$ 0.44

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	<u>Three Months Ended September 30,</u>	
	<u>2003</u>	<u>2002</u>
Basic weighted average common shares outstanding	20,000,000	20,000,000
Diluted weighted average common shares outstanding	20,080,572	20,000,000

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

**ARCH WIRELESS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(unaudited and in thousands, except share and per share amounts)

	<u>Reorganized Company</u>		<u>Predecessor Company</u>
	<u>Nine Months Ended September 30, 2003</u>	<u>Four Months Ended September 30, 2002</u>	<u>Five Months Ended May 31, 2002</u>
Revenues	\$ 462,452	\$ 271,124	\$ 365,360
Operating expenses:			
Cost of products sold (exclusive of depreciation, amortization and stock based and other compensation shown separately below)	4,351	4,993	10,426
Service, rental, and maintenance (exclusive of depreciation, amortization and stock based and other compensation shown separately below)	145,382	80,166	105,990
Selling (exclusive of stock based and other compensation shown separately below)	35,703	23,340	35,313
General and administrative (exclusive of depreciation, amortization and stock based and other compensation shown separately below)	132,505	86,673	116,668
Depreciation and amortization	91,859	52,612	82,720
Stock based and other compensation	9,232	2,904	
Total operating expenses	<u>419,032</u>	<u>250,688</u>	<u>351,117</u>
Operating income	43,420	20,436	14,243
Interest expense, net	(13,984)	(11,084)	(2,178)
Gain on extinguishment of debt			1,621,355
Other income (expense)	315	(179)	110
Income before reorganization items, net and fresh start			

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	Reorganized Company		Predecessor Company
accounting adjustments	29,751	9,173	1,633,530
Reorganization items, net			(22,503)
Fresh start accounting adjustments			47,895
Income before provision for income taxes	29,751	9,173	1,658,922
Provision for income taxes	(12,250)		
Net income	\$ 17,501	\$ 9,173	\$ 1,658,922
Basic net income per common share	\$ 0.88	\$ 0.46	\$ 9.09
Diluted net income per common share	\$ 0.87	\$ 0.46	\$ 9.09
Basic weighted average common shares outstanding	20,000,000	20,000,000	182,434,590
Diluted weighted average common shares outstanding	20,028,504	20,000,000	182,434,590

*The accompanying notes are an integral part of these unaudited consolidated financial statements*

**ARCH WIRELESS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
*(unaudited and in thousands)*

	Reorganized Company		Predecessor Company
	Nine Months Ended September 30, 2003	Four Months Ended September 30, 2002	Five Months Ended May 31, 2002
Cash flows from operating activities:			
Net income	\$ 17,501	\$ 9,173	\$ 1,658,922
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	91,859	52,612	82,720
Gain on extinguishment of debt			(1,621,355)
Fresh start adjustments			(47,895)
Gain on tower site sale			(1,287)
Accretion of long-term debt	4,681	4,067	
Amortization of stock and other compensation	2,436	597	

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	Reorganized Company		Predecessor Company
Deferred income tax provision	12,250		
Losses on disposals of property and equipment	6		
Other income	(179)		
Provisions for doubtful accounts and service adjustments	20,065	21,560	34,355
Changes in assets and liabilities:			
Accounts receivable	(4,032)	(17,696)	(2,827)
Inventories			796
Prepaid expenses and other	14,724	20,238	(18,021)
Accounts payable and accrued expenses	(7,968)	495	(11,843)
Customer deposits and deferred revenue	(7,124)	(3,097)	4,325
Other long-term liabilities	2,600	151	(727)
Net cash provided by operating activities	146,819	88,100	77,163
Cash flows from investing activities:			
Additions to property and equipment	(18,395)	(34,511)	(44,474)
Proceeds from disposals of property and equipment	3,106		
Receipts from note receivable	173		
Net cash used for investing activities	(15,116)	(34,511)	(44,474)
Cash flows from financing activities:			
Repayment of long-term debt	(110,000)	(40,259)	(65,394)
Net cash used for financing activities	(110,000)	(40,259)	(65,394)
Effect of exchange rate changes on cash		13	32
Net increase (decrease) in cash and cash equivalents	21,703	13,343	(32,673)
Cash and cash equivalents, beginning of period	37,187	39,527	72,200
Cash and cash equivalents, end of period	\$ 58,890	\$ 52,870	\$ 39,527
Supplemental disclosures:			
Interest paid	\$ 6,177	\$ 1,055	\$ 2,257
Asset retirement obligation	\$ 1,244	\$	\$
Repayment of debt with restricted cash	\$	\$	\$ 36,899
Issuance of new debt and common stock in exchange for predecessor liabilities	\$	\$	\$ 416,101
Reorganization expenses paid	\$	\$	\$ 22,503

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

**ARCH WIRELESS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(unaudited)*

(a) *Preparation of Interim Financial Statements* The consolidated financial statements of Arch Wireless, Inc. ( Arch or the Company ) have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. The financial information included herein, other than the consolidated balance sheet as of December 31, 2002, has been prepared without audit. The consolidated balance sheet at December 31, 2002 has been derived from, but does not include all the disclosures contained in, the audited consolidated financial statements for the year ended December 31, 2002. In the opinion of management, these unaudited statements include all adjustments and accruals consisting only of normal recurring accrual adjustments, which are necessary for a fair presentation of the results of all interim periods reported herein. These consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in Arch s Annual Report on Form 10-K for the year ended December 31, 2002. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for a full year.

(b) *Bankruptcy-Related Financial Reporting* The consolidated financial statements of Arch, prior to its emergence from chapter 11 on May 29, 2002 (the Predecessor Company ), have been prepared in accordance with the American Institute of Certified Public Accountants Statement of Position 90-7, Financial Reporting by Entities in Reorganization under the Bankruptcy Code ( SOP 90-7 ). Arch has prepared the consolidated financial statements on a going-concern basis of accounting. This basis of accounting contemplates continuity of operations, realization of assets and liquidation of liabilities in the normal course of business. Upon emergence from chapter 11, Arch (the Reorganized Company ) restated its assets and liabilities, in accordance with SOP 90-7, on the fresh start basis of accounting which requires recording the assets on a fair value basis similar to those required by Statement of Financial Accounting Standards ( SFAS ) No. 141 Business Combinations.

(c) *Risks and Other Important Factors* Based on current and anticipated levels of operations, Arch s management anticipates that net cash provided by operating activities, together with the \$58.9 million of cash on hand at September 30, 2003, will be adequate to meet its anticipated cash requirements for the foreseeable future.

In the event that net cash provided by operating activities and cash on hand are not sufficient to meet future cash requirements, Arch may be required to reduce planned capital expenditures, sell assets or seek additional financing. Arch can provide no assurances that reductions in planned capital expenditures or proceeds from asset sales would be sufficient to cover shortfalls in available cash or that additional financing would be available or, if available, offered on acceptable terms.

Arch believes that future fluctuations in its revenues and operating results may occur due to many factors, particularly the decreased demand for our messaging services. If the rate of decline of messaging units in service exceeds Arch s expectations, its revenues will be negatively impacted, and such impact could be material. Arch s plan to consolidate its networks may also negatively impact revenues as customers experience a reduction in, and possible disruptions of, service in certain areas. Arch may be unable to adjust spending in a timely manner to compensate for any future revenue shortfall. It is possible that, due to these fluctuations, Arch s revenue or operating results may not meet the expectations of investors and creditors, which could impair the value of its debt and equity securities.

(d) *Reclassifications* Certain amounts from the prior year have been reclassified to conform to current year presentation.

(e) *Long-lived Assets* Intangible and other assets were comprised of the following at September 30, 2003 (in thousands):

	Useful Life	Gross Carrying Amount	Accumulated Amortization	Net Balance
Purchased subscriber lists	3 yrs	\$ 3,547	\$ 3,547	\$
Purchased Federal Communications Commission licenses	5 yrs	3,311	2,088	1,223
Other		3		3
		<u>\$ 6,861</u>	<u>\$ 5,635</u>	<u>\$ 1,226</u>



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Aggregate amortization expense for intangible assets for the three and nine months ended September 30, 2003 was \$290,000 and \$2,125,000, respectively. Estimated amortization expense for intangible assets for the remainder of 2003, and for fiscal years 2004 to 2007 is \$83,000, \$333,000, \$333,000, \$333,000 and \$141,000, respectively.

Intangible and other assets were comprised of the following at December 31, 2002 (in thousands):

	Useful Life	Gross Carrying Amount	Accumulated Amortization	Net Balance
Purchased subscriber lists	3 yrs	\$ 10,807	\$ 2,542	\$ 8,265
Purchased Federal Communications Commission licenses	5 yrs	8,300	968	7,332
Other		3		3
		\$ 19,110	\$ 3,510	\$ 15,600

(f) *Income Taxes* Arch accounts for income taxes under the provisions of SFAS No. 109 Accounting for Income Taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities, given the provisions of enacted laws.

SFAS No. 109 establishes guidelines for companies that qualify for fresh start accounting under SOP 90-7 and have a valuation allowance on their net deferred tax assets at the date of emergence from bankruptcy. These provisions require that any subsequent reduction in a deferred tax asset valuation allowance that existed at the date of fresh start accounting be first credited against an asset established for reorganization value in excess of amounts allocable to identifiable assets, then credited to other identifiable intangible assets existing at the date of fresh start accounting and then, once these assets have been reduced to zero, credited directly to additional paid in capital. As a result, release of the valuation allowance for the nine months ended September 30, 2003 has reduced the carrying value of intangible assets by \$12.3 million, the amount of the income tax provision.

The effective income tax rate differs from the statutory federal tax rate primarily due to the effect of state income taxes.

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires Arch to make estimates and assumptions that affect the reported amount of its tax-related assets and liabilities. Arch has made significant estimates involving current and deferred income taxes, tax attributes and tax valuation reserves, relating to the interpretation of various tax laws, historical bases of tax attributes associated with certain tangible and intangible assets and limitations surrounding the realizability of our deferred tax assets. Arch does not recognize certain current and future tax benefits until it is deemed probable that certain tax positions will be sustained. A valuation allowance was established upon emergence from bankruptcy since, based upon information available at that time, it was deemed more likely than not that the deferred tax assets would not be realized. Forming a conclusion that a valuation allowance is not needed is difficult when a history of losses exists. Resolution of the uncertainties and estimates upon which these judgments are based could materially affect the balance of the net deferred tax asset disclosed in Arch's Form 10-K for the year ended December 31, 2002, and such difference, if any, could have a material positive or adverse effect on Arch's results of operations and financial position. At September 30, 2003, Arch continues to maintain a full valuation allowance on its net deferred tax assets.

(g) *Segment Reporting* In conjunction with its emergence from chapter 11 during the quarter ended June 30, 2002, Arch reassessed the segment disclosure requirements of SFAS No. 131 Disclosures about Segments of an Enterprise and Related Information. Due to various operational changes which occurred before and during the bankruptcy proceedings, such as the elimination of dedicated sales and management resources for two-way messaging, Arch no longer believes that its one and two-way messaging operations meet the disclosure standards of separate operating segments as set forth in SFAS No. 131. In 2002 however, Arch believed it had two operating segments: domestic operations and international operations, but no reportable segments, as international operations were immaterial to the consolidated entity. As of December 2002, Arch no longer consolidated the results of certain Canadian subsidiaries. Therefore Arch's results currently relate solely to domestic operations and its minority interests in its Canadian subsidiaries. The disclosures below reflect the subsidiaries' results for the 2002 periods only (in thousands).

### *Geographic Information*

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Three Months Ended September 30,

	2003		2002	
Revenues:				
United States	\$	143,623	\$	197,281
Canada				4,876
<b>Total</b>	<b>\$</b>	<b>143,623</b>	<b>\$</b>	<b>202,157</b>

	Reorganized Company		Predecessor Company
	Nine Months Ended September 30, 2003	Four Months Ended September 30, 2002	Five Months Ended May 31, 2002
Revenues:			
United States	\$ 462,452	\$ 264,599	\$ 357,630
Canada		6,525	7,730
<b>Total</b>	<b>\$ 462,452</b>	<b>\$ 271,124</b>	<b>\$ 365,360</b>

	September 30, 2003		September 30, 2002	
Long-lived assets:				
United States	\$	235,282	\$	367,996
Canada				4,668
<b>Total</b>	<b>\$</b>	<b>235,282</b>	<b>\$</b>	<b>372,664</b>

Prior to emergence from chapter 11, Arch determined that it had three reportable segments; one-way messaging operations, two-way messaging operations and international operations. Management made operating decisions and assessed individual performances based on these segments. One-way messaging operations consisted of the provision of paging and other one-way messaging services to Arch's U.S. customers. Two-way messaging operations consisted of the provision of two-way messaging services to Arch's U.S. customers. International operations consisted of the one and two-way messaging operations of two of Arch's Canadian subsidiaries.

Each of these segments incurred, and were charged, direct costs associated with their separate operations. Common costs shared by one and two-way messaging operations were allocated based on the estimated utilization of resources using various factors that attempted to mirror the true economic cost of operating each segment.

The following table presents financial information related to Arch's segments as of and for the five months ended May 31, 2002 (in thousands):

	One-way Messaging Operations	Two-way Messaging Operations	International Operations	Consolidated
Revenues	\$ 303,773	\$ 53,857	\$ 7,730	\$ 365,360
Depreciation and amortization expense	42,231	36,418	4,071	82,720
Operating income (loss)	8,496	8,975	(3,228)	14,243

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	One-way Messaging Operations	Two-way Messaging Operations	International Operations	Consolidated
Capital expenditures	20,815	22,976	683	44,474

(h) *Equity* On June 12, 2003, Arch's stockholders approved a merger between Arch and a wholly owned subsidiary. Pursuant to the merger, which became effective on June 13, 2003, each issued and outstanding share of common stock, \$0.001 par value per share, of Arch was converted into the right to receive one share of Class A common stock, par value of \$0.0001 per share. The rights of the Class A common stock are identical to those of the common stock except for the par value and certain restrictions on the transfer of shares of Class A common stock. The transfer restrictions will become effective once a cumulative change in ownership, as defined in sections 382 and 383 of the Internal Revenue Code, of 40% has occurred and generally restrict shareholders who hold 5% or more of the outstanding Class A common stock from entering into certain transactions without prior approval of Arch. Once the transfer restrictions are no longer necessary to protect the tax benefits associated with our federal income tax attributes, the Class A common stock will be subject to conversion back into common stock, without transfer restrictions, on a share-for-share basis.

(i) *Stock Incentive Plan* On June 12, 2003, Arch's stockholders approved an amendment to the 2002 Stock Incentive Plan that increased the number of shares of common stock authorized for issuance under the plan from 950,000 to 1,200,000. In connection with the amendment to the plan, options to purchase 249,996 shares of common stock at an exercise price of \$0.001 per share were issued to certain members of the board of directors. The options vested 50% upon issuance and the remaining 50% will vest on May 29, 2004. The compensation expense associated with these options of \$1.7 million is being recognized in accordance with the fair value provisions of SFAS No. 123, *Stock Based Compensation* over the vesting period of the options, \$215,000 and \$1,089,000 of which has been recognized for the three months and nine months ended September 30, 2003, respectively, and \$574,000 of which has been deferred. The transition to these provisions was accounted for effective January 1, 2003 and disclosed in accordance with the provisions of SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, utilizing the prospective method.

(j) *Earnings per Share* Basic earnings per share is computed on the basis of the weighted average common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average common shares outstanding plus the effect of outstanding stock options using the *treasury stock* method. The components of basic and diluted earnings per share were as follows (in thousands, except share and per share amounts):

	Reorganized Company				Predecessor Company
	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2003	Three Months Ended September 30, 2002	Four Months Ended September 30, 2002	Five Months Ended May 31, 2002
Net income	\$ 6,186	\$ 17,501	\$ 8,826	\$ 9,173	\$ 1,658,922
Weighted average common shares outstanding	20,000,000	20,000,000	20,000,000	20,000,000	182,434,590
Dilutive effect of:					
Options to purchase common stock	80,572	28,504			
Common stock and common stock equivalents	20,080,572	20,028,504	20,000,000	20,000,000	182,434,590
Earnings per share:					
Basic	\$ 0.31	\$ 0.88	\$ 0.44	\$ 0.46	\$ 9.09
Diluted	\$ 0.31	\$ 0.87	\$ 0.44	\$ 0.46	\$ 9.09

(k) *Recent and Pending Accounting Pronouncements* In November 2002, the FASB issued FASB Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN No. 45 clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and the initial measurement provisions of FIN No.

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45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN No. 45 are applicable for financial statements of interim periods ending after December 15, 2002. Arch adopted FIN No. 45 on January 1, 2003.

In February 2003, as permitted under Delaware law, Arch entered into indemnification agreements with 18 persons, including each of its directors and certain members of management, for certain events or occurrences while the director or member of management is, or was serving, at its request in such capacity. The maximum potential amount of future payments Arch could be required to make under these indemnification agreements is unlimited; however, Arch has a director and officer insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid under the terms of the policy. As a result of Arch's insurance policy coverage, Arch believes the estimated fair value of these indemnification agreements is minimal. Therefore in accordance with FIN No. 45, Arch has not recorded a liability for these agreements as of September 30, 2003.

In November 2002, the Emerging Issues Task Force ( EITF ) issued No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF No. 00-21 addresses certain aspects of accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF No. 00-21 establishes three principles: revenue should be recognized separately for separate units of accounting, revenue for a separate unit of accounting should be recognized only when the arrangement consideration is reliably measurable and the earnings process is substantially complete and consideration should be allocated among the separate units of accounting in an arrangement based on their fair values. EITF No. 00-21 is effective for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003, therefore Arch adopted its provisions on July 1, 2003 on a prospective basis. Upon adoption, Arch evaluated its revenue recognition policies and determined revenue associated with device sales and the provision of messaging services represent two units of accounting. Accordingly, on July 1, 2003, Arch began recognizing revenue from device sales for all device sales upon shipment. Previously, Arch had recognized revenue from the sale of one-way devices upon shipment and had deferred revenue from two-way device sales and amortized the revenue over the estimated customer relationship in accordance with the provisions of SAB 101. The adoption of EITF No. 00-21 resulted in approximately \$600,000 of additional revenue being recognized in the three months ended September 30, 2003 than would have been recognized under SAB 101. In accordance with the transition provisions of EITF No. 00-21, Arch will continue to recognize previously deferred revenue and expense from the sale of two-way devices in accordance with the amortization schedules in place at the time of deferral. At September 30, 2003, Arch had approximately \$2.8 million of deferred revenue and \$796,000 of deferred expense from the sale of two-way devices that will be recognized over the next seven quarters.

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In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This statement amends SFAS No. 133 to provide clarification on the financial accounting and reporting of derivative instruments and hedging activities and requires contracts with similar characteristics to be accounted for on a comparable basis. Arch adopted SFAS No. 149 on July 1, 2003 and the adoption did not have a material effect on its financial condition or results of operations.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. It requires the classification of a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Arch adopted SFAS No. 150 on July 1, 2003 and the adoption did not have a material effect on its financial statements or results of operations.

In May 2003, the EITF issued No. 01-08, Determining Whether an Arrangement Contains a Lease. EITF No. 01-08 provides guidance on how to determine whether an arrangement contains a lease that is within the scope of SFAS No. 13, Accounting for Leases. The guidance in EITF No. 01-08 is based on whether the arrangement conveys to the purchaser (lessee) the right to use a specific asset. Arch adopted EITF No. 01-08 on July 1, 2003 and the adoption did not have a material effect on its financial condition or results of operations.

(1) *Subsequent Event* In September 2003, the indenture governing Arch's 12% notes was amended to permit Arch to repurchase up to an aggregate compounded value of \$22.4 million of the 12% notes. Subsequent to September 30, 2003, Arch entered into several negotiated transactions in which it repurchased an aggregate of \$22.4 million compounded value of its 12% notes for aggregate consideration of \$22.9 million plus accrued interest of \$1.1 million. The repurchased 12% notes were retired. The 12% note repurchase transactions were funded from Arch's cash on hand.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Forward-Looking Statements**

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words believes, anticipates, plans, expects and similar expressions are intended to identify forward-looking statements. There are a number of important factors that could cause our actual results to differ materially from those indicated or suggested by such forward-looking statements. These factors include, without limitation, those set forth below under the caption Factors Affecting Future Operating Results.

**Overview**

The following discussion and analysis should be read in conjunction with our consolidated financial statements and notes and the following subsections of the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K: Overview, PageNet Merger, Results of Operations and Inflation.

We market and distribute our services through a direct sales force and a small indirect sales force.

*Direct.* Our direct sales force leases or sells devices directly to customers ranging from small and medium-sized businesses to Fortune 500 companies and government agencies and represents our most significant sales and marketing efforts. We intend to continue to market to commercial enterprises utilizing our direct sales force as these enterprises have typically disconnected service at a lower rate than individual consumers.

*Indirect.* Our indirect sales force sells devices and access to our messaging networks to third parties, or resellers, who then resell messaging services to consumers or small businesses. Resellers generally are not exclusive distributors of our services and often have access to networks of more than one provider. Competition among network providers to attract and maintain resellers is based primarily upon price. We intend to continue to provide access to our messaging networks to resellers and to concentrate on relationships that are profitable and where longer term partnerships can be established and maintained.

The following tables set forth units in service and revenue associated with our channels of distribution:

	As of September 30,				As of June 30,	
	2003		2002		2003	
	Units	%	Units	%	Units	%
(units in thousands)						
Direct	3,600	81%	4,806	75%	3,787	79%
Indirect	868	19	1,613	25	986	21
Total	4,468	100%	6,419	100%	4,773	100%

	For the Quarter Ended September 30,				For the Quarter Ended June 30,	
	2003		2002		2003	
	Revenue	%	Revenue	%	Revenue	%
(dollars in thousands)						

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	For the Quarter Ended September 30,				For the Quarter Ended June 30,				
Direct	\$	133,395	93%	\$	184,981	92%	\$	143,056	93%
Indirect		10,228	7		17,176	8		11,020	7
<b>Total</b>	<b>\$</b>	<b>143,623</b>	<b>100%</b>	<b>\$</b>	<b>202,157</b>	<b>100%</b>	<b>\$</b>	<b>154,076</b>	<b>100%</b>

We derive the majority of our revenues from fixed monthly or other periodic fees charged to subscribers for wireless messaging services. Such fees are not generally dependent on usage. As long as a subscriber remains on service, operating results benefit from the recurring payment of these fees. Revenues are generally dependent on the number of units in service and the monthly charge per unit. The number of units in service changes based on subscribers added, referred to as gross placements, less units cancelled, or disconnects. The net of gross placements and disconnects is commonly referred to as net gains or losses of units in service. The absolute number of gross placements is monitored on a monthly basis. In addition, the ratio of gross placements for a period to the number of sales representatives for the same period, referred to as gross placements per sales representative, is also reviewed. This measurement indicates the productivity of our sales force and the sales level of each type of our messaging services and is an indicator of the relationship of revenues and sales expenses. Disconnects are also monitored on a monthly basis. The ratio of units disconnected in a period to average units in service for the same period, called the disconnect rate, is an indicator of our success retaining subscribers which is important to maintain recurring revenues and control operating expenses.

The following table sets forth our gross placements and disconnects for the periods stated.

	For the Quarter Ended September 30,						For the Quarter Ended June 30,	
	2003			2002			2003	
	Gross Placements	Disconnects	Net Loss	Gross Placements	Disconnects	Net Loss	Gross Placements	Net Disconnects
Direct	141	327	(186)	216	562	254,460	191,822	

Supplemental disclosures of cash flow information:

Cash paid for interest	\$	128,507	155,591
Cash paid for income taxes		100	12,100

Supplemental disclosure of non-cash investing and financing activities:

Long-term debt incurred for purchase of property and equipment	44,334	-
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See accompanying notes to condensed consolidated financial statements.

DYNATRONICS CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## NOTE 1. PRESENTATION

The condensed consolidated balance sheets as of December 31, 2011 and June 30, 2011, and the condensed consolidated statements of operations for the three and six months ended December 31, 2011 and 2010, and the condensed consolidated statements of cash flows for the six months ended December 31, 2011 and 2010 were prepared by Dynatronics Corporation (the "Company") without audit pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all necessary adjustments, which consist only of normal recurring adjustments, to the financial statements have been made to present fairly the Company's financial position, results of operations and cash flows. The results of operations for the three and six months ended December 31, 2011 are not necessarily indicative of the results of operations for the fiscal year ending June 30, 2012. The Company previously filed with the SEC an annual report on Form 10-K which included audited financial statements for each of the two years ended June 30, 2011 and 2010. It is suggested that the financial statements contained in this Form 10-Q be read in conjunction with the financial statements and notes thereto contained in the Company's most recent Form 10-K.

## NOTE 2. NET INCOME (LOSS) PER COMMON SHARE

Net income (loss) per common share is computed based on the weighted-average number of common shares outstanding and, when appropriate, dilutive common stock equivalents outstanding during the period. Stock options are considered to be common stock equivalents. The computation of diluted net income (loss) per common share does not assume exercise or conversion of securities that would have an anti-dilutive effect.

Basic net income (loss) per common share is the amount of net income (loss) for the period available to each weighted-average share of common stock outstanding during the reporting period. Diluted net income (loss) per common share is the amount of net income (loss) for the period available to each weighted-average share of common stock outstanding during the reporting period and to each common stock equivalent outstanding during the period, unless inclusion of common stock equivalents would have an anti-dilutive effect.

The reconciliations between the basic and diluted weighted-average number of common shares outstanding for the three and six months ended December 31, 2011 and 2010 are as follows:

	Three Months Ended December 31		Six Months Ended December 31	
	2011	2010	2011	2010
Basic weighted-average number of common shares outstanding during the period	12,792,666	13,439,637	12,877,024	13,442,958
Weighted-average number of dilutive common stock options outstanding	39,624	4,363	-	7,920

during the period				
Diluted weighted-average number of common and common equivalent shares outstanding during the period	12,832,290	13,444,000	12,877,024	13,450,878

Outstanding options for common shares not included in the computation of diluted net income (loss) per common share, because they were anti-dilutive, for the three months ended December 31, 2011 and 2010 totaled 810,462 and 921,834, respectively, and for the six months ended December 31, 2011 and 2010 totaled 860,618 and 896,834, respectively.



## NOTE 3. STOCK-BASED COMPENSATION

Stock-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized over the employee's requisite service period. The Company recognized \$16,068 and \$12,533 in stock-based compensation expense during the three months ended December 31, 2011 and 2010, respectively, and recognized \$32,329 and \$24,077 in stock-based compensation expense during the six months ended December 31, 2011 and 2010, respectively. These expenses were recorded as selling, general and administrative expenses in the condensed consolidated statements of operations.

Stock Options. The Company maintains a 2005 equity incentive plan for the benefit of employees. Incentive and nonqualified stock options, restricted common stock, stock appreciation rights, and other stock-based awards may be granted under the plan. Awards granted under the plan may be performance-based. As of December 31, 2011, there were 905,114 shares of common stock authorized and reserved for issuance, but not granted under the terms of the 2005 equity incentive plan, as amended.

The following table summarizes the Company's stock option activity during the six-month period ended December 31, 2011.

	Number of Options	Weighted-Average Exercise Price
Outstanding at beginning of period	933,462	\$ 1.33
Granted	-	-
Exercised	-	-
Cancelled	(72,844 )	1.46
Outstanding at end of period	860,618	1.31
Exercisable at end of period	567,108	1.56

The Black-Scholes option-pricing model is used to estimate the fair value of options granted under the Company's stock option plan. There were no options granted during the six months ended December 31, 2011.

As of December 31, 2011, there was \$68,445 of unrecognized stock-based compensation cost related to grants under the stock option plan that is expected to be expensed over a weighted-average period of 4 years. There was \$3,909 of intrinsic value for options outstanding as of December 31, 2011.

## NOTE 4. COMPREHENSIVE INCOME (LOSS)

For the three and six months ended December 31, 2011 and 2010, comprehensive income (loss) was equal to the net income (loss) as presented in the accompanying condensed consolidated statements of operations.

## NOTE 5. INVENTORIES

Inventories consisted of the following:

December 31,    June 30,

	2011	2011
Raw materials	\$ 2,375,172	2,329,536
Finished goods	3,807,131	3,656,027
Inventory obsolescence reserve	(348,878 )	(337,748 )
	\$ 5,833,425	5,647,815

## NOTE 6. RELATED-PARTY TRANSACTIONS

The Company leases office and warehouse space in Detroit, Michigan; Hopkins, Minnesota; and Pleasanton, California from three stockholders and former independent distributors on an annual basis under operating lease arrangements. Management believes the lease agreements are on an arms-length basis and the terms are equal to or more favorable than would be available to third parties. The expense associated with these related-party transactions totaled \$39,000 and \$57,000 for the three months ended December 31, 2011 and 2010, respectively, and \$78,000 and \$114,300 for the six months ended December 31, 2011 and 2010, respectively.

NOTE 7. LINE OF CREDIT

The Company's revolving line of credit agreement includes covenants requiring the Company to maintain certain financial ratios. As of December 31, 2011, the Company was out of compliance with the "minimum pre-tax income by quarter" covenant (rolling twelve-month calculation); however, the Company received a waiver of compliance from the lender as of December 31, 2011 and for the six months then ended.

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

### Overview

Our principal business is the distribution, marketing and sale of physical medicine and aesthetic products, many of which we design and manufacture. We offer a broad line of medical equipment including therapy devices, medical supplies and soft goods, treatment tables and rehabilitation equipment. Our line of aesthetic products includes aesthetic massage and microdermabrasion devices, as well as skin care products. Our products are sold to and used primarily by physical therapists, chiropractors, sports medicine practitioners, podiatrists, plastic surgeons, dermatologists and aestheticians. We operate on a fiscal year ending June 30. For example, reference to fiscal year 2012 refers to the year ending June 30, 2012.

### Results of Operations

The following discussion and analysis of our financial condition and results of operations for the three and six months ended December 31, 2011, should be read in conjunction with the condensed consolidated financial statements and notes thereto appearing in Part I, Item 1 of this report, and our Annual Report on Form 10-K for the year ended June 30, 2011, which includes audited financial statements for the year then ended. Results of operations for the three and six months ended December 31, 2011 are not necessarily indicative of the results that will be achieved for the full fiscal year ending June 30, 2012.

### Net Sales

Net sales increased approximately 1% to \$8,275,430 for the quarter ended December 31, 2011, compared to \$8,199,347 for the quarter ended December 31, 2010. Net sales for the six months ended December 31, 2011, increased 1% to \$16,272,232, compared to \$16,118,635 for the same period in 2010. The increase in sales is mostly attributable to progress in developing business through Group Purchasing Organizations ("GPO's") and national accounts contracts secured in the past year. We began the process of introducing Dynatronics' branded products to GPO member facilities in March 2011. This process is expected to gain momentum over the next several quarters and management remains optimistic about the potential of increasing business with these large national accounts and GPO's. GPO business is a new market for Dynatronics that holds significant potential, but will also take time to develop.

### Gross Profit

Gross profit increased 1.4% to \$3,212,958, or 38.8% of net sales, for the quarter ended December 31, 2011, compared to \$3,169,441, or 38.7% of net sales, for the quarter ended December 31, 2010. Gross profit was \$6,215,056, or 38.2% of net sales, for the six months ended December 31, 2011, compared to \$6,121,274, or 38.0% of net sales, for the six months ended December 31, 2010. The increase in gross profit during the current quarter and six month periods reflects sales mix that involved a slightly higher percentage of sales through direct sales representatives rather than dealers. The sales through direct sales representatives are retail sales; sales to dealers are at wholesale pricing. Going forward, we expect improved sales of higher margin capital equipment along with increased retail level sales through our network of direct sales representatives will sustain current or higher gross profit margins as product sales to GPO members grow and as new products are introduced in coming months.

### Selling, General and Administrative Expenses

Selling, general and administrative (“SG&A”) expenses increased \$52,123 to \$2,686,401, or 32.5% of net sales, for the quarter ended December 31, 2011, from \$2,634,278, or 32.1% of net sales, for the quarter ended December 31, 2010. SG&A expenses increased \$246,473, to \$5,381,268, or 33.1% of net sales, for the six months ended December 31, 2011, from \$5,134,795, or 31.9% of net sales, for the six months ended December 31, 2010. The increase in SG&A expenses for the first six months of fiscal year 2012 reflects higher sales expenses associated with the development of the GPO business, together with improvements made to the Company’s information systems and e-commerce website, and higher personnel costs. The principal components of these increased SG&A expenses for the quarter ended December 31, 2011 were as follows:

- \$32,760 of higher selling expenses; and
- \$21,221 of higher labor and depreciation expenses.

Partially offsetting these increases was \$1,858 in lower general expenses, primarily related to lower bank charges.

The following factors impacted SG&A expenses for the six months ended December 31, 2011, as compared to the same period in 2010:

- \$136,774 of higher selling expenses;
- \$121,600 of higher production labor, license fees and depreciation expenses.

Partially offsetting these increases was \$11,901 in lower general expenses, primarily related to lower bank charges, financing fees and amortization expense related to intangibles.

#### Research and Development Expenses

Research and development (“R&D”) expenses increased \$56,342 to \$412,861, or 5.0% of sales, in the quarter ended December 31, 2011, compared to \$356,519, or 4.3% of sales in the quarter ended December 31, 2010. R&D expenses increased \$62,893, to \$769,208 for the six months ended December 31, 2011, from \$706,315 for the six months ended December 31, 2010. We are developing a record number of new products that are expected to be introduced during the last six months of fiscal year 2012. These development efforts are directly responsible for the significant R&D expenses we are incurring. We anticipate that R&D expenses will return to more historical levels in coming quarters as we complete development of these new products. We believe that developing new products is a key element in our growth strategy. R&D costs are expensed as incurred.

#### Income Before Income Tax Provision

Pre-tax income for the quarter ended December 31, 2011, totaled \$72,179 compared to \$113,040 for the quarter ended December 31, 2010. Pre-tax loss for the six months ended December 31, 2011, totaled \$33,750 compared to pre-tax income of \$142,777 for the six months ended December 31, 2010. The \$40,861 reduction in income before taxes for the current quarter can be explained primarily by a \$56,342 increase in R&D expense compared to the same quarter last year. For the six-month period ended December 31, 2011, R&D expenses accounted for \$62,893 of the \$176,527 reduction in income before taxes when compared to the six-month period ended December 31, 2010, with the balance of the difference being attributable to higher sales expense associated with our pursuit of GPO and national account business, higher sales commissions due to greater retail related sales, and increased depreciation and amortization expense related to higher investment levels in information systems.

#### Income Tax Provision

Income tax provision was \$25,845 for the quarter ended December 31, 2011, compared to \$45,201 for the quarter ended December 31, 2010. Income tax benefit was \$11,824 for the six months ended December 31, 2011, compared to an income tax provision of \$57,926 for the six months ended December 31, 2010. The effective tax rate for the second quarter of fiscal year 2012 was 35.8% compared to 40.0% for the same period in fiscal year 2010. The effective tax rate for the six months ended December 31, 2011, was 35.0% compared to 40.6% for the prior year period. The difference in the effective tax rates is attributable to certain permanent book to tax differences as well as higher R&D tax credits in fiscal year 2012. While these items are not significant, substantive changes in the tax rate can occur based on our level of profitability.

#### Net Income

Net income decreased to \$46,334 (\$.00 per share) for the quarter ended December 31, 2011, compared to \$67,839 (\$.01 per share) for the quarter ended December 31, 2010. Net loss totaled \$21,926, or \$.00 per share, for the six months ended December 31, 2011, compared to net income of \$84,851, or \$.01 per share, for the six months ended

December 31, 2010. The decrease in earnings for the quarter and six months ended December 31, 2011, compared to the prior year periods was a result primarily of the higher selling, depreciation and R&D expenses discussed above. The increase in expenses was partially offset by higher sales, improved gross profit margins, and lower interest expense.

#### Liquidity and Capital Resources

We have financed operations through available cash reserves and borrowings under a line of credit with a bank. Working capital was \$4,112,347 as of December 31, 2011, inclusive of the current portion of long-term obligations and credit facilities, compared to working capital of \$4,552,731 as of June 30, 2011. In connection with our ongoing stock buyback program, during the quarter ended September 30, 2011, we used cash of approximately \$301,000 to repurchase approximately 268,000 shares of our common stock in the open market. No shares were repurchased during the quarter ended December 31, 2011.

The current ratio was 1.6 to 1 as of December 31, 2011, compared to 1.8 to 1 as of June 30, 2011. Current assets represented 71% of total assets as of December 31, 2011 and 70% of total assets as of June 30, 2011.

#### Accounts Receivable

Trade accounts receivable, net of allowance for doubtful accounts, increased \$15,110, or 0.4%, to \$3,687,238 as of December 31, 2011, compared to \$3,672,128 as of June 30, 2011. Trade accounts receivable represent amounts due from our customers including medical practitioners, clinics, hospitals, colleges and universities and sports teams as well as dealers and distributors that purchase our products for redistribution. We believe that our estimate of the allowance for doubtful accounts is adequate based on our historical knowledge and relationship with these customers. Accounts receivable are generally collected within 30 days of the agreed terms.

#### Inventories

Inventories, net of reserves, increased \$185,610, or 3.3%, to \$5,833,425 as of December 31, 2011, compared to \$5,647,815 as of June 30, 2011. The amount of inventory we carry fluctuates each period. A main contributor to those fluctuations is inventory purchases from overseas suppliers which are typically larger purchases.

#### Accounts Payable

Accounts payable increased \$117,986, or 5.5%, to \$2,245,149 as of December 31, 2011, from \$2,127,163 as of June 30, 2011. The increase in accounts payable is a result of the timing of our weekly payments to suppliers and the timing of purchases of product components. Accounts payable are generally not aged beyond the terms of our suppliers. We generally take advantage of available early payment discounts when offered by our vendors.

#### Cash and Cash Equivalents

Our cash and cash equivalents position as of December 31, 2011, was \$254,460, a decrease of 33.9%, from cash and cash equivalents of \$384,904 as of June 30, 2011. Our cash position varies from quarter to quarter, but typically stays within a range of \$200,000 to \$400,000. We expect that cash flows from operating activities, together with amounts available through an existing line of credit facility, will be sufficient to cover operating needs in the ordinary course of business for at least the next twelve months. If we experience an adverse operating environment, including a further worsening of the general economy in the United States, or unusual capital expenditure requirements, additional financing may be required. No assurance can be given that additional financing, if required, would be available on terms favorable to us, or at all.

#### Line of Credit

The outstanding balance on our line of credit increased \$359,305 to \$2,943,242 as of December 31, 2011, compared to \$2,583,937 as of June 30, 2011. During the quarter ended September 30, 2011, borrowings of approximately \$301,000 were used to repurchase approximately 268,000 shares of the Company's common stock in the open market. No shares were repurchased during the quarter ended December 31, 2011. Interest on the line of credit is based on the 90-day LIBOR rate (0.58% as of December 31, 2011) plus 3%. The line of credit is collateralized by accounts receivable and inventories. Borrowing limitations are based on approximately 45% of eligible inventory and up to 80% of eligible accounts receivable, up to a maximum credit facility of \$7,000,000. Interest payments on the line are due monthly. As of December 31, 2011, the borrowing base was approximately \$4,960,000, resulting in approximately \$2,017,000 available on the line. The line of credit includes covenants requiring us to maintain certain financial ratios. As of December 31, 2011, we were in compliance with all loan covenants with the exception of the covenant regarding the minimum amount of pre-tax income, measured on a rolling four quarter basis. This covenant



was not met due primarily to high R&D expenses. However, the bank has granted a waiver for this covenant as of December 31, 2011 and for the period then ended. The line of credit expires on December 15, 2012.

We believe that amounts available under the line of credit as well as cash generated from operating activities will continue to be sufficient to meet our operating requirements.

## Debt

Long-term debt, excluding current installments decreased \$139,984 to \$2,098,433 as of December 31, 2011, compared to \$2,238,417 as of June 30, 2011. Long-term debt is comprised primarily of the mortgage loans on our office and manufacturing facilities in Utah and Tennessee. The principal balance on the mortgage loans is approximately \$2,274,000 with monthly principal and interest payments of \$37,503.

## Inflation and Seasonality

Our revenues and net income have not been unusually affected by inflation or price increases for raw materials and parts from vendors.

## Stock Repurchase Plan

We have a stock repurchase plan that has been ongoing since 2003. Purchases of shares may be made from time-to-time, in the open market, through block trades or otherwise, and are based on market conditions, the level of our cash balances, general business opportunities, and other factors. Our Board of Directors periodically approves the dollar amounts for share repurchases under the plan. As of December 31, 2011, \$848,450 remained available under the plan for purchases. There is no expiration date for the plan.

## Critical Accounting Policies

This Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our condensed consolidated financial statements. The preparation of these financial statements requires estimates and judgments that affect the reported amounts of our assets, liabilities, net sales and expenses. Management bases estimates on historical experience and other assumptions it believes to be reasonable given the circumstances and evaluates these estimates on an ongoing basis. Actual results may differ from these estimates.

The following critical accounting policies involve a high degree of judgment and complexity and require significant estimates and judgments used in the preparation of our condensed consolidated financial statements.

## Inventory Reserves

The nature of our business requires that we maintain sufficient inventory on hand at all times to meet the requirements of our customers. We record finished goods inventory at the lower of standard cost, which approximates actual costs (first-in, first-out) or market. Raw materials are recorded at the lower of cost (first-in, first-out) or market. Inventory valuation reserves are maintained for the estimated impairment of the inventory. Impairment may be a result of slow-moving or excess inventory, product obsolescence or changes in the valuation of the inventory. In determining the adequacy of reserves, we analyze the following, among other things:

- Inventory quantities on hand;
- Product acceptance in the marketplace;
- Customer demand;
- Historical sales;
- Forecast sales;
- Product obsolescence;
- Technological innovations; and
- Character of the inventory as a distributed item, finished manufactured item or raw material.

Any modifications to estimates of inventory valuation reserves are reflected in the cost of goods sold within the statement of operations during the period in which such modifications are determined necessary by management. As of December 31, 2011 and June 30, 2011, our inventory valuation reserve balance, which established a new cost basis, was \$348,878 and \$337,748, respectively, and our inventory balance was \$5,833,425 and \$5,647,815, net of reserves, respectively.

#### Revenue Recognition

Sales revenues are recorded when products are shipped, title has passed to the customer, and collection of any resulting receivable is reasonably assured. Amounts billed for shipping and handling of products are recorded as sales revenue. Costs for shipping and handling of products to customers are recorded as cost of sales.

#### Allowance for Doubtful Accounts

We must make estimates of the collectability of accounts receivable. In doing so, we analyze historical bad debt trends, customer credit worthiness, current economic trends and changes in customer payment patterns when evaluating the adequacy of the allowance for doubtful accounts. Our accounts receivable balance was \$3,687,238 and \$3,672,128, net of allowance for doubtful accounts of \$350,741 and \$293,436, as of December 31, 2011 and June 30, 2011, respectively.

#### Deferred Income Tax Assets

At each reporting date, our management performs an analysis of the deferred income tax assets and their recoverability. Based on several factors, including our strong earnings history of pre-tax profit averaging over \$500,000 per year in 19 of the last 22 fiscal years, we believe that it is more likely than not that all of the net deferred income tax assets will be realized.

#### Business Plan and Outlook

In calendar 2011, we announced the signing of contracts with four GPOs: Premier, Inc., Amerinet, Inc., FirstChoice Cooperative and Champs Group Purchasing. These GPOs represent tens of thousands of clinics and hospitals around the nation. With the broader offering of products now available through our catalog and e-commerce website, we are better able to compete for this high volume business. Over the past two years, we have also been successful in becoming a preferred vendor to many national and regional accounts. We believe these contract signings represent important milestones toward our goal of expanding our customer base and increasing our market share.

The contracts with the GPOs represent a license to solicit business directly from the members of the respective GPOs. The GPOs do not order any product directly. They serve the function of negotiating favorable pricing terms on behalf of their members. Most GPO members are loyal to the GPOs in which they have membership and will not typically consider vendors that are not on contract.

Our contract with Amerinet, Inc. allows us to sell capital equipment to its 51,000 clinic members. Capital equipment typically includes non-commodity products over \$150 in price. While we may solicit supply-type business from Amerinet customers, we are not under contract to do so. Our contract with FirstChoice Cooperative covers all products that we offer to its 20,000 members. Our contract with Premier, Inc. is to provide products to its members in the “colleges and universities and alternate markets” category which is a subset of its total membership. We expect to realize broader benefits under the Premier Inc. agreement as our involvement with this GPO exposes our products to all of its 95,000 “healthcare” category members. We anticipate this exposure will create interest and possibilities for additional business from these healthcare members. Some of Premier, Inc.’s healthcare members, including Champs Group Purchasing, have negotiated contracts with us directly to obtain access to our products. These contracts present us with significant opportunities for increasing sales in markets that have previously been unavailable to us. Cultivating business through these GPO contracts and seeking additional contracts with other GPOs is a major focal point of our strategy for building our business.

While sales to GPO-related accounts have increased by 42% since the contracts became effective last March, that 42% increase only translates into an annual pace of approximately \$700,000 in increased sales. Management had expected to attain a higher pace after ten months of effort. Nevertheless, the trend of sales to GPO members continues to rise. While the slope of the line is not as steep as we would like, we remain optimistic regarding the potential of these accounts. We are currently in discussion with two additional GPO’s that anticipate issuing new contracts during calendar 2012. We are working with these groups to have the best opportunity possible to obtain contracts with them.

During fiscal year 2012, we plan to introduce a new, updated version of our product catalog. This new catalog will expand our product offering in order to better service the broader needs of GPO's and national accounts. It will also provide an excellent new sales tool for all of our sales representatives in the field as well as provide a foundation for expanding our e-commerce platform.

In December 2010, we introduced to the physical medicine market a new electronic patient communications platform called Stream. Stream is an automated service that leverages the latest technologies to connect practitioners with their patients via e-mail, text messaging and social networking tools to provide state-of-the-art communications and marketing tools for practitioners. The system reduces patient “no shows,” reactivates past patients and generates new patients. In addition, it provides a wide range of analytics and delivers automated appointment reminders – all while improving staff efficiency. The launch of this product has been slower than expected, but the reviews from those who are using the product are mostly very favorable. The continued development of Stream represents an opportunity to significantly improve overall gross margins and profitability for the Company as each sale creates a recurring monthly revenue stream. Our efforts over the next year to work with our partner, Solutionreach (formerly known as Smile Reminder), to refine the presentation and implementation of this very unique and valuable service will be critical to realizing the full potential of this program.

Over the past few years, consolidations in our market have changed the landscape of our industry’s distribution channels. At the present time, we believe that there remain only two companies with a national direct sales force selling proprietary and distributed products: Dynatronics and Patterson Medical. All other distribution in our market is directed through catalog companies with no direct sales force, or through independent local dealers that have limited geographical reach. In the past year, we have reinforced our direct sales team to include over 50 direct sales employees and independent sales representatives. In addition to these direct sales representatives, we continue to enjoy a strong relationship with scores of independent dealers. We believe we have the best trained and most knowledgeable sales force in the industry. The changes taking place within our market provide a unique opportunity for us to grow market share in the coming years through recruitment of high-quality sales representatives and dealers.

To further our efforts to recruit high-quality direct sales representatives and dealers as well as to better appeal to the large GPOs and national customers, we intend to continue to improve efficiencies of our operations and the sales support for the industry. Chief among the steps we are taking to make these improvements was the introduction of our first true e-commerce solution on July 6, 2010. With the introduction of this e-commerce solution, customers are able to more easily place orders and obtain information about their accounts. Sales representatives are increasing their effectiveness with the abundance of information available to them electronically through our e-quote system which is a companion to the e-commerce solution introduced. Not only is our e-commerce solution easy and efficient to use, it should also facilitate reducing transactional costs thus enabling us to accommodate higher sales without significantly increasing overhead.

The passage in 2010 of the Patient Protection and Affordable Care Act along with the Health Care and Educational Reconciliation Act will affect our future operations. The addition of millions to the rolls of the insured will increase demand for services. That increased demand could lead to increased sales of our products. The magnitude of those increases is difficult to assess at this time. A negative impact of this legislation as enacted is its imposition of an excise tax on all manufacturers of medical devices. Barring a change in the statute, we estimate that this tax would be approximately \$300,000 to \$400,000 annually for Dynatronics. Because of the phase-in of various provisions in the legislation, the full effects on our business and industry are not expected to be felt until 2013 at the earliest. This makes it difficult to project the full impact this legislation will have on our business in future periods. There is also a possibility that future Congresses will amend the legislation prior to it becoming fully effective or the courts may rule all or part of the legislation unconstitutional. In addition, rule-making under the law is not yet complete. In the meantime, we are working to take full advantage of every opportunity presented by this legislation to increase sales and to offset any negative effects that may accompany those opportunities.

We continue to focus research and development efforts on new product innovation and enhancing existing products. The scope of our R&D effort is more significant than at any time in our history. More new products are scheduled for introduction during calendar 2012 than we have ever done in any other calendar year. Most of the new products should be released in the first half of calendar 2012. The commitment to innovation of high-quality products

has been a hallmark of Dynatronics and will continue throughout the coming year. This renewed emphasis on R&D contributed in large part to the lower profitability we experienced over the past year and expect this trend will continue for the first three quarters of fiscal year 2012. R&D costs for us have been cyclical in nature. The current higher costs are reflective of the fact we are in a more intense part of the development cycle. Once the new products are introduced, R&D costs are expected to cycle back to a lower level until the next new products are further advanced in the development cycle. Management is confident the short-term costs associated with the more intense part of the development cycle will yield long-term benefits and are important to assuring that we maintain our reputation for being an innovator and leader in product development in the industry.

Economic pressures from the recent recession in the United States have affected available credit that would facilitate large capital purchases, and have also reduced demand for discretionary services such as those provided by the purchasers of our aesthetic products. As a result, we reduced our expenses in the Synergie division. We believe that our aesthetic devices remain the best value on the market and we are seeking innovative ways to market these products, including strategic partnerships, both domestic and international, to help regain sales momentum.

We have long believed that international markets present an untapped potential for growth and expansion. Adding new distributors in several countries will be the key to this expansion effort. Our past efforts to improve international marketing have yielded only marginal improvements. We remain committed, however, to finding the most cost effective ways to expand our markets internationally. Over the coming year, our efforts will be focused on partnering with key manufacturers and distributors interested in our product line or technology. Our Utah facility, where all electrotherapy, ultrasound, traction, light therapy and Synergie products are manufactured, is certified to ISO 13485:2003, an internationally recognized standard of excellence in medical device manufacturing. This designation is an important requirement in obtaining the CE Mark certification, which allows us to market our products in the European Union and in other international locations.

Refining our business model for supporting sales representatives and distributors also will be a focal point of operations. We will continue to evaluate the most efficient ways to maintain our satellite sales offices and warehouses. In addition, more emphasis is being placed on pricing management to protect margins for both manufactured and distributed products. The ongoing refinement of this model is expected to yield further efficiencies that will better achieve sales goals while, at the same time, reduce expenses.

Our efforts to prudently reduce costs in the face of some economic uncertainty have made us a leaner operation. We will continue to be vigilant in maintaining appropriate overhead costs and operating costs while still building appropriate support for anticipated increases in sales.

The strategic decision four years ago to merge with key dealers and vertically integrate our operations has opened new opportunities for us to expand our distribution operations. Historically, we have been a manufacturer and designer of physical medicine and aesthetic products that also distributed a limited number of products from other manufacturers. Our business model is transforming with our sales of other manufacturers' products now representing a greater share of our overall sales. Manufactured products continue to provide the majority of gross profit margin, but the growth trends we are forecasting indicate greater growth potential for distributed products over manufactured products. Therefore, during fiscal year 2012 we will evaluate ways of improving our business model to better reflect our growing role as a distributor of other manufacturers' products.

Based on our defined strategic initiatives, we are focusing our resources in the following areas:

- Improving sales by pursuing business opportunities with GPOs and large chains of clinics, including national and regional accounts.
- Continuing development of new state-of-the-art products, both high-tech and commodity, in fiscal year 2012, primarily for the rehabilitation markets.
- Introducing a new 2012 product catalog featuring a broader product offering.
- Using our e-commerce solution in order to facilitate business opportunities and reduce transactional costs.
- Pursuing opportunities to introduce the Stream software service to large groups of clinics and buying groups in addition to making it available to individual practitioners.
- Reinforcing distribution through a strategy of recruiting direct sales representatives and working closely with the most successful distributors of capital equipment.
- Maintaining operational efficiencies by monitoring manufacturing and transactional costs, automating processes, redefining policies and procedures and working to make every customer a profitable customer.



- Strengthening pricing management and procurement methodologies.
- Minimizing expense associated with the Synergie product line until demand for capital equipment re-emerges, and, in the meantime, seeking additional independent distributors and strategic partnerships.
- Focusing international sales efforts on identifying key distributors and strategic partners who could represent the Company's product line, particularly in Europe.

- Improving efficiencies as a distributor of other manufacturers' products and considering ways to enhance our role as a distributor and not just a manufacturer.
- Exploring strategic business alliances that will leverage and complement our competitive strengths, increase market reach and supplement capital resources.

#### Cautionary Statement Concerning Forward-Looking Statements

The statements contained in this Form 10-Q, particularly the foregoing discussion in Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, that are not purely historical, are "forward-looking statements" within the meaning of Section 21E of the Exchange Act. These statements refer to our expectations, hopes, beliefs, anticipations, commitments, intentions and strategies regarding the future. They may be identified by the use of words or phrases such as "believes," "expects," "anticipates," "should," "plans," "estimates," "intends," "potential," among others. Forward-looking statements include, but are not limited to, statements regarding product development, market acceptance, financial performance, revenue and expense levels in the future and the sufficiency of existing assets to fund future operations and capital spending needs. Actual results could differ materially from the anticipated results or other expectations expressed in such forward-looking statements. The forward-looking statements contained in this report are made as of the date of this report and we assume no obligation to update them or to update the reasons why actual results could differ from those projected in such forward-looking statements, except as required by law.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to various market risks. Market risk is the potential risk of loss arising from adverse changes in market prices and rates. We do not enter into derivative or other financial instruments for trading or speculative purposes. There have been no material changes in our market risk during the quarter ended December 31, 2011, although the general weakness in the U.S. economy is expected to lead to greater discounting market-wide to stimulate sales in a declining economic environment. In addition, further weakening of the economy could result in greater risks of collections of accounts receivable.

Our primary market risk exposure is interest rate risk. As of December 31, 2011, approximately \$4,226,000 of our debt bore interest at variable rates. Accordingly, our net income is affected by changes in interest rates. For every one hundred basis point change in the average interest rate under our existing debt, our annual interest expense would change by approximately \$42,260.

In the event of an adverse change in interest rates, we could take actions to mitigate our exposure. However, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no such actions.

#### Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness, as of December 31, 2011, of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. The purpose of this evaluation was to determine whether, as of the evaluation date, our disclosure controls and procedures were effective to provide reasonable assurance that the information we are required to disclose in our filings with the Securities and Exchange Commission, or SEC, under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based on their evaluation, our management has concluded, that our disclosure controls and

procedures were effective as of December 31, 2011.

There has been no change in our internal control over financial reporting during the quarter ended December 31, 2011 that has materially affected, or that is reasonably likely to materially affect, our internal control over financial reporting.

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## PART II. OTHER INFORMATION

### Item 5. Other Information

#### NASDAQ Minimum Bid Requirement

On November 9, 2011, we received a deficiency letter from the NASDAQ Stock Market, indicating that we had failed to comply with the minimum bid requirement for continued inclusion under Marketplace Rule 4310(c)(4). Under the deficiency notice, our common stock is subject to potential delisting because, for a period of 30 consecutive business days, the bid price of the common stock closed below the minimum \$1.00 per share requirement for continued inclusion. NASDAQ allows six months to comply with the rule and an additional six months if certain criteria are met. We believe the deadline for compliance with the rule will be November 9, 2012. If prior to that date the bid price of our common stock closes at \$1.00 per share or more for a minimum of 10 consecutive business days, NASDAQ staff may provide written notification that we have achieved compliance with the rule.

We are using our best efforts to regain compliance with the minimum bid price rule. However, there can be no assurance that compliance will be achieved given the overall current condition of financial and stock markets in the United States. If compliance is not achieved and our stock is delisted, we expect that the common stock will begin trading on the OTC bulletin board where there is no minimum bid requirement.

#### Related-Party Transactions

We rent office and warehouse space in Pleasanton, California from the Rajala Family Trust, a shareholder of Dynatronics. The monthly lease payment is \$9,000 and the lease term is renewable annually. In addition, we rent office and warehouse space in Detroit, Michigan from Steve Cyman, a shareholder of the Company. The monthly lease payment is \$3,500 and the lease automatically renews on a semi-annual basis unless it is terminated. We rent office space in Hopkins, Minnesota from Andy Moore, a shareholder of the Company. The monthly lease payment is \$500 and the lease automatically renews on an annual basis unless it is terminated. These shareholders are the former owners of three of the dealerships acquired on June 30 and July 2, 2007. As part of the purchase price for their distribution companies, the Rajala Family Trust, Steve Cyman and Andy Moore were paid with shares of Dynatronics common stock. Mr. Rajala and Mr. Cyman beneficially own 5% or more of our outstanding common stock. Management believes that the monthly rental payments for each facility are comparable to or below market rates for similar properties.

The Company has agreed to repurchase up to \$100,000 of Dynatronics common stock from Mr. John Rajala and from Mr. Tony Trolio annually for three years at full market value of the stock price. These agreements became effective on July 1, 2010 and run through June 30, 2013. Pursuant to these agreements, Mr. Rajala and Mr. Trolio each sold \$100,000 of their stock to the Company during the year ended June 30, 2011, the first year of the agreement.

### Item 6. Exhibits

#### (a) Exhibits

- 3.1 Articles of Incorporation and Bylaws of Dynatronics Laser Corporation. Incorporated by reference to a Registration Statement on Form S-1 (No. 2-85045) filed with the SEC and effective November 2, 1984

3.2	Articles of Amendment dated November 21, 1988 (previously filed)
3.3	Articles of Amendment dated November 18, 1993 (previously filed)
10.1	Loan Agreement with Zions Bank (previously filed)
10.2	Amended Loan Agreement with Zions Bank (previously filed)
10.3	1992 Amended and Restated Stock Option Plan (previously filed)
10.4	Dynatronics Corporation 2005 Equity Incentive Award Plan (previously filed as Annex A to the Company's Definitive Proxy Statement on Schedule 14A filed on October 27, 2006)
10.5	Form of Option Agreement for the 2005 Equity Incentive Plan for incentive stock options (previously filed as Exhibit 10.8 to the Company's Annual Report on Form 10-KSB for the fiscal year ended June 30, 2006)
10.6	Form of Option Agreement for the 2005 Equity Incentive Plan for non-qualified options (previously filed as Exhibit 10.9 to the Company's Annual Report on Form 10-KSB for the fiscal year ended June 30, 2006)
10.7	Building Lease Agreement with The Rajala Family Trust dated June 30, 2009
10.8	Executive Employment Agreement (Beardall) (previously filed as exhibit to Current Report on Form 8-K, filed with the Commission on March 7, 2011)
11	Computation of Net Income per Share (included in Notes to Consolidated Financial Statements)
31.1	Certification under Rule 13a-14(a)/15d-14(a) of principal executive officer (filed herewith)
31.2	Certification under Rule 13a-14(a)/15d-14(a) of principal financial officer (filed herewith)
32	Certifications under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350) (filed herewith)
101.xbrl	XBRL Instance
101.ins	XBRL Schema
101.cal	XBRL Calculation

101.def XBRL Definition

101.lab XBRL Label

101.pre XBRL Presentation

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SIGNATURES

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

DYNATRONICS CORPORATION  
Registrant

Date February 14, 2012      /s/ Kelvyn H. Cullimore, Jr.  
Kelvyn H. Cullimore, Jr.  
President and Chief Executive  
Officer  
(Principal Executive Officer)

Date February 14, 2012      /s/ Terry M. Atkinson, CPA  
Terry M. Atkinson, CPA  
Chief Financial Officer  
(Principal Financial and Accounting  
Officer)